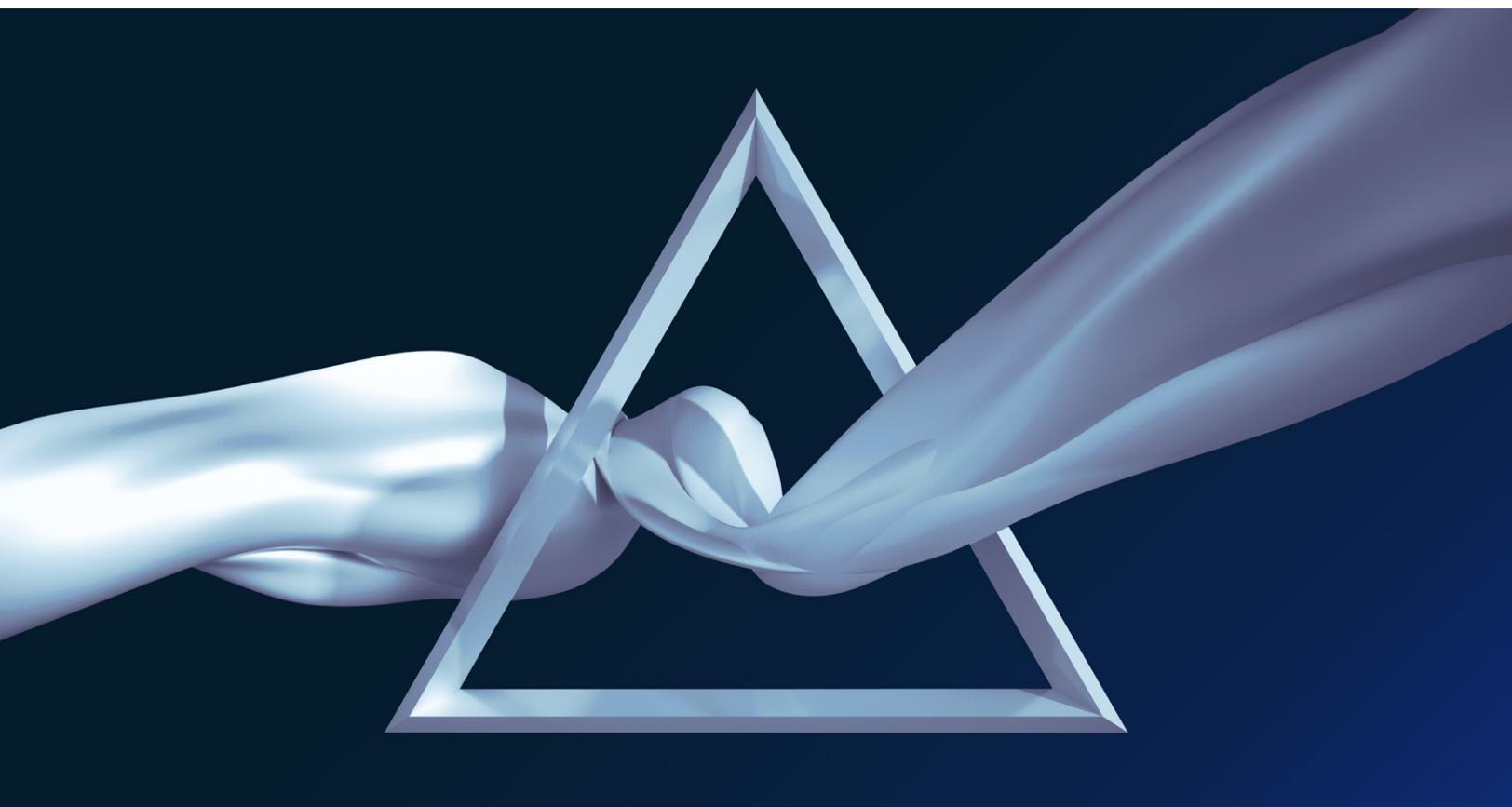


Strategy & Corporate Finance Practice

In conversation: The great acceleration

As trends speed up and outperformers increase their leads, companies urgently need to set a path for post-COVID-19 growth.



