McKinsey Digital

The big boost: How incumbents successfully scale their new businesses

Corporations can help their new ventures scale up if they avoid these six actions that can undermine success.

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So you've launched a new business, gotten the funding, built a product, and created a brand. But after some initial success, it's not scaling. What do you do?

If this situation is familiar to you, you're not alone. In fact, only one in five incumbents succeed in scaling their business after their initial success. That's not unexpected in the volatile world of start-ups, but it's a dispiriting failure rate nonetheless—and it doesn't have to be that way.

Our experience with dozens of companies launching businesses is that more than 60 percent of scaling efforts can succeed. This significant improvement in the rate of success should be welcome news for large incumbents looking for new growth in the face of unprecedented economic hardships.

We know from past economic crises that businesses succeed by reining in costs and driving innovation. Given the great digital migration that has occurred during COVID-19, that innovation needs to be focused on digital—from direct-to-consumer models to remote services.

Scaling new businesses is where the value is

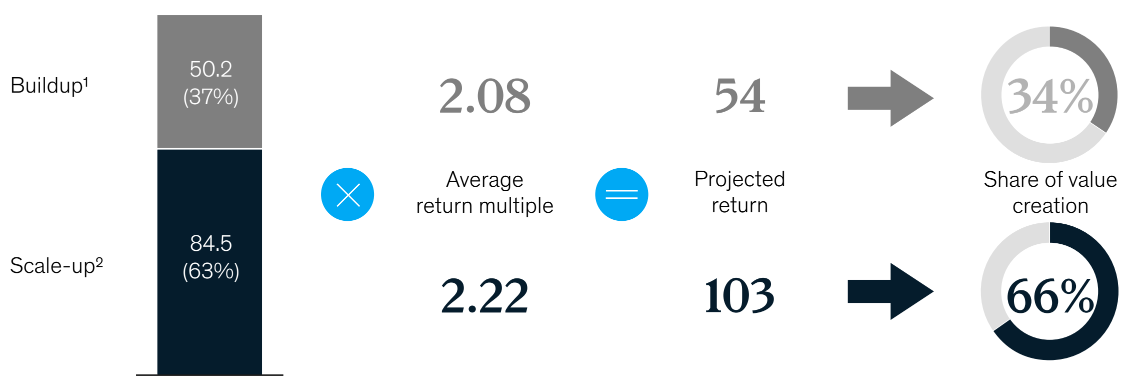
While most companies tend to focus on launching new businesses, the real value comes from being able to scale them up. Based on an analysis of US venture-capital (VC) data, two-thirds of value is created when a company scales up to penetrate a significant portion of the target market (Exhibit 1). VC firms have a clear understanding of that value. Of the $135 billion invested by US VC firms in 2018, 63 percent was deployed to enable successful start-ups to scale their product or service (series C funding and later).[1]

Among the start-ups that have successfully built a product and completed at least series B funding, only 22 percent succeed independently at getting to that stage.[2] Another 27 percent are absorbed at some point through an M&A transaction and are

[1] *2Q 2019 PitchBook-NVCA Venture Monitor,* PitchBook, July 10, 2019, pitchbook.com; McKinsey analysis.
[2] According to data of 1,762 venture-backed companies that have achieved product-market fit (evidenced as having completed a series B funding round); *2Q 2019 PitchBook-NVCA Venture Monitor,* PitchBook, July 10, 2019, pitchbook.com; McKinsey analysis.

Exhibit 1
Two-thirds of value creation is achieved through scale-ups.

US venture-capital-firm capital allocation, 2018
$ billion



[1]Seed, series A and B.
[2]Series C and later.
Source: *2Q 2019 PitchBook-NVCA Venture Monitor*; McKinsey analysis

successful. About 51 percent manage to sustain themselves but cannot scale, or they just die off.

While there is less data publicly available about the success of corporate-backed ventures, we observe similar patterns there as well. Many corporates operate “innovation factories” to launch new businesses, but few of them ever become a sizable new business unit of the parent.

