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Strategy at the speed of digital

To succeed in the digital age, companies need to significantly raise their metabolic rate.

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In this episode of the *Inside the Strategy Room* podcast, we share McKinsey research on how fast and boldly companies need to move to win in the digital era, and describe some common pitfalls in digital strategy and ways to avoid them. This is an edited transcript. For more conversations on the strategy issues that matter, subscribe to the series on Apple Podcasts or on Google Play.

Sean Brown: From McKinsey's Strategy and Corporate Finance Practice, I'm Sean Brown. Welcome to *Inside the Strategy Room*. In this episode we discuss how digital leaders execute strategic moves with a speed and power that far exceeds those of their peers. I'm joined by co-authors of a recent *McKinsey Quarterly* article, "The drumbeat of digital: How winning teams play." Tanguy Catlin is a senior partner in our Boston office who focuses on digital strategy and insurance clients. Laura LaBerge, based in Stamford, Connecticut, is a member of our digital strategy team. It's my pleasure to welcome you both.

Laura, let me start with you. You and Tanguy previously wrote about pitfalls that cause digital strategies to fail. How does this new research expand on that?

Laura LaBerge: We started by looking into what is really known about disruption. It isn't new—it's been happening for centuries. Prior to digital, incumbents typically experienced a survival rate of less than 20 percent during extreme disruptions. So, we asked more than 2,000 organizations how well prepared they felt to navigate the current change, and 92 percent did not feel their current business model would be economically viable as digitization progressed. Tanguy and I wanted to understand why digital is so hard. We looked at organizations attempting large digital transformations and surveyed thousands of companies implementing digital change at various scales and with various degrees of success.

Sean Brown: First, tell us what you have learned about the reasons why digital strategies fail.

Laura LaBerge: We identified five reasons. The first is fuzzy definitions. If you ask ten companies how they define digital, you will probably get 12 different answers. This is because of digitization's complex nature. Digital needs to be defined in two dimensions: economic and operational. Today, you can have instant and perfect replication of intellectual property, and assets such as software can be disseminated on a very large scale. This has a host of economic implications for the old-school rules about value, profit, and competition.

Tanguy Catlin: It's important to recognize that our economies are driven by supply and demand curves, which we studied in school. These curves change dramatically when your marginal cost becomes zero, as when music replication is completely free, and that leads to completely different business models. We no longer buy CDs, we use subscription services. Very few organizations take the time to understand and map out the economic impact of digital on their supply and demand curves, and the implications those have for substitute and complementary products. As a result, they are surprised when the ecosystem in which they compete suddenly starts to evolve very rapidly.

The definition of digital that most companies use is operational, which allows them to know who in the organization is in charge of what. That is equally important, but that operational definition needs to recognize that you are living in a connected world, and digital allows you to have real-time engagement with people and equipment. The information you can gather from this real-time connection allows you to automate and streamline many decision-making processes. Then the analytics layer you put on top of that can create a predictive engagement model that leads eventually to a different business model. However, too many organizations focus on the operational definition and underestimate the economic implications of a digital economy, which leads them to fail to size up the threat digital poses to their business.

Sean Brown: Can you elaborate on the way the new economics of digital are changing the competitive landscape for incumbent companies?

Laura LaBerge: Many organizations have spent decades understanding how to make trade-offs in their businesses, where the profit pools are, and the structure of their value chains. Digital changes all that. First, on an overarching level, digital currently destroys more economic value for incumbents than it creates. There are two main drivers. The first one is that digital creates transparency that allows a much higher percentage of value to be transferred to customers than happened in the past. For example, digital marketplaces create price transparency, and bundling, which protects margins in many industries, is being undone by companies like Amazon and Tencent. They are also commoditizing products and services. This is a huge shift in the way value is distributed between companies and end users.

The second big mechanism for this value destruction is the consolidation of value pools. New digital offerings are often much more integrated. Think of smartphones: they not only replace the old phone but the camera, the navigation device, the music player, the video game console, or even TV in certain circumstances. If you add up the cost of all those devices, smartphones, expensive as some may be, are a lot cheaper than those individual items. The digital value pools are smaller than the original pools, and these transfers are sometimes quite abrupt.