In this episode of the *Inside the Strategy Room* podcast, co-authors of two recent articles—on growth strategies during downturns and the acceleration of trends since the pandemic’s start—help shed light on the reasons behind the widening gap in corporate performance and how companies can position themselves to be among those gaining ground. Rebecca Doherty is a global leader in our growth and innovation practice and serves healthcare, industrial, and technology clients. Nicholas Northcote is a partner currently on a research fellowship focused on corporate growth and setting strategy during the coronavirus pandemic. He was a major contributor to our recent book, *Strategy Beyond the Hockey Stick*, upon which some of this podcast is based. This is an edited transcript of the discussion. For more conversations on the strategy issues that matter, subscribe to the series on Apple Podcasts or Google Play.

Sean Brown: Nic, you analyzed how the COVID-19 pandemic has affected companies’ and industries’ positions on the Power Curve of Economic Profit, which was at the core of the *Strategy Beyond the Hockey Stick* book. What prompted you to undertake this research?

Nicholas Northcote: There is a lot of confusion about what is happening in the stock market at the moment. On average, stock prices are not far off their pre-COVID-19 peaks. However, when you zoom in on the spread of performance across industries,

that dispersion is extremely wide. Some industries, such as some technology and grocery players, have large positive returns while others have equally large losses, including airlines, travel and tourism, and energy. We were curious what this suggests for the future of corporate profit pools, so we calculated the implied long-term economic profit of the largest 3,000 companies globally. We were not interested in the market levels as such but in the patterns emerging. And those patterns are, we believe, meaningful, and consistent across measurement periods and with what we see at our clients. They’re also very different from what we saw during the 2007–2009 crisis.

Sean Brown: What were some of your main findings?

Nicholas Northcote: First, this crisis has led to a widening gap between those at the top and those at the bottom of the performance curve. This gap between top and bottom quintiles was widening before the pandemic, but the crisis has dramatically amplified it. The top quintile has gained \$240 billion of implied economic profit. Even when you exclude the big four outliers—Amazon, Apple, Alphabet, and Microsoft—that group is still up by \$150 billion. The bottom quintile, on the other hand, is down about \$400 billion.

Sean Brown: The pandemic has had a very different impact on different industries. What role does that play in the pattern you see?

‘In the last crisis, we saw more of a reshuffling of industries. This time, we see the top sectors pulling further away from those at the bottom.’

—Nicholas Northcote

Nicholas Northcote: The cross-industry view is interesting. When we compare the average 2019 economic profit with what the market is implying for future profits, industries that were on top before the crisis have expanded their lead. Semiconductors, pharmaceuticals, software, and media have all increased their overall economic profit (Exhibit 1). Those at the bottom, on the contrary, have suffered: banks, utilities, and transportation have bigger implied losses than the historical norm.

So this industry lens shows a widening gap between the top- and bottom-performing sectors.

