McKinsey&Company

How digital reinventors are pulling away from the pack

McKinsey Global Survey results

As digitization progresses, incumbents competing in new, digital ways are already outperforming those that continue to operate traditionally.

Digitization is a long way from running out of steam, since the bulk of company revenues in most industries still come from traditional sources. Yet the results from McKinsey's latest survey on digital strategy suggest that a digital divide is already taking shape.[1] Companies competing in traditional ways (that is, without applying digital technologies and strategies in their businesses) have seen lower rates of revenue and earnings growth than have companies competing in digital ways—and those rates are tightly correlated with the level of digitalization, or digitization, in their respective sectors.[2] But other players are seeing tremendous growth as digitization advances. The companies making digital moves—digital natives, industry incumbents competing in new and digital ways, and incumbents moving into new sectors—are out-performing their traditional-incumbent counterparts.

We call these companies digital reinventors. While most respondents say that their companies are making at least marginal investments in digital, we found last year that few had achieved top-quartile growth and

Jean-François Martin

high returns—not surprising, given the lukewarm response to digitization the average respondent reports in this year's survey. Digital reinventors, in contrast, are embracing digital with both their investments and their strategic decision making. Our results indicate that companies in this group are not only investing *more* in digital but also investing and executing differently. The reinventors are investing at scale in technology, analytics, and digital talent—not just playing on the margins—and investing much more aggressively in business-model innovations or entirely new business models. They make more digital-related acquisitions and divestitures than traditional incumbents do; they are likelier to accelerate changes in their own businesses; and they are using more advanced, innovative technologies. The results indicate that their efforts are paying off: the reinventors are seeing larger gains in revenues and earnings than are traditional incumbents that have yet to embrace digitization.

