McKinsey & Company

Electric Power & Natural Gas Practice

Traditional company, new businesses: The pairing that can ensure an incumbent's survival

To guard against disruption, established companies should launch new businesses that have start-up–like freedom—along with access to advantages that start-ups usually lack.

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June 2019

The list of long-established companies that have been disrupted by fast-moving, tech-enabled powerhouses gets longer by the day. Facing pressure from younger, more innovative challengers, many incumbent companies in the energy sector are also reinventing themselves through a dual effort to digitize their legacy businesses and create new enterprises. Indeed, McKinsey research shows that top-performing companies in various industries divide their capital evenly between transforming their core businesses and developing new ones.[1] Yet few established energy players have managed to turn breakthrough concepts into billion-dollar growth engines that could help secure their long-term survival.

What keeps companies that aren't digital natives from hatching unicorns? Their capacity for innovation isn't necessarily constrained by a lack of good ideas. Many invest huge sums in research. They also seek outsiders' ideas by starting incubators and venture funds and buying start-ups. Rather than a shortage of inspiration, we've observed that older companies' main challenges are an excess of institutional control and an inability to scale up innovations. In a recent McKinsey survey, many respondents said parent companies had hindered the development of their start-ups and limited entrepreneurs' freedom to make decisions.

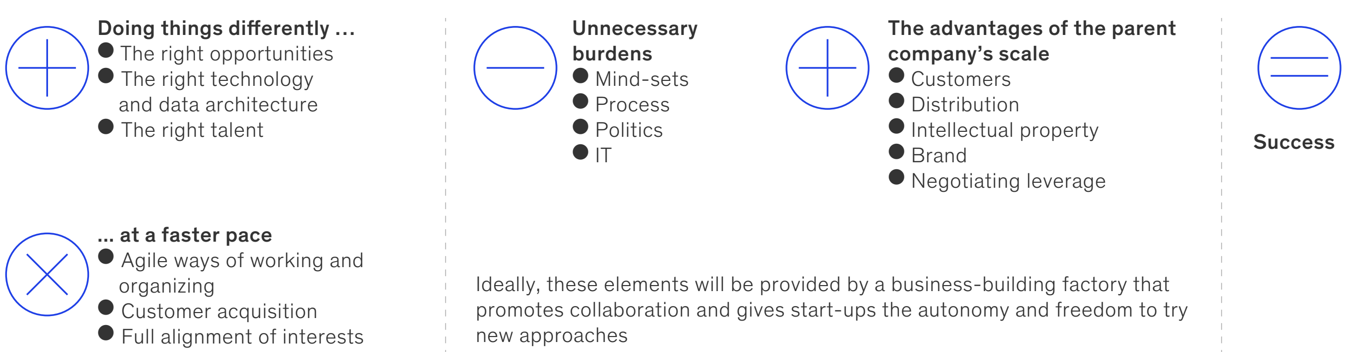
To overcome the scale-up challenge and respond to the threat of disruption, companies must rethink their operating model for innovation-led growth. The most effective models combine a strategic innovation process with multiple mechanisms for powering innovation development and scale-up. A crucial mechanism we've seen companies establish is an in-house "factory" for building and scaling up disruptive new businesses in ways that corporate accelerators and incubators normally don't.

Such a factory doesn't only assemble the resources and talent to help entrepreneurs start businesses and navigate the early stages of growth. Unlike a conventional accelerator or incubator, the factory also serves as a buffer that shields new enterprises from the unnecessary bureaucratic burdens that can interfere with a start-up's ways of working while

Exhibit 1

A winning formula for building new businesses combines the methods and pace of successful tech start-ups with the scale of long-standing companies.

The winning formula



[1] The survey asked respondents to indicate how much digital capital their companies had allocated to digitizing core businesses and developing new digital businesses. It identified top-performing companies as those in the top decile for organic revenue growth: 25 percent or more in the past three years. For more, see "A winning operating model for digital strategy," January 2019, McKinsey.com.

endowing these enterprises with the advantages of the parent company's scale (Exhibit 1). In this article, we'll offer our insights on how established companies are using factories to create disruptive businesses with the growth potential to counter the pressures of digital competition.