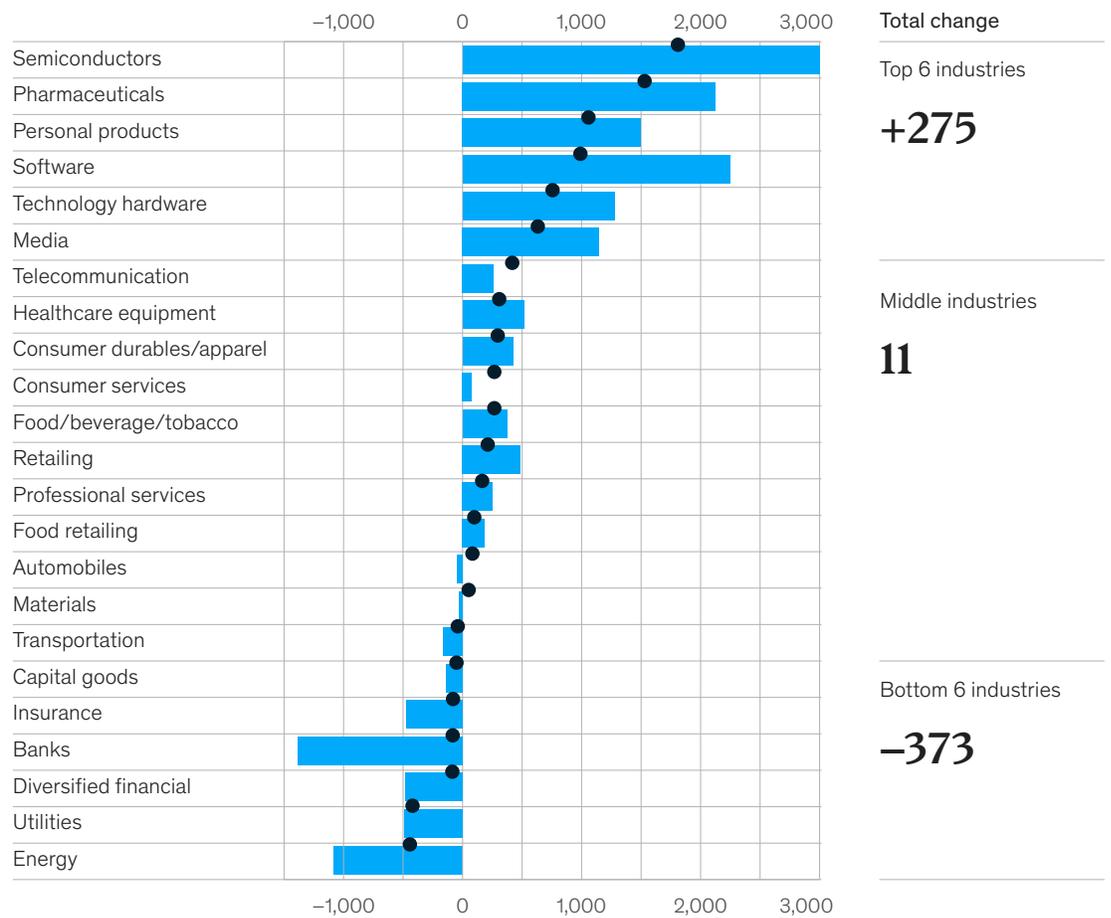
What is particularly noteworthy is that in the last crisis we saw more of a reshuffling of industries. Sectors such as banking and energy fell from the top of the Power Curve all the way to the bottom and some that were on the bottom climbed to the top. This time, we see the top sectors pulling further away from those at the bottom.

Exhibit 1

The best industries are getting better, and the worst are getting worse.

Average economic profit by industry,
\$ billion (n = 2,562)¹

● 2018 ■ Long term, 2020-market-valuation implied



¹Largest nonfinancial companies by revenue in 2018 with data for 2003–18 available. Source: Corporate Performance Analytics by McKinsey

Sean Brown: Why is the gap widening this time around? Is it mainly due to the way the pandemic has changed how we work and buy?

Nicholas Northcote: It's logical to look to the short-term behavioral shifts caused by this crisis—the lockdowns and health concerns pushing people online or the reduction in demand for discretionary goods and services. While that is a contributing factor, we believe it is only a small part of the story. Our analysis suggests this widening gap has been driven largely by an acceleration of trends that existed before the crisis. Industries that were growing economic profit before have grown their profit by more and vice versa. It makes intuitive sense, right? Many of the trends coming to the forefront now were there before the crisis, the likes of everything digital including e-commerce, telemedicine, education, as well as slowing globalization, more polarized politics. There have been very few big U-turns.

Additionally, I would argue that some of the trends accelerated by COVID-19 will not reverse after the crisis. For example, a grocer in China that opened 3,000 order-and-collect spots around urban centers is not planning to shut any of them down. When we recently ran a survey asking a hundred people in our network about their innovations driven by the recent disruption, roughly 70 said they do not expect most of them to revert back to pre-COVID-19 status, which speaks to the longer-term nature of these trends.

Sean Brown: What should those who find themselves on the wrong side of these trends do? And how do you identify the trends early enough to stay ahead of them?

Nicholas Northcote: The challenge is less about identifying the trends than freeing up resources to act on them. How do you take resources away from underperforming business areas and shift the portfolio toward tailwinds? That is often hamstrung by rigid budgeting processes, social dynamics among the top team and other organizational factors. That said, some of our clients are complementing their usual expert-led brainstorming with artificial intelligence and analytics to uncover

opportunities. SparkBeyond, a McKinsey partner company, for example, has an AI platform able to scan 400 billion public and scientific web pages to identify early-stage trends in everything from patent data to investment flows to online and social media, then search for concrete investment opportunities.

Rebecca Doherty: I think your point around resource reallocation and tactical capability building is often where companies differentiate themselves. Whether you choose to develop an innovative capability internally or through M&A to move into a more trend-friendly adjacency, this is where we see investment.