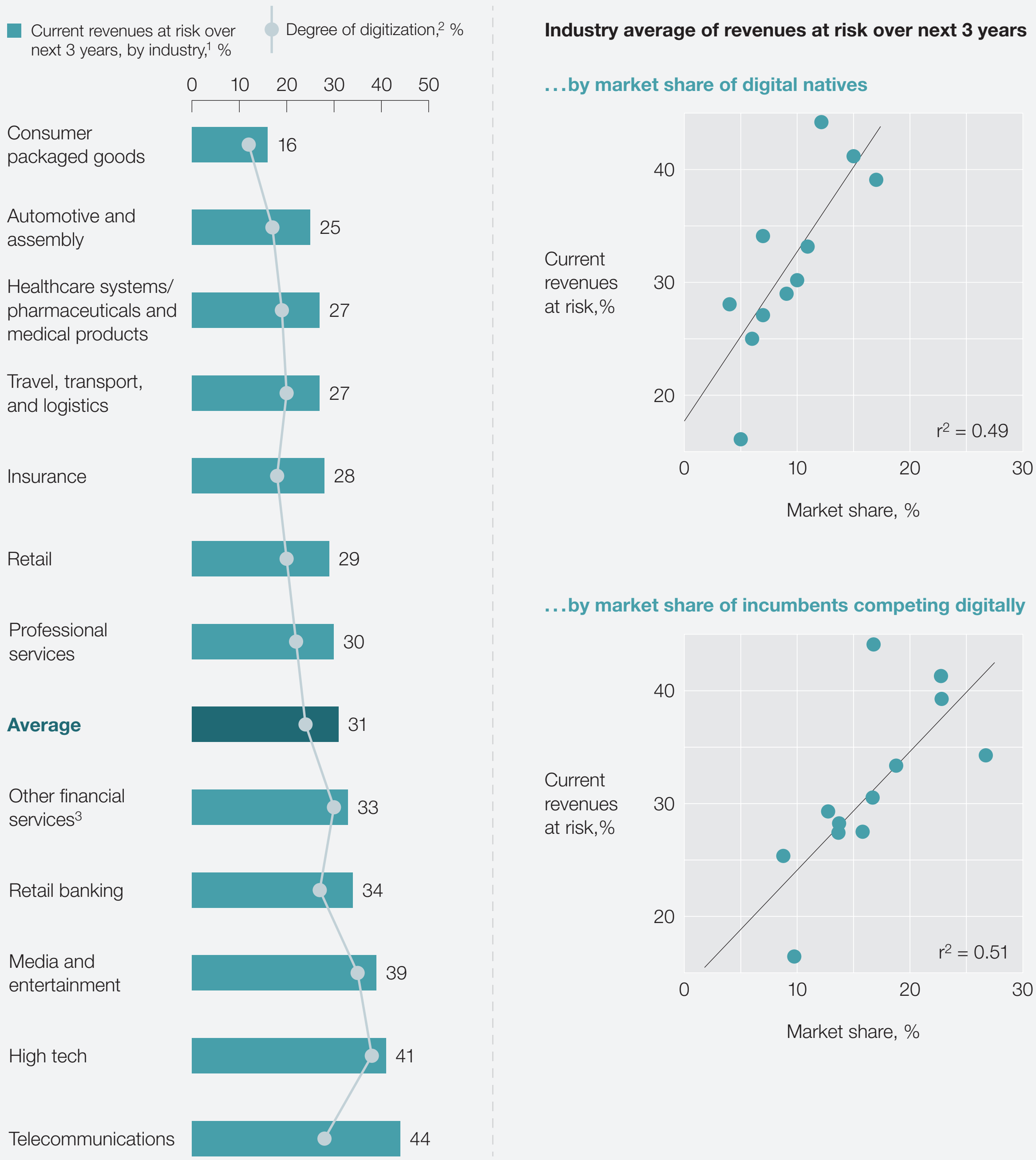
Growing pressure on incumbents

As digitization continues to progress, its expected effects on revenues seem pronounced. When respondents were asked how much of their companies' revenues would be at risk in the next three years if those companies took no further action to address digital pressures, they estimated that almost one-third could be lost or cannibalized. Consistent with our earlier research showing that increased levels of digitization produce shrinking profit and revenue pools at the industry level,[3] the revenues at risk are even greater in the industries (high tech, as well as media and entertainment) experiencing the highest levels of digitization.[4]

But the level of digitization is only part of the industry picture. Despite a common belief that digital natives are the greatest threat to an industry's existing market share, the results indicate that incumbents competing in digital ways pose just as great a threat to other companies, if not a greater one (Exhibit 1). The correlation between the market share owned by digital natives and revenues at risk is on par with that of incumbents playing digitally.[5] This finding is consistent with other work suggesting that incumbents can have a strong effect on the market and on the pace of digital disruption in a given industry,[6] and this effect is only magnified by the more powerful positioning of these incumbents. Since those competing in digital ways already own a larger market share than digital natives do, on average, they can also make larger shifts in the economics of their respective markets.

To date, the loss of revenues as digitization has expanded is already clear. Nearly 20 percent of all respondents report negative revenue growth in the past three years. But some companies can thrive in a more digitized landscape: specifically, those trying to reinvent themselves by embedding digital technologies in the core of their business models and by launching new digital businesses. Respondents at incumbents playing digitally are twice as likely as traditional incumbents to report exceptional financial growth (that is, an average compound annual growth rate of more than 25 percent) during this same period.

Exhibit 1 **Companies expect significant risk to their revenues from digitization if they take no action to respond in the years ahead.**



[1] For consumer packaged goods, n = 50; for automotive and assembly, n = 68; for healthcare systems/pharmaceuticals and medical products, n = 101; for travel, transport, and logistics, n = 45; for insurance, n = 65; for retail, n = 72; for professional services, n = 247; for other financial services, n = 130; for retail banking, n = 60; for media and entertainment, n = 82; for high tech, n = 237; for telecommunications, n = 50.
[2] Based on share of organizations' sales from products/services that are sold through digital channels; share of core products/services that are digital in nature (eg, virtualized or digitally enhanced); share of core operations automated and/or digitized; and share of volume in supply chain that is digitized or moves through digital interactions with suppliers.
[3] Excludes respondents in insurance and retail banking.