Sean Brown: How does that destruction of value square with the potential value creation from entirely new digital offerings? Or do you mean that the value destruction just affects incumbents?

Laura LaBerge: That's a good question. Over the past couple of years, digital has taken about half a point off GDP, but we do not expect that trend to continue because as these old value pools shrink, digital creates new ones. That's why this mechanism we are discussing is so important: if you are still innovating around the edges of increasingly shrinking value pools, that's a hard-to-win game, whereas if you move into the growing value pools being created, you have a much greater chance of remaining economically viable or even fast-growing. So, organizations need to understand how their overall value is changing and where it is going. An interesting thing to note is that in many industries, the source of disruption isn't an existing player but someone from outside the value chain. Disruptors are coming across industries and the value is being siphoned from one industry to another, which means the model of looking at your place in a single, monolithic value chain is breaking down.

Tanguy Catlin: What Laura just described is a wonderful illustration of the current reality of digital: the consolidation of the marketplace. It leads to a winner-takes-all environment where not only is the profit pool shrinking and distributed primarily to the customer, but the participants also are seeing their pie redistributed to fewer players. Amazon is probably the most telling example: in just over a decade, the profit pool has moved completely to one company. We see that happening across many industries. Once disruption starts, the acceleration of profit aggregation by a few—typically two or three—companies is remarkable. So, companies need to think strategically about their objectives. Remaining number seven or number eight in a market undergoing digital disruption is not a viable strategy.

Sean Brown: Given this winner-takes-all scenario, how should an incumbent invest in digital? It seems to imply that you have to go big or go home.

Tanguy Catlin: You're exactly right. Companies need to move faster and be bolder. Bolder might mean repositioning yourself on the chess board, and that involves M&A—both acquisitions and divestitures. And it's a game of musical chairs, so you need to make sure there are still chairs for you and move faster toward your objective.

Laura LaBerge: Not only do you have to move faster but move first. Even five years ago, being a fast follower versus being first mover—there were differences between those strategic postures, but the outcomes were not drastically different. Now, being a first mover or extremely fast follower is starting to have significant economic benefits. Part of the reason is the rate at which organizations can learn with digital. In the past, it was often six months after a product launch that you would do the postmortem to understand what was working and what wasn't. Now you can have three-day iterations. This causes is a rapid divergence. The first mover, rather than being on version 2.0 when someone offers a me-too product, is on version 40. This, combined with network effects, gives first movers a huge advantage. If you are first to lock in strategic partnerships, in many cases, just from a scale perspective, you win.

Sean Brown: What about the other aspect Tanguy mentioned—the importance of being bold?

Laura LaBerge: One of the things I find fascinating about digital is how it is changing the notion of playing it safe. In the past, that meant making predictable, incremental changes, innovating at the edges but on a steady path forward. In digital, that increasingly turns out not to be a safe route. The path to success tends to be innovating truly new offerings, not just applying digital lipstick on your existing offerings. This is a mind-set shift that a lot of incumbents struggle with.

Sean Brown: How and where do these digital leaders make their bolder moves?

Tanguy Catlin: To capture the shifting value pools, organizations need to reposition themselves. Our research shows that the best-performing companies are more aggressive on the M&A front in acquiring digital businesses that represent those new pools (Exhibit 1). The top performers had more than 50 percent higher focus on that than other companies. To compete in those new value pools, you also need competency. You need to understand the customer's needs at a granular level, and leverage data analytics at scale. Top performers not only acquire digital businesses but digital capabilities and talent, often doing M&A for that purpose alone, not to gain a new product or service. And you see a direct correlation between the fastest-growing companies in our research and the portion of their talent dedicated to driving digital opportunities.

Laura LaBerge: On any metric, digital leaders are devoting a higher percentage to digital M&A. They are doing more deals and allocating a larger share of their total M&A budgets to digital acquisitions. Typically, M&A is a critical component of executing the digital strategy.

Sean Brown: Do companies put in any guardrails to manage the risk around these bold bets, especially with M&A?