A look at BP's business-building unit

BP's upstream digital transformation is well underway, achieved in part through a number of homegrown technologies focused on production optimization. Supported by a multiyear research program, one technology harnesses fiber-optic sensing to listen to sounds deep in the subsurface. By identifying distinct acoustic signatures for sand, fluid, and gas, the technology can precisely locate each substance entering a well so corrective action can be taken.

Early trials in 2014 and 2015 proved the technology's value in several oil fields, bringing wells back online that had been shut down, while increasing production in others. Deployment at scale was elusive, however, with regional businesses seeking additional trials and assurances prior to committing. R&D teams often identify one or two early-adopting business units relatively easily, but building a track record can be more challenging.

In 2018, BP set up a new business-building unit, focusing entirely on scale-up. The acoustic-sensing technology was a prime candidate, given its market potential and intellectual property.

With coaching and support, the original inventors of the technology became cofounders of a new business, scoping the value proposition, securing executive approval, hiring talent, accelerating their tech stack, and using agile to rapidly expand the service offer and deployment model.

The new venture brings the best of both worlds. On the one hand, it benefits from the substantial infrastructure, expertise, and relationships that a large company affords, opening doors to an extensive network of customers. This advantage is then coupled with autonomy, setting aside some of the typical burdens and baggage that might come with this backing. Operating as a stand-alone start-up, the business has scaled fast and is on course to deliver significant value to BP in its first year.

Why long-standing companies are entering the start-up race

The push by BP and other large companies to create disruptive businesses by following the start-up playbook represents a crucial response to the emergence of nimble, inventive enterprises that use powerful technology tools to roil once-stable sectors.[2] Some of the most dominant winners are the new tech giants, which exploit network effects to make bold forays across industry lines and wrest market share from incumbents.[3] Moreover, these tech giants continue launching new businesses by staying true to the start-up DNA that made them successful: they empower people to rapidly pursue their commercial ideas without being stifled by the legacy organization.

The disruptive threat from very young companies is nearly as menacing. The average unicorn—a company valued at $1 billion or more in private markets—is just six years old, and the market capitalization of unicorns has increased nearly ninefold in the five years since their IPOs.

The rapid growth of newer companies is also reflected in the turnover of the S&P 500 index. In the late 1970s, the organizations in the S&P 500 index had been on that list for an average of approximately 35 years. Today, the average tenure

[2] Jacques Bughin, Laura LaBerge, and Anette Mellbye, "The case for digital reinvention," *McKinsey Quarterly*, February 2017, McKinsey.com.
[3] For more, see Venkat Atluri, Miklós Dietz, and Nicolaus Henke, "Competing in a world of sectors without borders," *McKinsey Quarterly*, July 2017, McKinsey.com; and Tushar Bhatia, Mohsin Imtiaz, Eric Kutcher, and Dilip Wagle, "How tech giants deliver outsized returns—and what it means for the rest of us," September 2017, McKinsey.com.

is closer to 20 years (Exhibit 2). Another telling fact: during the past five years, companies in the S&P Global 1200 that were founded within the past 30 years generated four times as much shareholder value as longer-standing companies.

Amid this boom, large companies have stepped up their attempts to tap the value-creating prowess of entrepreneurs. (This approach isn't new. In the late 1990s, for example, big businesses rushed to create start-up incubators, acquire fast-growing internet companies, and set up venture-investing units.) To take one measure of their activity, the number of corporate venture-capital (CVC) organizations making their first investments increased from 64 in 2013 to 264 in 2018.[4] In a recent McKinsey survey of executives involved with CVCs, incubators, and accelerators, 92 percent of