Sean Brown: We've spoken about the cross-industry view and industry-level trends. Is that all that's driving the growing performance gap between companies?

Nicholas Northcote: The cross-industry view explains only about half of the dispersion. The other half comes from within the same industry. In 19 of the 23 industries we studied, companies in the top quintile of their industry before the crisis have grown economic profits by more than those in the bottom quintile. So this stretching is happening both across industries and within industries. What's particularly interesting is that this pattern is not only evident in high-performing industries, where you often see averages skewed by outliers such as Amazon or Google—we see it in underperforming ones too. We think it has a lot to do with the fact that companies with resilient business models have pulled away from those with legacy ones. It's a combination of business model innovation and strategic moves that, either before or as a result of the pandemic, have repositioned their portfolios ahead of these trends. That seems to be the differentiating factor.

Rebecca Doherty: These are deliberate choices. For example, in the energy sector you have companies in solar that moved early to capitalize on the solar trend and have seen performance accelerate during this downturn. In the last downturn, one consumer company began offering financing for its products to lower-income customers and even though their core business did not fare well in that crisis, their financing business helped their results.

Sean Brown: Are there specific lessons from the last downturn that can help companies reverse their performance slide or advance their growth during the recovery from this one?

Rebecca Doherty: What we saw in the last downturn is that the outperformers leapfrogged their competitors during the recovery. They started on growth strategies coming out of the downturn and then turbocharged them in the recovery (Exhibit 2). Those that significantly grew their revenue during the last recovery pulled away from competitors even more than what we see companies doing now, and their peers could not make up that ground later.

The lesson is that you need to lead with a through-cycle mindset. This is not about reacting to short-term events but thinking holistically about your strategy.

How will I continue acting on it? Leaders tend to double down on innovation, sales, and digital capabilities, but that requires first creating the optionality: not growth and investment at any cost but putting yourself in an operationally and financially stable position to act on opportunities. Some don't have that flexibility right now and those companies should focus on shoring up their balance sheets. But for others that can create that optionality, now is the time to think about what to do with it. You want to make big moves, whether it is turbocharging the core business, looking at adjacencies that expose you to positive trends, or expanding into more resilient geographies.

Some of this can be done organically through business model innovation, some with investing to build up the core business. M&A is another big lever, especially right now. Mergers and acquisitions are down this year but judging by the activity in the past few months, you would expect an upturn. What is my M&A strategy and my diligence approach? Finally, you need to invest in capabilities. If you think about running a race, this is the part when you are training so when the time comes to unleash your power, you have built the foundation.

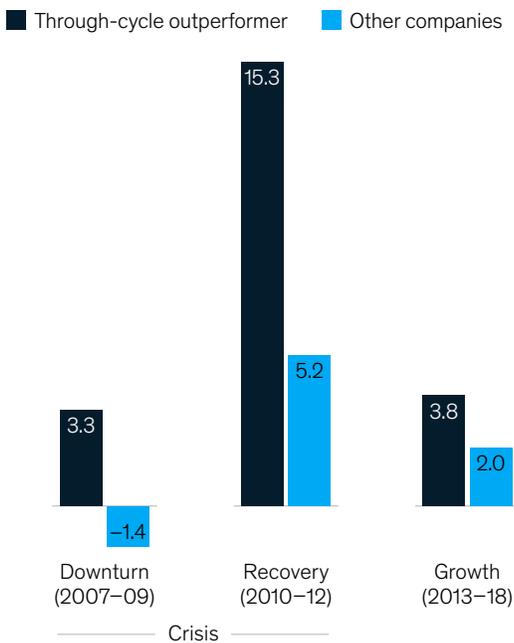
Sean Brown: Nic, you mentioned resilient business models. How big a role did those models play in widening the performance gap between companies?

Nicholas Northcote: A lot of the dispersion within industries has been driven by what we call future-ready business models, whether those innovations happened before or during the crisis. Take media for example, where we see streaming models pulling away from traditional satellite models. One of my favorite examples is telehealth. Tele-consultations had represented single-digit shares of total consultations for many years and in some places went up to 70 percent overnight. Some of that will reverse but, again, we don't expect many sectors to revert fully. Some of my banking clients are considering never reopening many of their branches after lockdowns. They have been talking about omnichannel and online banking for a long time but worried about losing some of their demographics. Now, the pandemic has accelerated the shift. In that

Exhibit 2

The time is now—through-cycle outperformers leapfrog during recovery.