Tanguy Catlin: In general, you are more likely to see a number of smaller acquisitions than big transformative ones, unless the industry's level of disruption is advanced and a company has little choice but to make a big acquisition. The approach successful

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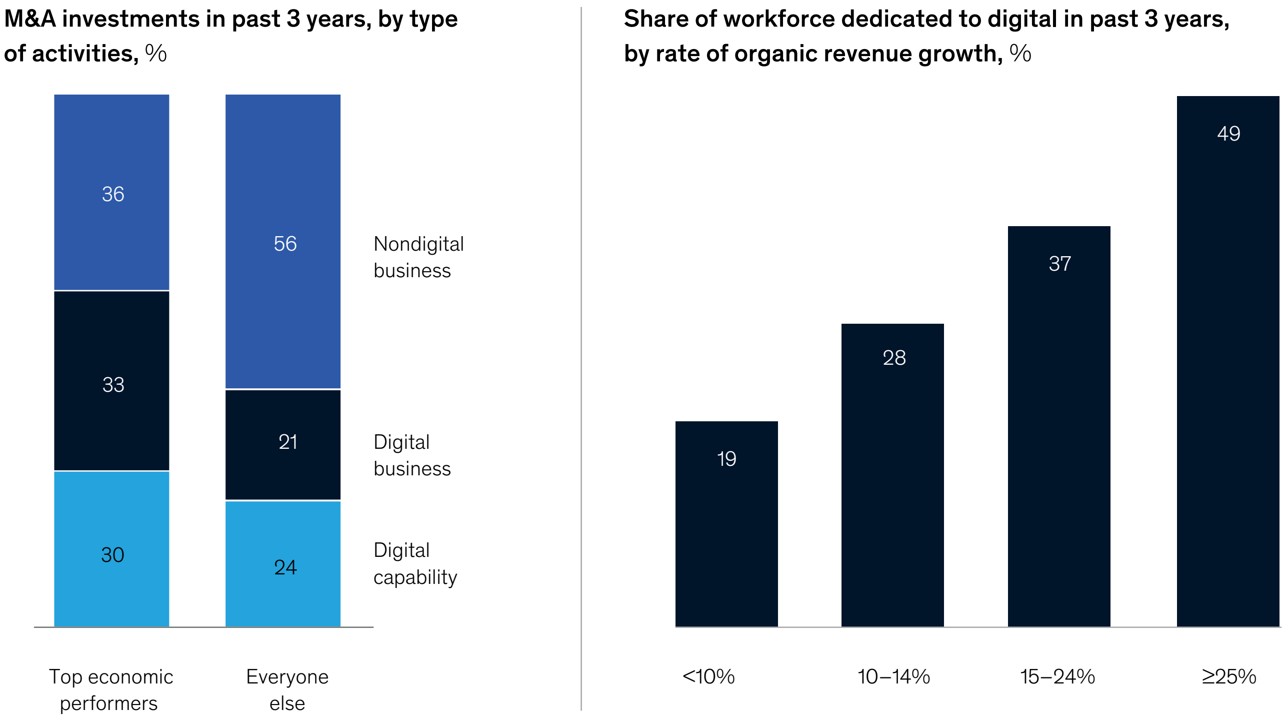
—Tanguy Catlin

Exhibit 1

Top performers spend big on digital capabilities.



Note: Figures may not sum to 100%, because of rounding.

organizations take is to build M&A machines that look for organizations that, over time, can help them evolve where they compete.

Sean Brown: So, profit pools are shifting. You have a few winners taking most of the profits, and they often come from outside the industry. Is it just technology driving these changes?

Tanguy Catlin: Our economy is migrating toward ecosystem-based economics. The global behemoths in terms of market capitalization used to be organizations focused on specific industries and either relying on significant levels of capital or very large numbers of employees. Just a decade later, a completely different type of company is dominating. Those are what we describe as ecosystem-based companies, and they are redefining more than one category at a time—companies like Microsoft, Amazon, and Alphabet. Just three or four years ago, the share of worldwide sales controlled by ecosystems was shy of 10 percent. By 2025, we project they will reach a quarter, if not a third, of the worldwide economy. This is happening very fast in some geographies. It's already almost the dominant mode in China. We believe that by 2025, $60 trillion of global revenue will be concentrated in just 12 ecosystems.