Exhibit 2

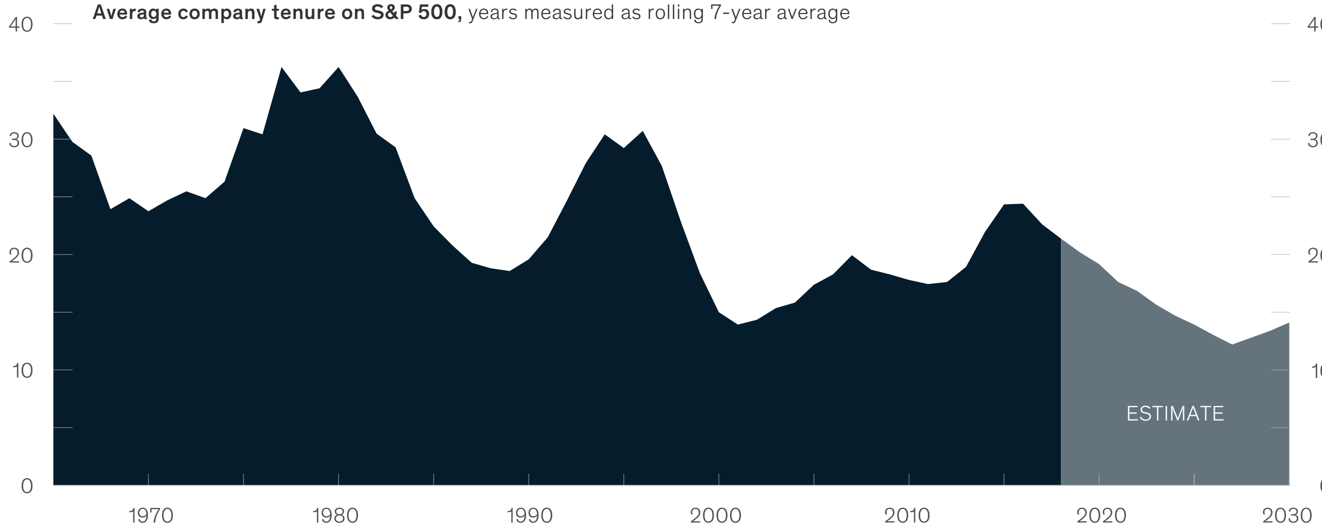
Organic growth has eluded many long-standing companies, and younger companies are outperforming these more established players.

The speed of disruption is accelerating …

Median age of S&P top 10, 2000	Median age of S&P top 10, 2018	Average S&P 500 tenure by 2027	Average age of a unicorn start-up	5-year valuation growth in post-IPO unicorns[1]
85 years	33 years	12 years	6 years	8.7 ×

… causing a steady decrease in the tenure of S&P 500-listed companies

Average company tenure on S&P 500, years measured as rolling 7-year average



[1] McKinsey research on previous unicorns that have been publicly traded for 5 years or more; compares current market capitalization with valuation in last funding round.
Source: *3Q 2018 VC Valuations Report*, PitchBook Data, November 14, 2018, pitchbook.com; Innosight Holdings; McKinsey analysis

[4] *The 2018 Global CVC Report*, CB Information Services, February 2019, cbinsights.com.

respondents agreed that their companies had seen a significant increase in the financial value of the enterprises in which they had invested.[5]

However, the survey also found that corporate business-building activities are often hampered by certain challenges associated with working in a legacy organization. Almost half of the respondents said internal policies had slowed the development of new businesses. Less than 10 percent said their companies had given start-ups full freedom to operate.

Nor are established companies consistently giving their start-ups the kind of support that could help them gain an edge. One-quarter of respondents said the parent company had not enabled its start-ups to capture even one advantage from the parent company's scale, compared with the support they might have received from private investors. Just 25 percent strongly agreed that their companies had the capabilities to deliver advantages associated with scale. Respondents most often cited a mismatch of expectations or ways of working as the reason why parent companies and start-ups had found it difficult to collaborate effectively (Exhibit 3).

Exhibit 3

Executives report that traditional companies seldom make it easy for in-house start-ups to operate and capitalize on the parent company's advantages.