There is a way to significantly increase the odds of success. From our work helping 35 corporations scale their new businesses, there has emerged a clear recipe that has increased the scale-up success rate to 60 percent, from 22 percent.[3]

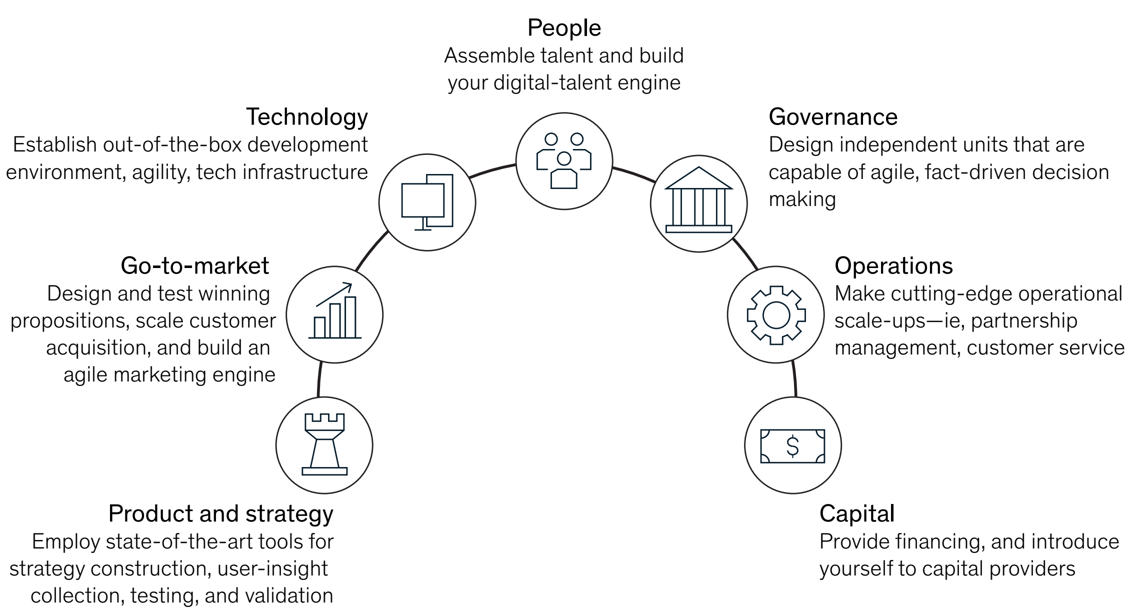
Avoiding the six most common issues that undermine scale

Our experience and analysis show that successful corporate-backed start-ups follow a precise playbook that covers seven areas (Exhibit 2). At first glance, the seven areas are unsurprising and likely on the agenda of each corporate-sponsored venture. The difference between successes and failures, however, lies in the ability to reach threshold levels of proficiency in *all* of the seven areas. We have seen new corporate-backed businesses fail to scale when they have performed well in five areas but not in the other two. Even within a given area, failure in a single practice can be enough to torpedo the entire venture’s ambitions for scale.

[3] Analysis based on 35 corporate scale-ups that Leap by McKinsey has delivered to date. The sample currently produces run-rate revenue of more than $4 billion and includes industries in finance, telco, entertainment, consumer goods, and oil and gas. Both B2C and B2B business models were included. All 35 were corporate founded and owned.

Exhibit 2

Successful corporate-backed start-ups follow a precise playbook that covers seven areas.



Among the many “failure modes” that can undermine a new business’s ability to scale, we have identified six that are particularly prevalent among corporate ventures.

Focusing on the wrong customer metrics

Start-ups scale because of strong unit economics; they generate real value. One rule of thumb is that customer lifetime value should be greater than or equal to twice the cost of customer acquisition. Too often, however, companies get excited about vanity metrics, such as share of voice or traffic, or they pour substantial money into marketing to, in effect, “buy customers.” These businesses then flame out when they try to scale because customers don’t actually value the product enough.