The typical response to digital is underwhelming

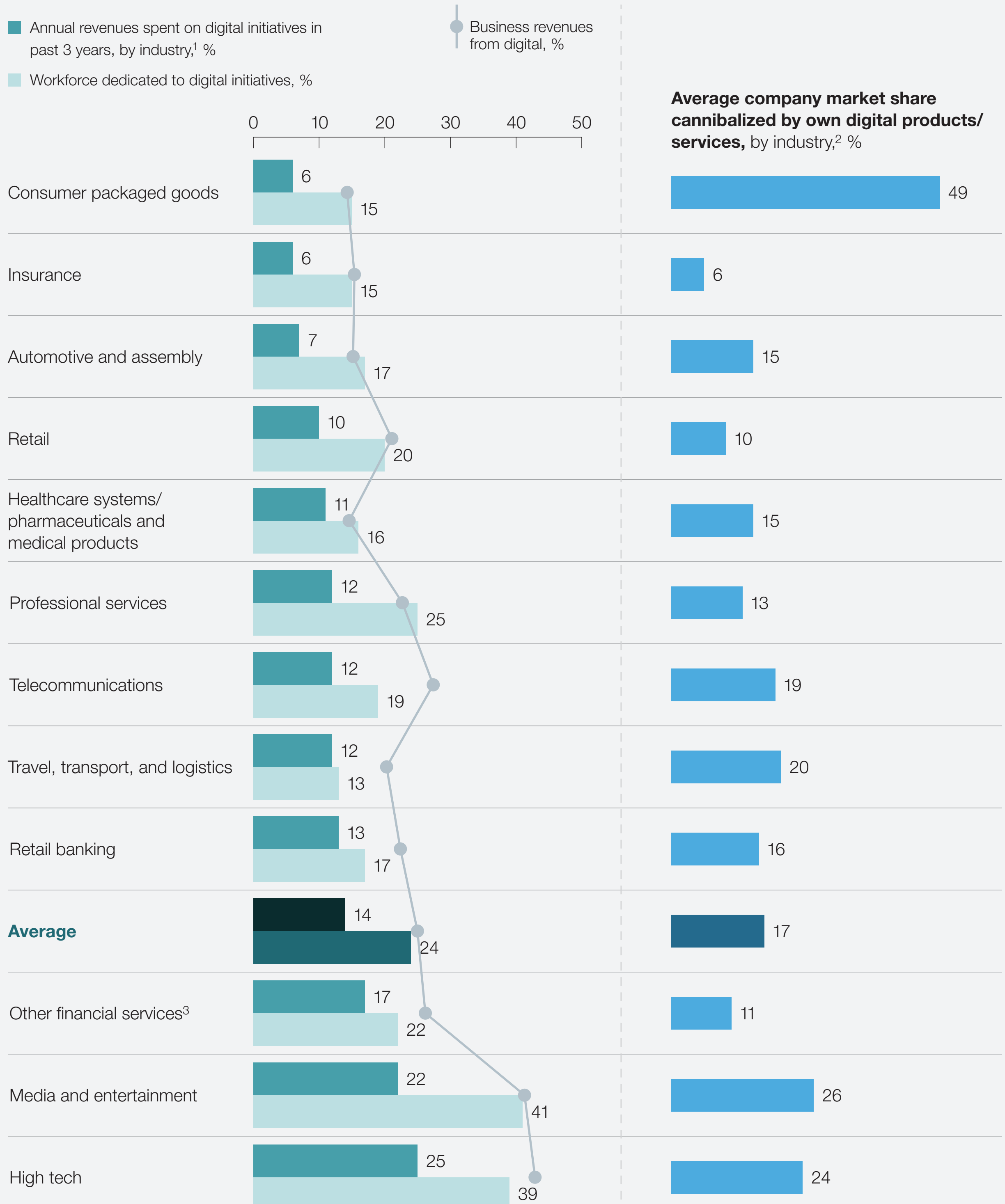
With so much revenue at stake from digitization, what have companies been doing in response? The results show that while most have a plan in place, it is tentative at best. Most respondents say their companies have invested only modestly in digitization. On average, the share of both revenues and full-time employees that incumbents are investing in digital initiatives is proportional to the revenues they are earning from digital (Exhibit 2). But according to respondents, much of their net gain in revenue growth has been cannibalized by their own digital versions of core products and services, so many companies appear to be treading water rather than moving forward. This suggests that companies may be underinvesting in digital—especially in industries where the highest-returning digital investments (for example, in the Internet of Things, automation, and predictive maintenance) do not directly drive frontline sales.

These lackluster results are not surprising when we look more closely at where the average company is investing. Respondents say their companies tend to invest only in the most proven digital technologies (big data, mobile, and traditional web technologies, for example). At the same time, more than half have made no changes to their business portfolios because of digitization, and less than 20 percent report either acquiring businesses to supplement their long-term digital strategies or divesting any of their current businesses. And only one-third say their companies have launched new digital businesses, while just over half report digitizing at least a few elements of their business models—an approach that appears to play around the edges of the business rather than involving more significant digital innovations or investments.