Building new businesses is a high priority of senior management

But the large-company setting is not always favorable: internal policies tend to slow growth, and new businesses are not granted autonomy to act

have been engaged in business building for 5+ years

agree that new-venture building has brought significant financial value

agree that their businesses are subject to the same policies (eg, HR), with almost half of all respondents claiming politics slow down the process of growth

agree that businesses must get input from stakeholders across the corporate group to execute day-to-day decisions

Against this backdrop, many companies are struggling to convert their strengths into advantages for their new businesses

"We are a large multinational, and as such, we are subject to the traditional silos and focus on individual lines of business success, sometimes at the expense of the new-venture-growth opportunities"

"We face struggles with core-company approach vs new-venture need to operate differently"

"Influencing the strategic decision-making process while maintaining the venture's flexibility of operations at the same time becomes a challenging task, especially during incubation"

Source: McKinsey survey of 93 C-level and vice president/executive vice president–level executives (representing more than 70 companies) with direct control over business-building activities at their organizations.

[5] The survey was in the field in May and June 2019 and garnered responses from 93 C-suite and vice president/executive vice president–level executives and managers based in France, Germany, Italy, the United Kingdom, and the United States, representing more than 70 companies across a wide range of industries and company sizes. All respondents indicated that they control one or more of their companies' business-building activities (investing in start-ups directly or through corporate venture funds, operating a dedicated incubator that helps internal ideas or pilots become stand-alone ventures, operating a dedicated accelerator that helps younger or smaller ventures to scale up, or otherwise building or creating new ventures).

New enterprises and traditional companies: Understanding the mismatch

As previously noted, start-ups innovate and scale rapidly by adhering to priorities and methods that don't fit neatly in traditional companies. But if executives can better understand the new breed of start-ups, they can adjust their business-building approaches to suit these enterprises.

Today's new-business template

The young companies that have grown the fastest in recent years typically exhibit six defining features.

A compelling business opportunity. Our experience suggests that fast-growing start-ups target opportunities that lie at the nexus of three considerations: a large market that can be unlocked in incremental steps, a technology model that takes advantage of ecosystems, and a clear path toward attractive monetization.

A modern technology stack. One advantage that start-ups enjoy over established companies is that they build their technology stacks from scratch, rather than having to work with legacy IT. Our experience suggests that it is possible to assemble modular, off-the-shelf components and some proprietary code into a high-performance technology stack capable of supporting the initial minimum-viable-product stage in just three or four weeks.

Adaptable talent. The strongest start-ups we've seen are led by people who are comfortable managing uncertainty by following test-and-learn methods and who are willing to accept failures made for the sake of learning. They are also able to hire and motivate diverse specialists (designers, product owners, software developers, data scientists, salespeople, and so on). These qualities matter more than a particular industry background—not least because founders mustn't hesitate to reorient their enterprises when they find better opportunities beyond the industry where they first intended to compete. In a McKinsey interview, Aaron Levie, CEO of the cloud-storage company Box, said, "In the first year and a half of the company, I would say every 48 hours we'd change our business model."[6]

Youse: Digital innovation in Brazil's insurance market

Caixa Seguradora, Brazil's third-largest financial institution by assets, created Youse as a stand-alone company designed to provide clients with all-digital customer experiences. The company organized itself according to agile principles, with eight product teams that launched three minimum viable products within the company's first 12 weeks and developed digital customer journeys for purchasing and issuing policies, providing customer service, and filing and handling claims. Youse's IT specialists also created the company's technology architecture from scratch, developing applications according to a microservices approach, which configures each application as a package of self-contained components.

Youse entered Brazil's property-and-casualty-insurance market within 15 months of being formed. One and a half years later, the insurer had sold more than 300,000 policies and was generating some 200 million reais (about $50 million) in annual revenue.

[6] "From start-up to scale: A conversation with Box CEO Aaron Levie," October 2018, McKinsey.com.