Successful start-ups focus from day one on the projected lifetime value for each targeted customer segment, and they review critical leading and lagging indicators every day. Noteworthy among high performers is their fixation on a single “star metric” that is most indicative of success for their business. In many cases, that metric reflects some element of time related to the customer’s experience with the product. This is why onboarding is a full-time job at many start-ups and they obsess over the first ten clicks. Facebook, for example, knew it could get to one billion users when it could get seven friends to sign up in less than ten days. For Slack, the star metric is 2,000 messages sent within a team.[4]

For a telco in Indonesia launching a new business, it discovered that the daily number of new customers from referrals was the key metric. Focusing on that metric, it prioritized its customer-referral program, and within one month, customer referrals were comprising more than 20 percent of all new daily customers. Success against this metric drastically reduced the average cost of acquisition per customer and has helped the business reach its 12-month customer goal in just seven months.

Paying for numbers, not quality

Many companies have trouble accurately calculating the cost of acquiring a *valuable* customer, which inevitably leads to inflated customer-acquisition budgets. The issue tends to be that companies focus on the customer-acquisition cost but not on the quality of the customer, as measured in terms of revenue, margin, or customer lifetime value. “You should examine existing and new customers separately,” says Tarek Müller, cofounder of the Hamburg-based fashion retail unicorn, AboutYou. “Corporates usually don’t check this detail, and their existing customers end up subsidizing new ones.”

Successful scale-ups develop a clear point of view about which customers are the most valuable at a segment level. They monitor each incoming segment, typically on a monthly basis, and its behavior over time—for example, how often customers in that segment use a product, or which features they use most often. This obsession with understanding what works best with each customer segment is of particular importance in being able to scale beyond early adopters to more mainstream customers. These learnings in essence become the playbook for attracting new valuable customers.

This approach is particularly relevant in industries with long-standing customer relationships and strong data. When a Scandinavian asset-management firm, for example, launched a new business, it developed an artificial-intelligence-based lead-scoring engine built on more than 70 data points from its web analytics, internal benchmarks on lifetime value of previous customer segments (high-net-worth individuals with at least five to six investments), and external databases (Exhibit 3). This made it possible for digital-marketing programs to target high-value customer segments and to focus sales teams on the most promising incoming leads. This enabled the company to scale the new business rapidly, while at the same time keeping marketing costs low. The engine helped the company to double and triple the rate of high-value-customer intake within two years.

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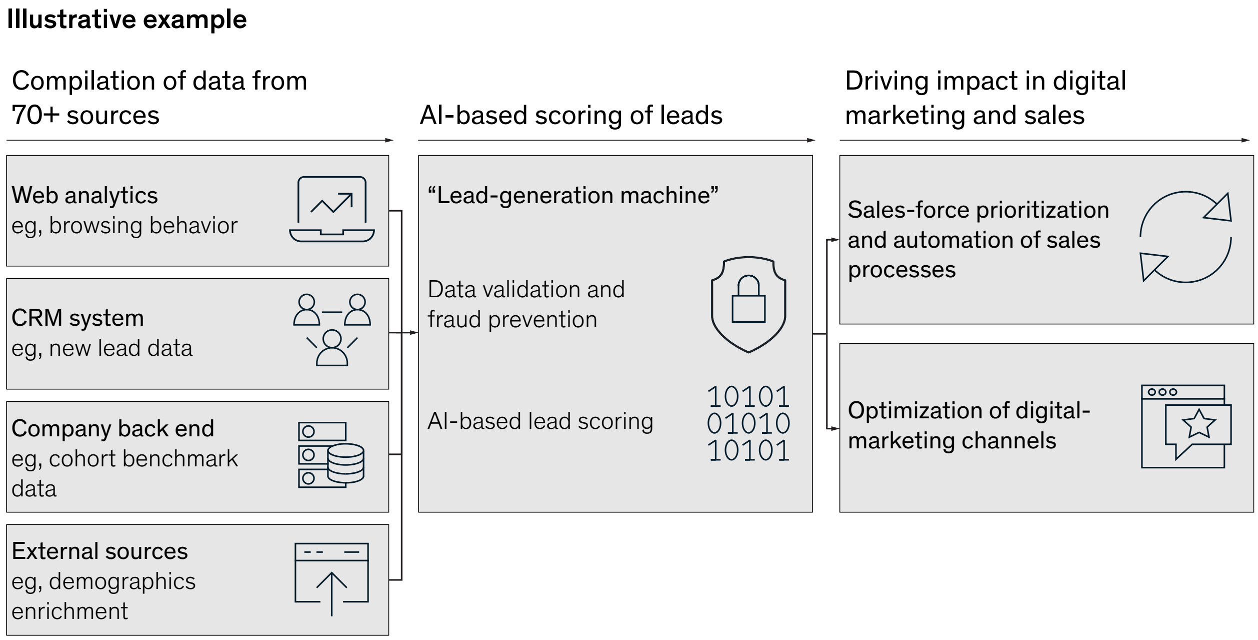
[4]Chamath Palihapitiya, “How we put Facebook on the path to 1 billion users,” YouTube, January 9, 2013, youtube.com; “From 0 to $1B—Slack’s founder shares their epic launch strategy,” First Round Review, January 27, 2015, firstround.com.