Of course, this changes when respondents perceive a greater risk to their core businesses. Respondents who believe that the greatest amount of these revenues may be at risk are far more likely than average to say their companies will need to make significant changes to their business models to remain

Most respondents say their companies have invested only modestly in digitization. On average, the share of both revenues and full-time employees that incumbents are investing in digital initiatives is proportional to the revenues they are earning from digital.

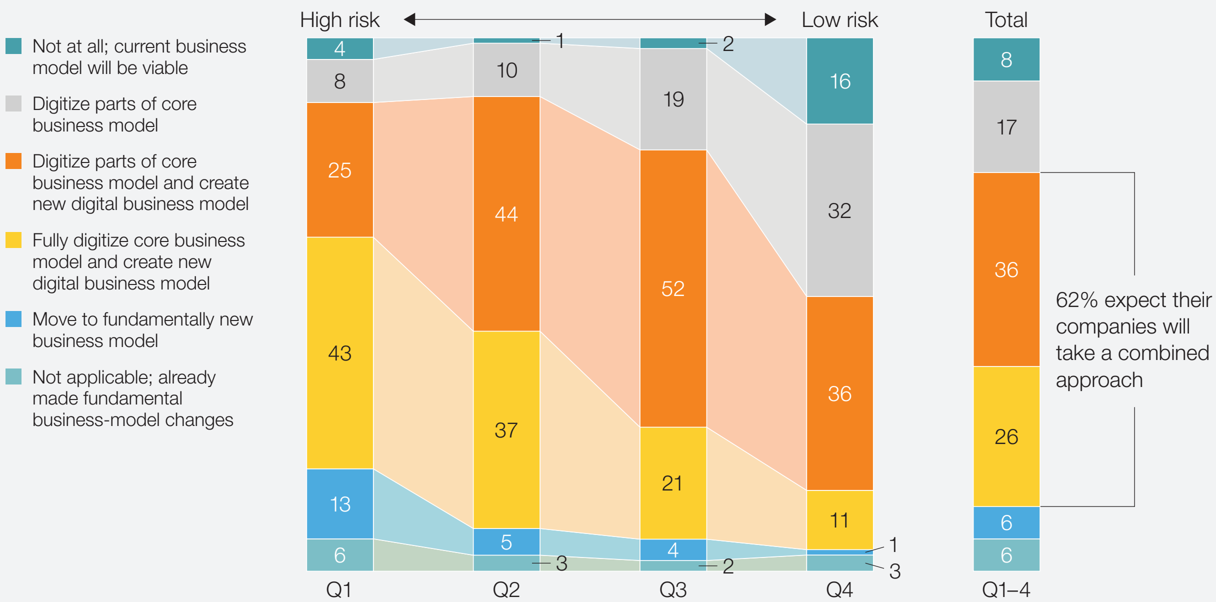
Exhibit 2 **The share of budgets and people that companies invest in digitization is proportional to the revenues earned from it.**



[1] That is, compound annual—not total—revenues from sale of digital products and/or services, or revenues generated through digital channels. For consumer packaged goods, n = 50; for insurance, n = 65; for automotive and assembly, n = 68; for retail, n = 72; for healthcare systems/pharmaceuticals and medical products, n = 101; for professional services, n = 247; for telecommunications, n = 50; for travel, transport, and logistics, n = 45; for retail banking, n = 60; for other financial services, n = 130; for media and entertainment, n = 82; for high tech, n = 237.
[2] Respondents only were asked this question if they said they have launched digital versions of their products or services.
[3] Excludes respondents in insurance and retail banking.

Exhibit 3 **Companies expecting the greatest revenue losses will need to digitize the core business fully or jettison it entirely.**

Extent to which companies' business models should change to be economically viable, by quartile of perceived revenues at risk, % of respondents[1]



[1] Figures may not sum to 100%, because of rounding.

economically viable (Exhibit 3). Most respondents—on average and across industries—say their companies should take a hybrid approach: transforming their core businesses while also creating new digital business models.

