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Digital disruption and the role of M&A

Mergers, acquisitions, and divestitures are an important way for companies to reposition their organizations to compete in the digital age.

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In this episode of the *Inside the Strategy Room* podcast, senior partner Simon Blackburn discusses how leading companies are using M&A to fundamentally change where and how they compete in the digital age. This is an edited transcript. For more conversations on the strategy issues that matter, subscribe to the series on Apple Podcasts or Google Play.

Podcast transcript

Sean Brown: From McKinsey's Strategy and Corporate Finance practice, I'm Sean Brown. Welcome to *Inside the Strategy Room*. With digital technologies unleashing ever more change in industry structures and company business models, mergers, acquisitions and divestitures are an important way for companies to reposition their organizations to compete in the digital age. In today's podcast, Cam MacKellar, a McKinsey contributing editor, talks with Simon Blackburn, a senior partner in our Sydney office, about the role of M&A in adapting to digital disruption. Their conversation was recorded at our 2019 Australian M&A Conference in Sydney.

McKinsey: Simon, thank you for joining us today.

Simon Blackburn: It's a pleasure.

McKinsey: Tell me, what is driving digital disruption?

Simon Blackburn: I think it's a few things. One is a kind of virtuous cycle of disruption between proliferation of data, the acceleration of compute power and algorithms to harness that data and connectivity. We have better data at our fingertips telling us what's going on across our customers, our salesforce, our refinery, or our oil field. And the compute power means we can build models that allow us to predict behaviors and outcomes or optimize throughput or automate processes in ways that we couldn't at scale before. And connectivity means you can do that more or less anywhere, anytime, and deliver the results into the hands of people that need them wherever they're working. And so that's certainly one of the drivers of disruption.

And second is what I guess I'd refer to as the combinatorial tech explosion. This is the idea that it's not about individual innovations, but how they're combined and harnessed into really transformational experiences.

Obviously, smartphones sitting in our pockets are one great example of that. Another is autonomous vehicles. Think about the combination of GPS technology, radar, lidar, sensors, video cameras, compute power, and connectivity. Each of those are innovations in their own right, some have been around for a while, some are more recent, but it's really the combination of all of those together along with cleverer new algorithms that are causing us to really rethink what the future of transportation might look like.

And so the result is I think we see pretty fundamental changes to a lot of business models out there. And they're really distorting the economics of supply and demand in different ways. That includes freeing up latent supply and matching it with demand. Unbundling of existing demand and what you're seeing with streaming services or even new business systems that radically lower the cost of doing business as you're seeing in a lot of financial services right now.

So while the concept of disruption isn't new, we do think that the combination of those self-reinforcing loops of digital technologies such as data, compute power, and connectivity are allowing business models to be disrupted in ways that are at a pace and scale that are different.

McKinsey: What scale of response does this kind of digital disruption demand for incumbent companies?

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—Simon Blackburn

Simon Blackburn: The scale of response required is large. And of course the dynamics of that new urgency vary from industry to industry. But our belief is that we’re seeing this across all of the industries that we look at. And it’s exacerbated by the network effects that cause a winner-takes-all dynamic to take place where, as you reach scale, as you gain greater data on, for example, your customers and their behavior, it allows you to personalize and customize your offers, which in turn makes you more effective, and the scale, of course, also extends then into your supply chain, your ability to form partnership, and to acquire competitors.

McKinsey: If we’re in a winner-takes-all world, do the winners simply have a better digital strategy?

Simon Blackburn: In most cases you’re right. You certainly do need a digital strategy. And that typically involves thinking through what are the different domains or parts of the business and the degree of threat and disruption that each of them is encountering, and therefore how much value is at stake. And flowing from that, how do you protect or capture that value by harnessing new capabilities, new technologies, or new ways of working?

So that might mean, for example, that you’re reinventing a customer journey end-to-end. It might mean you’re automating a process. Or it might mean you’re using advanced analytics to predict customer behavior or optimize throughput through a chemical plant. And all of that’s sensible activity. And it is activity that organizations should be pursuing. But we actually think that it’s not a sufficient response in most cases. And there’s actually a deeper set of questions that organizations should be asking before they get to “we need a digital strategy.”

That deeper set of question includes, “Is our core strategy robust in an age of digital disruption?” This gets at the question of, “How will digital disruption fundamentally impact our current business model? And is it fit for purpose in the new world?” And, so given the nature of these disruptions, “What will be the future sources of value and what will it take to capture that value?” And therefore, “What’s the optimum strategy to pursue?”

So an example in financial services might be that I’m a bank and my digitization strategy says that I’m going to engage with my customers by digital or mobile channels. I’m going to straight-through process loan applications. And I’m going to use advanced analytics to predict behaviors in what I might be able to offer to my customers. That’s the digitization strategy. The question of, “Is my core strategy robust in an age of digital disruption?” might make you ask the question of, “Well, who are going to be the lenders of success in the future? What is the future of peer-to-peer lending? What are the sources of funding that are going to be relevant in the market that I’m playing in? Should I be enabling organizations that I currently view as my competitors and turning them into partners by offering banking as a service capability to them?” So these are the types of responses that asking the first question might provoke.

McKinsey: So it's about having a strategy for the digital age rather than just a digital strategy.

Simon Blackburn: I think it's actually having both. And both inform themselves. Because actually it turns out that by asking the question, "Is my strategy robust in an age of digital disruption?" is going to point me to the areas where I'm most at risk of becoming less relevant to my customers. And in doing so, that will therefore provide a road map for the digital strategy that I should launch.