Exhibit 3

Identifying high-value customers helps start-ups to scale.



Relying on 'synergies'

On paper, large corporations can provide the new businesses they launch with massive benefits, from customer data to access to capital. In practice, however, the benefits to the new venture rarely outweigh the hazards. Despite the best of intentions, corporates often smother promising businesses, which more often than not wither before they can scale. One area where this is particularly prevalent is around perceived "synergies," where the corporation makes its own systems and processes available to the new business. The problem is that these systems are often expensive, complex, slow, and difficult to use. Corporate procurement or hiring processes can be particularly cumbersome. Corporates, for example, typically take 65 days on average to hire someone; start-ups need to hire people in fewer than 14. New businesses need different partners, tech stacks, and capabilities, and they need the autonomy to choose them.

Corporates that are most successful commit to providing the new businesses with support where it's needed and access to key assets. New businesses need real independence, existing customers, and data.

Truly independent governance generally means that the new venture can make 90 percent of decisions autonomously (hiring, product-design choices, marketing-budget reallocations), 9 percent with the main sponsor from the incumbent corporation (strategic choices, overall budget), and 1 percent in alignment with the parent (M&A, major pivots). This autonomy typically exceeds that of line or business-unit managers.

A leading global automotive company took this more flexible approach to governance to heart. From the beginning, for example, the new business agreed on a set of clear sales, revenue, and product-development goals. As it met these milestones, budgets were automatically released, thus freeing the start-up from having to go through approval processes each time it required funding.

With this setup, monthly meetings were with the "operational sponsor group" rather than a steering committee. At every meeting, the new business started with a list of the five things it needed, rather than a progress update. Quarterly meetings with top executives of the parent company turned into discussion sessions on the long-term vision. Additionally, a dedicated board member was assigned to be available to the start-up at any time and to be responsible for resolving impediments within 48 hours. When, for example, the start-up decided to set up its own marketing-technology stack (including a customer-relationship-management system and marketing automation software) to keep the tool setup lean and cost effective, corporate IT blocked the decision. The assigned board member then stepped in and supported the start-up, which allowed it to go forward with its own solution and helped it save 60 percent of its marketing-technology budget.

This governance model enabled the venture to make decisions quickly. For example, when COVID-19 hit, the start-up was the first in its industry to have a COVID-19-specific offering, developing and launching it in only two weeks.

Assigning a corporate manager to lead the new business

Most corporates tend to bring in experienced managers from their enterprise to run the new business, but that rarely works. That's because they often don't have the right skills to succeed. "To be able to pivot in times of uncertainty, you need to have real entrepreneurs," says Müller. A great start-up CEO brings extraordinary drive, sales instinct, and a willingness to "break things" as needed. This person should have the entrepreneurial qualities—risk taking, launching new initiatives, test-and-learn mindset, charismatic leadership—that typical VCs look for when they evaluate start-up CEOs.