Median revenue growth CAGR, %, (n = 2,098)



‘The time to act is now because in a few years, we suspect it will be too late and you will be trying to catch up.’

–Rebecca Doherty

survey I mentioned earlier, 90 percent of those who felt their companies had responded effectively to the COVID-19 disruption cited some form of business model innovation.

And the disruption is not just digital, it's along the whole value chain. I recently spoke with a strategy executive from one of the oil majors who said on some of their offshore platforms, they reduced staffing by 90 percent and have seen no negative impact on production or safety. That has led them to wonder whether they need to fundamentally rethink their labor model.

Rebecca Doherty: Companies need to think about the downstream effects of the trends, too. With many people ordering online, what does that mean for store footprint? Should retailers switch to smaller stores or rethink their warehouses? More smaller warehouses could speed up delivery times. Could warehouse owners capitalize on this changing business model? Or think about cold storage and the whole supply chain that needs to be built for that type of delivery. Those are interesting opportunities.

Sean Brown: Many of the initial shifts happened with incredible speed. Do companies need to make changes to their talent strategies and other operating models to make those new business models endure?

Rebecca Doherty: Talent is a big consideration for many companies right now. Almost every company I talked to before the crisis was thinking through, how do I win in the war for talent? Now, they are thinking beyond that. How much do I recruit externally? How much do I upskill internally for new jobs? With a decreased footprint, where do I want to recruit this talent? How do I think about international talent?

Sean Brown: Let's switch to M&A. Rebecca, you had mentioned it as a key lever that growth outperformers in the last downturn used. Can you first define what you mean by outperformers?

Rebecca Doherty: These are companies that both grew faster and maintained higher profit margins than their peers. One thing we saw is that they did larger deals and more deals. But going back to the through-cycle mindset idea, they tended to adopt a programmatic approach to acquisitions, buying several businesses over time and building a real capability and presence in a market versus doing a big-bang type of deal. These companies reaffirmed their convictions: “These M&A themes that I was executing against continue to make sense and maybe should be accelerated, so how do I think about getting good value for companies now?”

The second element is figuring out your competitive advantage. Is it a technical capability or a client base that would be attractive to a target company? Lastly comes cash and this goes back to having operational flexibility. Companies that started in a stronger financial position could buckle down to accelerate their M&A strategies.

Sean Brown: Digital capabilities are obviously in high demand these days. Are growth outperformers particularly active in digital M&A, and how does that compare with the previous downturn?

Rebecca Doherty: Back in the early 2010s, the share of outperformers and other companies pursuing digital deals was roughly similar. Then, in 2015–2019, outperformers started doing more digital M&A and that added to their outperformance gap. This year has only accentuated that pattern. In 2020, overall M&A activity is down but

outperformers have widened the gap in the amount of digital M&A they are doing compared to their peers.

Sean Brown: What are the main takeaways you want to leave listeners with?

Rebecca Doherty: The value at stake is large. The gap between the top and bottom performers is widening both across sectors and within sectors. Secondly, you need to make multiple moves. It's not about doubling down in one area but being strategic, staying true to your North Star while spreading your bets a little, whether it's in business model innovation, adjacencies, or specific capabilities. And the time to act is now, or at least to start thinking about where you will place your bets. Because in a few years, we suspect it will be too late and you will be trying to catch up.

Nicholas Northcote: The ambition setting and the moves you put into your strategy will be dependent on your starting position. Some find themselves with strong balance sheets today and are well positioned ahead of trends. For them, it's about pulling in capital to strengthen that position. For those at the other extreme, facing headwinds and with weaker balance sheets, it's about survival, which means either restructuring or divestitures to free up resources they can then reallocate toward trend-friendly business areas. One thing that is consistent for everybody: the time to act is now, because those that are behind are falling further behind. The past suggests that in times of disruption, being the first to move and moving the boldest can enable you to leapfrog your peers, regardless of starting position.

Rebecca Doherty is a partner in McKinsey's San Francisco office, and **Nicholas Northcote** is a director of strategy and corporate finance in the Brussels office. **Sean Brown**, global director of communications for the Strategy and Corporate Finance practice, is based in Boston.

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