Fast-paced operations. Speed of learning is a vital factor in a start-up's success because first movers and fast followers gain major advantages amid digital competition.[7] In a McKinsey interview, José Filippini, the CFO of Youse, a direct-to-consumer insurtech business launched by Brazilian financial leader Caixa Seguradora, said, "We also based the decision to launch Youse on the clear idea that there is strategic advantage in being the first mover." (For more on Youse, see sidebar "Youse: Digital innovation in Brazil's insurance market.")

Since new businesses typically operate in uncharted commercial spaces, they must follow truly agile methods (as opposed to methods that many companies label agile but include only some facets of agile) to refine their products over many test-and-learn cycles.[8] As Box CEO Aaron Levie told McKinsey, "There was a lot of early constant iterating, constant pivoting of the business. That became one of our core values as a company."[9]

An agile customer-acquisition funnel. New businesses scale up rapidly by using agile methods and low-cost digital channels to attract and retain customers. The ability to rapidly iterate offerings and quickly acquire large numbers of customers is integral to winning market share from slower-moving incumbents.

Alignment of interests. The rapid change that people experience at start-ups can be thrilling as well as draining. Start-ups foster resilience in their people partly by offering them incentives—notably, equity stakes—to persevere. "[The] thing that actually unlocks human potential is when people feel they have control over their own destiny and they can make a killing if they really succeed on their wild bet," says Bill Gross, founder of Idealab.[10]

Unnecessary burdens and overlooked advantages: Why corporate start-ups often come up short

Even when new enterprises follow the described template, we have seen them struggle inside traditional companies for two main reasons.

The first reason is that traditional companies make it difficult for new businesses to follow the very practices that might make them successful. Scott Cook, the cofounder and executive-committee chairman of Intuit, described this phenomenon in a McKinsey interview: "Normally, companies put up a phalanx of barriers and hurdles and mountains to climb that may not seem hard for the boss or the CEO but are intensely hard, impossibly hard, for our young innovator to conquer."[11] Imagine an in-house start-up that draws up a cloud-based technology stack—but can't build it, because the parent company's chief information officer insists that the start-up operate in the enterprise-IT environment.

Sometimes naysayers at the parent company undermine start-ups. Sam Yagan, former CEO of Match, witnessed this dynamic after Match founded Tinder, a mobile dating app. In an interview with McKinsey, he said, "When we launched Tinder inside of Match, we found that there was resistance from some people inside the core business who saw Tinder as a threat—maybe to the business, maybe to their own expertise in the company, and certainly to the culture."[12]

Some parent companies do treat their start-ups as nearly independent entities, which helps them avoid unnecessary burdens. Unfortunately, this arm's-length relationship can also prevent start-ups from capitalizing on the advantages they can gain from the parent company's scale, such as a customer base and brand recognition (more on these follows).

[7] For more, see Jacques Bughin, Tanguy Catlin, Martin Hirt, and Paul Willmott, "Why digital strategies fail," *McKinsey Quarterly*, January 2018, McKinsey.com.
[8] Wouter Aghina, Karin Ahlback, Aaron De Smet, Gerald Lackey, Michael Lurie, Monica Murarka, and Christopher Handscomb, *The five trademarks of agile organizations*, January 2018, McKinsey.com.
[9] "From start-up to scale: A conversation with Box CEO Aaron Levie," October 2018, McKinsey.com.
[10] "How big companies can innovate," February 2015, McKinsey.com.
[11] Ibid.
[12] "Building data-driven culture: An interview with ShopRunner CEO Sam Yagan," *McKinsey Quarterly*, February 2019, McKinsey.com.

The inability to seize these advantages is the second reason why we often see corporate start-ups underperform.

A factory for building and scaling up new businesses

Although many corporate start-ups are too young to have reached massive scale by now, we have seen long-standing companies support the scaling of new businesses by establishing a dedicated business-building factory. The factory nurtures a portfolio of businesses by evaluating proposals, choosing which ones to back, working with the founders to develop business cases, securing funding from the parent company, hiring an initial team, and coaching founders.