At the same time, the start-up CEO has to be able to work constructively with corporate executives. That means being willing to invest time in understanding and addressing corporate concerns while also having sufficient diplomatic skills to challenge corporate orthodoxy. In this way, the CEO can ensure ongoing support, investment, and resources from the parent enterprise to scale the venture. Without that, corporate resistance can stifle promising start-ups. Having a sponsor at the board level who trusts the CEO can help smooth that relationship.

Finding the ideal venture CEO doesn't necessarily mean having to recruit someone from outside the company; there is no one preferred source of recruitment. In one European financial venture, the CEO was a senior internal hire from the parent bank. A global energy business, on the other hand, hired its venture CEO externally. Wherever the CEO comes from, he or she needs to be completely committed to the new venture.

Not leaving room in the budget for learning

As a promising business starts to scale, it's important to acknowledge that there will be setbacks. It is a fact of building a business and necessary, in fact, to learning and progress. That reality needs to be reflected in budgets. Some call it a "failure buffer" or a "learning buffer," but it's necessary in order to prevent setbacks from becoming showstoppers.

Implicit in having a learning buffer is the patience needed as the start-up goes through its growing pains. Many enterprises expect hockey-stick growth in three months, and if they don't see that progress, they'll start to choke off the business before it ever has a real chance to scale, which, in our experience, can take 12 to 18 months. A learning buffer doesn't mean, of course, providing the new business with infinite funding. The best enterprises release budget as the new business hits set targets. That money, however, needs to be ready to go so that the new business doesn't need to wait for endless rounds of approvals, which blunts momentum.

When one industrial player launched a new IoT-platform business, 20 percent of the investment was earmarked for learning during the first two years and 10 percent from then on. That commitment to learning was reflected in regular review meetings with enterprise headquarters, where the venture leadership answered two simple questions: What have we learned? and What are we doing differently based on what we've learned? Those learnings drove important decisions and adjustments to milestones. That budget for setbacks was supplemented by fast funding, which was automatically released based on milestone achievements. Milestones for the first two years were tied to unit economics (customer-acquisition costs and customer lifetime value, as opposed to absolute revenue or traffic numbers).

Adding unnecessary features

In Hollywood, there's a saying among writers that it's often necessary to "kill your babies." That means cutting out parts of a script that the writer may be fond of but that just don't work for the story overall. That applies to new businesses as well. The tendency is to continually add features to products or services, often based on an idea thrown out at a meeting by a board member or someone in the C-suite. But the burden of additional and unnecessary features will slowly suffocate a new product or service.

The most successful start-ups, on the other hand, are ruthless about eliminating features that the data say their customers don't want. That process of elimination, not addition, is absolutely critical. The antidote to the propensity to add features is to maintain a continuous focus on the customer, which means maintaining design and research intensity through the scale-up phase. "Making sure we're able to continuously improve our solution in a tight feedback loop with customers is absolutely crucial to success," says Hartmut Schaper, the CEO of Security & Safety Things.

In many cases, once a new business has successfully launched, the initial focus on design thinking and the customer often winds down. That's because people think they have already invested sufficient time in understanding their customers as they developed and launched the business. But as businesses scale, almost by definition, they will be exposed to new customers in new regions, new markets, new demographics, and new situations.

A home LTE service launched in a Southeast Asian market made sure that the customer-research team was a natural part of each sprint. That helped the business to focus just on value-added features for real customers, such as enabling easy "parental control" of access to a home Wi-Fi router via a mobile app.

Following this approach, a European telecom company that had launched a digital telco attacker proactively eliminated features after two years in the market and achieving a 10 percent market share. It launched an "attacker within the attacker" team to come up with a value proposition to disrupt itself. The new concept involved eliminating all features except for an on/off switch and eSIM delivery.

As businesses consider what it takes to scale up their start-ups, we have found that these three questions are especially helpful:

— What are the unit economics of your business, and how are they trending?

— Have you identified the barriers that prevent you from learning faster to accelerate your trajectory?

— Which decisions are you, the incumbent, currently making that you could delegate to the start-up?

Scaling is hard. It requires focus, determination, and discipline. But most important, it requires a commitment to the customer and the humility to understand that early success doesn't translate into future success. Success, in fact, needs to be continuously earned.

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