McKinsey: What is digital M&A? And what role does it play in responding to digital disruption?

Simon Blackburn: Well, look, inorganic growth has always played a role in helping organizations evolve their business model and find new sources of revenue. And that's true in the digital world as well. And quite frequently, we'll find particularly for incumbents, it can be long, difficult, and time-consuming to build the capabilities in house that they need. And the pace of change is such that digital M&A needs to play a role in transforming yourself to a business that's fit for purpose in this new world, particularly in one that, as we discussed, is winner takes all.

In order to be successful, however, a few things need to be true. First of all, we discussed early this idea that you need a strategy that's robust in an age of digital disruption. That's really important when it comes to M&A because your strategic posture and the rational for why you're seeking to build a set of capabilities or a market access, et cetera, is really crucial. And it's crucial because when building new digital businesses, it's typically a different muscle for the organization than we're used to building. And that takes time. And it takes a concerted effort, typically over multiple acquisitions, and frequently, over multiple years.

The winners are the ones who have real conviction about what they're trying to do strategically, and a willingness to stay the course and make multiple acquisitions, some of which will pay off better than others. But they also recognize that it's going to be a multiyear journey to really transform the way the business operates.

McKinsey: Right. So it's not just a one-off big deal to plug in a digital part of the business. It's about a steady stream of deals that follow a strategic intent.

Simon Blackburn: We really think that's the case. And it's not just the incumbents that need to think that way. Even if you look at digital natives like Google the number of deals that they're doing and their ability to harness outside technologies to supplement that is a core part of how they operate and how they think.

McKinsey: What gets in the way of these kind of deals?

Simon Blackburn: I think there are a few things. One is a knowledge gap. Most executive teams and boards are not deeply knowledgeable and familiar with their content in the digital and advanced analytics world. And that gap needs to be closed by a concerted effort of capability building, whether that's digital and analytics academies or acquiring different talent.

Second, valuation can be trickier. It typically doesn't follow the financial 101 framework that relies on deal synergies. You may be thinking much more about strategic fit and business model adaptation.

A third is an accelerated pace of change, and the speed at which the market is evolving. And that might mean that you need to pursue parallel paths at once. An important one is differences in culture. You'll often be acquiring organizations that have very different cultures and needing to think through carefully how you handle that. Is this something that you do on the side? Is it something that you need to take a reverse merger approach to, building into that new culture over time?

A fourth one is target visibility. It can be difficult for traditional organizations to get visibility into the landscape of smaller start-ups and providers that they might be looking to acquire here. And so a systematic set of tools and networks that you can leverage to build up that picture can be important.

And lastly is the concept of uncertainty. The question of how to evolve a strategy in the face of rapid disruption can often cause organizations to respond tentatively, whereas what the winners tend to be doing is moving boldly and programmatically in a particular direction.

McKinsey: Right. So that's interesting. There's a sense of getting over a fear.

Simon Blackburn: That's right. And the companies that are doing this well are making large numbers of acquisitions. They're not all game-changing acquisitions. But they're recognizing that they need a portfolio of bets and to see and learn from what works and scale that up.

McKinsey: OK. And what else are they doing well?

Simon Blackburn: I think the most important thing is bringing a multiyear horizon. We talked earlier about boldness mattering here and if you take an example in the media industry, Axel Springer in Europe I think is an organization where they built conviction in the mid-2000s about the degree to which the media business was going to be upended and set out over a period of six or eight years to fundamentally reshape the business. The traditional German newspaper company is now a European digital publishing powerhouse.

That didn't just involve making a bunch of acquisitions, although of course they did make acquisitions across all the different parts of their business. But it also recognized a willingness to challenge and cannibalize the existing business, because as you move to online, the revenue per eyeball is typically much less. And an organization that's willing to go through this needs to understand that there's going to be a transition period where revenues are going to be adversely affected. And that takes conviction. It takes conviction from the top team and conviction from the board to see this through and really take a programmatic approach.

McKinsey: How should the C-suite or the CEO think about digital disruption tomorrow, next week, or next month? What would you like to be top of mind there?

Simon Blackburn: First is to really face into the reality of where disruption is going to come from and the value at stake. It's not enough to have a digital strategy. You need a strategy that's robust in an age of digital disruption. And truly understanding whether your value propositions are going to hold up in a world of digital disruption is the starting point.

The second one is being bold and purposeful in your approach. And that means being bold and purposeful in how you allocate resources. It means

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having conviction in the direction that you set. And it means being willing to stay the course on building a portfolio of moves that will help you reinvent the company if that's what's required.

Then a third one is around digital M&A and driving that M&A from your strategic intent as you're being programmatic in your approach. And lastly, recognizing as you do so that digital M&A is going to require doing a bunch of things differently and staring into that and not finding yourself frozen into inaction because of your concern about whether you understand the space well enough. When we talk about how bold is better, to contextualize that a little bit, when we look at the top economic performers, they're one and a half times more likely to take bold moves in launching entirely new digital offerings than everyone else.

Similarly they spend three times as much of their revenue on M&A as the typical player. And of that M&A activity, a full two thirds is focused on digital business or digital capability building, versus less than half for the remaining players. So we see winners acting boldly, but also tilting their resource allocation significantly toward reinventing their offerings and building capabilities at scale through M&A.

Simon Blackburn is a senior partner in McKinsey's Sydney office, where **Cam MacKellar** is a McKinsey contributing editor.

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