Sean Brown: Can you clarify what you mean by ecosystems and how they affect competition?

Tanguy Catlin: If you manage your household today, you need to figure out your mortgage, your insurance, utilities, and other factors associated with living in that house. In an ecosystem-based economy, you would have one node aggregating all those services for you. That leads to a very different dynamic in how companies compete, depending on

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> —Laura LaBerge

whether you are the orchestrator of the ecosystem or a provider to it. There are fundamental strategy questions many organizations will need to address. First, to which ecosystems should you belong? And second, what role will you play in that ecosystem—as platform architect or service provider? And what types of partnerships do you need to put in place to remain relevant?

Sean Brown: How do the companies you studied manage all these challenges while still running their existing businesses?

Laura LaBerge: The way in which you balance these shifts will flex depending on the degree and pace of change in your industry. Is your entire business model being blown up, or is it a minor change? And do you have 20 years to get ahold of this, or is it happening now and you have two or three years max to make the pivot?

Organizations facing a high degree of change in a short period of time have really no choice but to make very aggressive moves to survive. This traditionally would be an M&A-type play because you don't have time to change organically. Other companies have time to balance between investing in their existing business that may be shrinking and putting capital toward building the path forward. Where is the growth going to happen? These organizations can develop the agile muscle and be ready to make pivots. In industries in which little change is happening currently, companies can survey the land and cherry-pick opportunities so they are ready if the landscape changes.

Sean Brown: Do you have any research on how much investment and effort companies are dedicating to new versus existing businesses?

Laura LaBerge: In our study, we found that 62 percent of companies were taking a combined approach—living in two worlds where they are both investing in their core business and building out new digital businesses. This is a very complex situation. Transforming your existing business, that's hard enough, but how do you keep the lights on while you make this shift and have the mindshare for both? Building an entirely new digital business brings a new level of complexity for incumbents because it can have a different operating model, a different culture, a different set of economics.

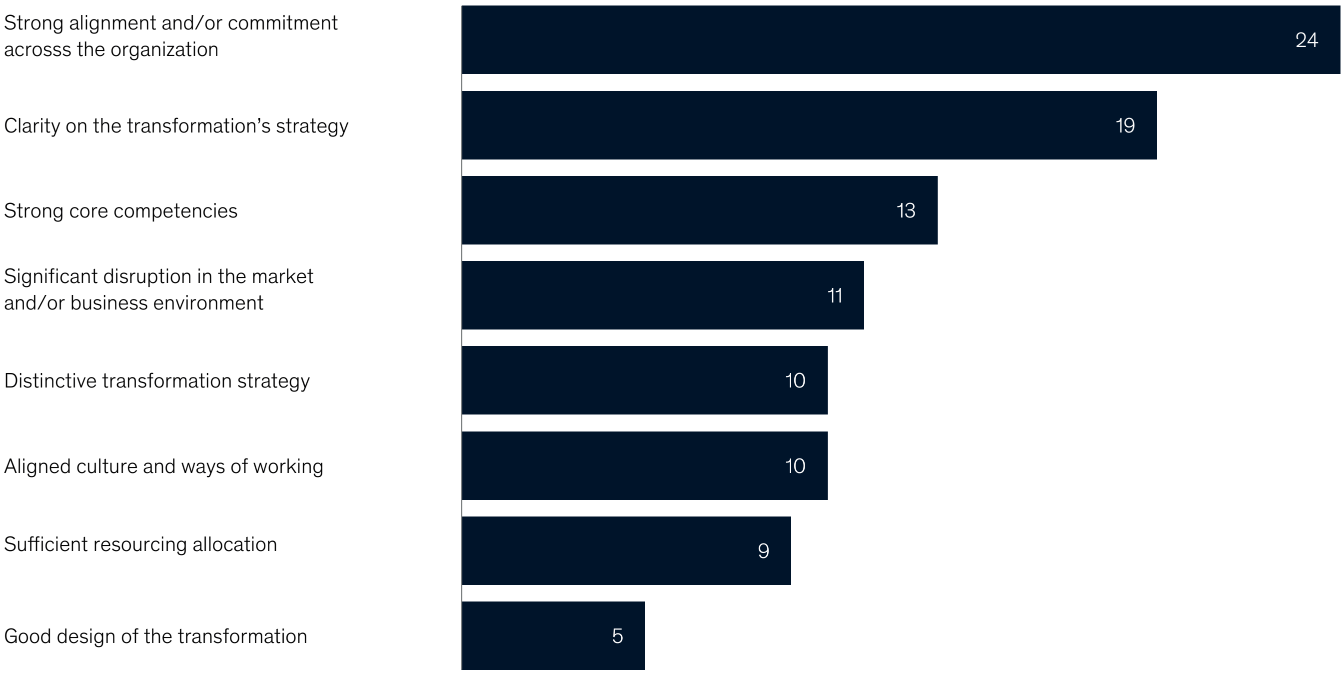
Sean Brown: Do you have any advice on how organizations should approach this challenge?