While these activities resemble those of a corporate accelerator or incubator, the business-building factory is positioned and staffed differently. A typical accelerator or incubator sits in a business unit and is led by a manager three or four tiers below the C-suite, with little or no authority to drive pace and unlock the advantages of scale. By contrast, a business-building factory should be positioned as a relatively independent, empowered arm of the company, staffed with several types of personnel:

— *Experienced entrepreneurs hired from outside the parent company.* Their main responsibilities are to help evaluate and prioritize business ideas and hire founders. They also coach founders through the typical ups and downs of scaling a new venture.

— *Influential, well-connected executives from the parent company.* In addition to representing the company as the controlling shareholder of each new business, these executives serve as advocates for the start-ups within the parent company. That role involves contacting other executives when a start-up must work around a bureaucratic requirement or tap the parent company's advantages and making sure that those executives understand the start-up's needs and that they accommodate them.

— *Specialists in business-building disciplines, such as design thinking, product ownership, software development, system and data architecture, data science, sales, and marketing.* These specialists make up a pool of shared staff who assist each start-up until it grows large enough to hire specialists of its own.

The position and staffing of the factory ensure that the new businesses are unburdened by the corporate bureaucracy and endowed with the parent company's advantages. The next sections offer a closer look at these two duties.

Liberating new businesses from the unnecessary burdens of bureaucracy

In our experience, corporate start-ups increase their odds of success when they have few, if any, obligations to the legacy features of the parent company. Ideally, the factory will give new businesses the autonomy of independent start-ups. At minimum, the executives in the factory will use their clout to ensure that new businesses have three types of freedom from the parent company.

Freedom from financial pressure. Start-up founders often prioritize market share and scale over profits. Research by the McKinsey Global Institute shows that among NASDAQ-listed software and internet companies, founder-controlled companies have 60 percent faster revenue growth and 35 to 40 percent lower profit margins and returns on invested capital than widely held companies.[13] But if the parent company pressures its new businesses to deliver short-term returns on investment, founders will be more likely to make decisions that limit a new business's long-term prospects.

Freedom from red tape. A parent company's bureaucracy can diminish one of the most powerful qualities that typical start-ups possess:

[13] For more, see "The new global competition for corporate profits," McKinsey Global Institute, September 2015, McKinsey.com.

the ability to make quick decisions. Every hour that a start-up's employees spend filling out forms or awaiting permission from a corporate functionary is an hour they aren't spending on product development or other value-creating activities. Parent companies should therefore refrain from imposing their requirements on new businesses (except for requirements related to legal and regulatory mandates).

Freedom to source talent. No corporate start-up should be required to fill its ranks with staff from the parent company. A start-up's hiring decisions should rest with the leadership team. That way, the start-up can draw from pools of workers who are disinclined to seek jobs at traditional companies and unfamiliar to corporate recruiters.

Unlocking the parent company's advantages

Established companies can bestow on their new businesses advantages that independent start-ups can't easily replicate. While the advantages that a start-up might need will vary, five generally stand out as especially valuable.

Customer relationships. A corporate start-up can gain an advantage with customers if the parent company positions the start-up's offerings as a complement to its own. For example, Royal FloraHolland, a large flower-growing and trading cooperative, had observed that growers and buyers were finding it more complicated to conduct direct trades because the network of trading platforms was becoming more fragmented. In response, the cooperative built a unified digital marketplace for auctions and direct trading of horticultural products. The new marketplace scaled up quickly because it brought growers and buyers onto a single platform and integrated with Royal FloraHolland's existing services. "By enabling our customers to thrive in the digital economy, we're reinventing our business for the future," said Gerhard van der Bijl, chief digital officer of Royal FloraHolland. (For more on Royal FloraHolland's digital marketplace, see sidebar "Floriday: A digital hub for horticultural trade.")

Distribution capabilities. If a corporate start-up's offerings complement the parent company's or can be distributed in a similar manner, then the new business can piggyback on the parent company's distribution system.