Laura LaBerge: If we go back to our theme of the drumbeat of digital, the pace of change is very high but just saying you have to move fast isn't helpful if you don't know what "fast" means. When we looked

Exhibit 2

We asked companies that have been successful with their digital momentum what helped them succeed.

Which of the following were the primary reasons for the transformation's ability to maintain its momentum or reach its full scale?, % of successful respondents (n = 302)



at organizations that successfully navigated major digital transformations, we found the two most important aspects were having strong alignment and commitment across the organization, and clarity about the transformation strategy (Exhibit 2). The good news is that those two things are doable. It's not like you have to come up with an innovation that's a decade ahead of everyone else.

Tanguy Catlin: We monitored management practices at thousands of companies to see how they make decisions around all the questions we've just talked about, including M&A, deployment of talent, and what initiatives to pursue. When we saw the results, Laura and I got goose bumps because there was a very clear and consistent difference in the metabolic rate between the companies that have the highest performance and the rest, across all industries. We found that typically, the leaders were operating at a four-times-faster pace of decision making. They assess customer data and preferences monthly, if not weekly, to inform their next product release or redesign experience. They evaluate their divestiture and acquisition portfolios quarterly when most organizations do that only during annual planning.

Doing what you do today four times faster entails all sorts of organizational and operating-model challenges. One way is to evolve toward agile budgeting and uncouple some decisions. If you are considering a digital investment, don't spend months thinking about a $15 million commitment—just fund something that allows you to quickly simulate the initiative, and to the extent that simulation is encouraging, start creating a soft concept.

Sean Brown: Have you seen approaches that are particularly effective in supporting such transformations?

Laura LaBerge: Having a chief digital officer or a chief transformation officer can help, because someone is looking across the business and making prioritizations. Another key aspect is having full alignment on the digital strategy. An organization-wide reallocation of talent or financial resources becomes very difficult when business leaders don't agree on what is most important. You get infighting: one group funds its part, but another group won't release the people it's supposed to provide, and everything just stalls. Organizations have to make hard calls—what is worth more to my company, an investment in customer experience or this productivity play?—and then reallocate resources.

Sean Brown: What implications does your research have for midsize companies that may not have the resources to pursue large-scale M&A to acquire digital capabilities?

Laura LaBerge: Actually, a large percentage of the companies we surveyed were midsize organizations. Obviously, they are not doing M&A on the same scale as some huge incumbents, but we also saw that when M&A isn't an option, partnerships are. You can partner in more strategic ways to gain digital capabilities.

Tanguy Catlin: The emergence of ecosystems creates many opportunities, just as eBay created a marketplace that all of a sudden allowed small and midsize enterprises a way out of competing on marketing to get exposure to customers. You don't need to be the architect—the eBay—of the ecosystem and still find a marketplace that allows you to reach millions of customers.

Sean Brown is McKinsey's global director of communications for strategy and corporate finance and is based in the Boston office, where **Tanguy Catlin** is a senior partner; **Laura LaBerge** is a senior expert in the Stamford office.

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