Intellectual property. Established companies possess intellectual capital—including data, technical know-how, and patents—that can benefit

Floriday: A digital hub for horticultural trade

For more than 100 years, Royal FloraHolland, a Netherlands-based cooperative of flower growers, has operated an international marketplace for flowers and plants. However, major changes in trading patterns, such as increases in small transactions and direct grower-to-buyer sales, were diminishing the volume of flowers sold through the marketplace. Trading volume was also shifting to digital marketplaces. To adapt, Royal FloraHolland created a digital platform that would connect growers to multiple digital sales channels. Over eight months, a team of digital specialists built Floriday, a minimum-viable-product version of the selling platform, and tested it with sellers. Royal FloraHolland has since acquired controlling stakes in certain digital sales channels to facilitate their collaboration with Floriday.

New10: A digital-lending start-up in the Netherlands

ABN AMRO Bank saw that changing customer needs and the emergence of fintechs could jeopardize a significant share of its lending revenue. It resolved to hit the market quickly with a digital-lending proposition for small and medium-size enterprises. The bank envisioned New10 as a purely digital lender and established the company as a separate entity, owned by ABN AMRO Bank, to accelerate its development.

Within its first two months, New10 had recruited and trained 40 people to perform key functions. The new hires built the company's technology environment from the ground up and designed a fully digital lending experience for customers. Its risk model also demonstrated higher predictability than ABN AMRO Bank's model. Six months after its formation, New10 entered the market, offering loan decisions in 15 minutes and funding transfers to customers within 48 hours. The digital lender also won more than 60 percent of its customers from rival institutions.

start-ups. Knowledge sharing between a parent company and a new venture worked well for ABN AMRO Bank, a large European bank, when it set up a digital-lending subsidiary called New10. New10 kept most of its operations separate from those of ABN AMRO Bank: it recruited and onboarded its own people, formed its own vendor relationships, and set up an entirely new technology architecture. But when it came time to establish other core capabilities, such as regulatory compliance and fraud management, New10 relied on the expertise of ABN AMRO Bank's compliance and risk functions. "Bringing in ABN AMRO Bank's expertise enabled New10 to develop our proposition more quickly than a stand-alone company could have and to offer attractive pricing and experiences to customers on the day we launched," said Patrick Pfaff, New10's founder. (For more on New10, see sidebar "New10: A digital-lending start-up in the Netherlands.")

Brand strength. An established company's brand can confer legitimacy on a start-up that helps it win customers. New10's marketing team also linked the new lending institution with ABN AMRO Bank, which helped New10 earn recognition as the "most desired brand" for lending to small and medium-size enterprises in the Netherlands.

Negotiating leverage. Start-ups can't match the purchasing power of large companies—or the scale they can offer potential partners.

The more a start-up relies on its parent company for assistance, the more difficult it can become for the start-up to maintain autonomy. A start-up that wishes to market to the parent company's customers, for example, might need permission from uncooperative account managers. Executive members of the factory can urge fellow executives to have their functions or business units provide start-ups with the assistance they need.

Another helpful practice is for the factory to enlist representatives of parent-company functions as liaisons to the new businesses, with responsibility for ascertaining their needs and coordinating functional support. The liaison's job should be a formal part-time role, or even a full-time role (if the parent company has a large portfolio of new businesses), with goals and incentives linked to the factory's performance.

"[Big] companies will never do something substantial or worth thinking about or worth writing a history book about in their core businesses," said venture capitalist Steve Jurvetson in a McKinsey interview. "But the beauty is that it doesn't mean big companies are dead; it just means big companies need to innovate outside their core businesses."[14] Innovating outside the core, however, is easier said than done. Too often, the legacy organization throttles business-building efforts and shuts would-be entrepreneurs out of departments that could give their start-ups an edge. To better the odds that new businesses will strengthen a parent company's financial prospects and strategic positioning, traditional companies can house their enterprises inside a factory that shelters them from bureaucratic burdens and provides them with the advantages of the parent organization's scale and know-how. Such a factory can provide long-standing companies with a renewable source of fast-growing business models that will sustain them in the turbulence of digital disruption.

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[14] "Inside the mind of a venture capitalist," McKinsey Global Institute, August 2016, McKinsey.com.