This is true even for respondents reporting the highest levels of revenues at risk, though tackling both the core business and new business models often involves a more complicated strategy and operating model than focusing on one or the other. Just 6 percent of all respondents say their companies must move to new, fully digital business models and leave the current ones behind. Only another 6 percent say their companies have already made the required changes to their business models to stay viable. Even among the most digitized industries, such as media and high tech, just one in ten respondents describes the current business model as viable in the long term.

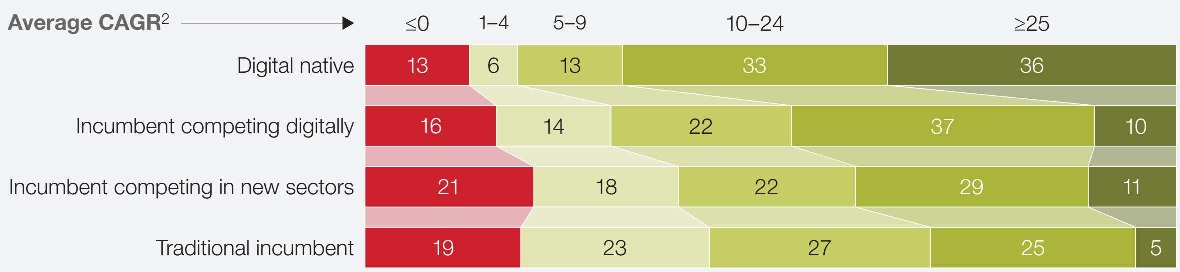
What are digital reinventors doing differently?

But not every company is responding tentatively. Some, and not just the digital natives, are embracing digital change. To better understand how different companies—incumbent or otherwise—are competing, we asked respondents to identify the current position of their own companies (each in its primary industry): digital natives, incumbents competing in new ways through digitization, incumbents competing in new industries through digital moves and initiatives, and incumbents competing primarily in traditional, nondigital ways. Responses from the first three groups—which we call digital reinventors—indicate that these companies are all outperforming their traditional-incumbent peers in revenues and earnings (Exhibit 4). Digital natives have impressive growth rates but are starting from a much smaller market share; respondents at the digital natives say they command a median of only 5 percent of the

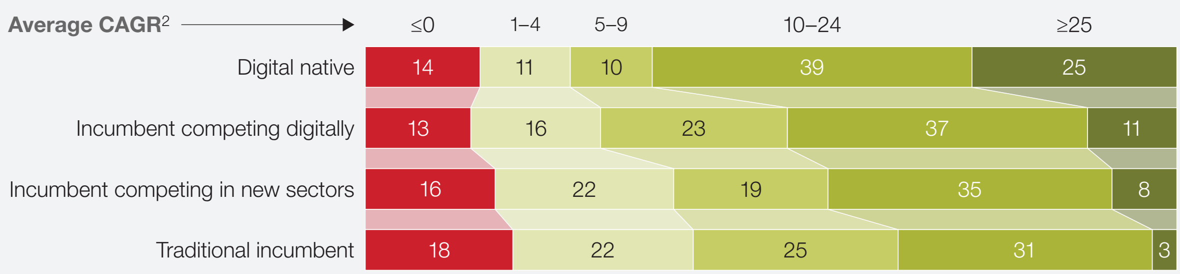
Exhibit 4

While digital natives are outgrowing industry incumbents, the incumbents that compete digitally are also doing well.

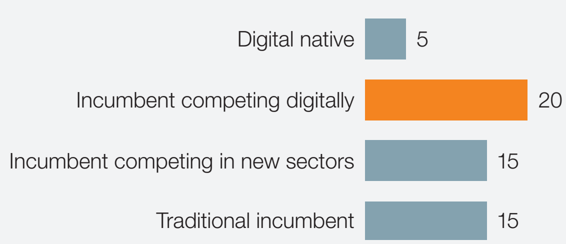
Rate of organic revenue growth, by company type,[1] %



Rate of organic EBIT[3] **growth, by company type,**[1] %



Median share of core market owned by respondents' companies, %



[1] Figures may not sum to 100%, because of rounding.
[2] Average compound annual growth rate, past 3 years.
[3] Earnings before interest and taxes.

markets of their industries. The incumbents competing digitally, by contrast, grow from a much larger base. Respondents from these companies report that they own a median of 20 percent of their core markets.

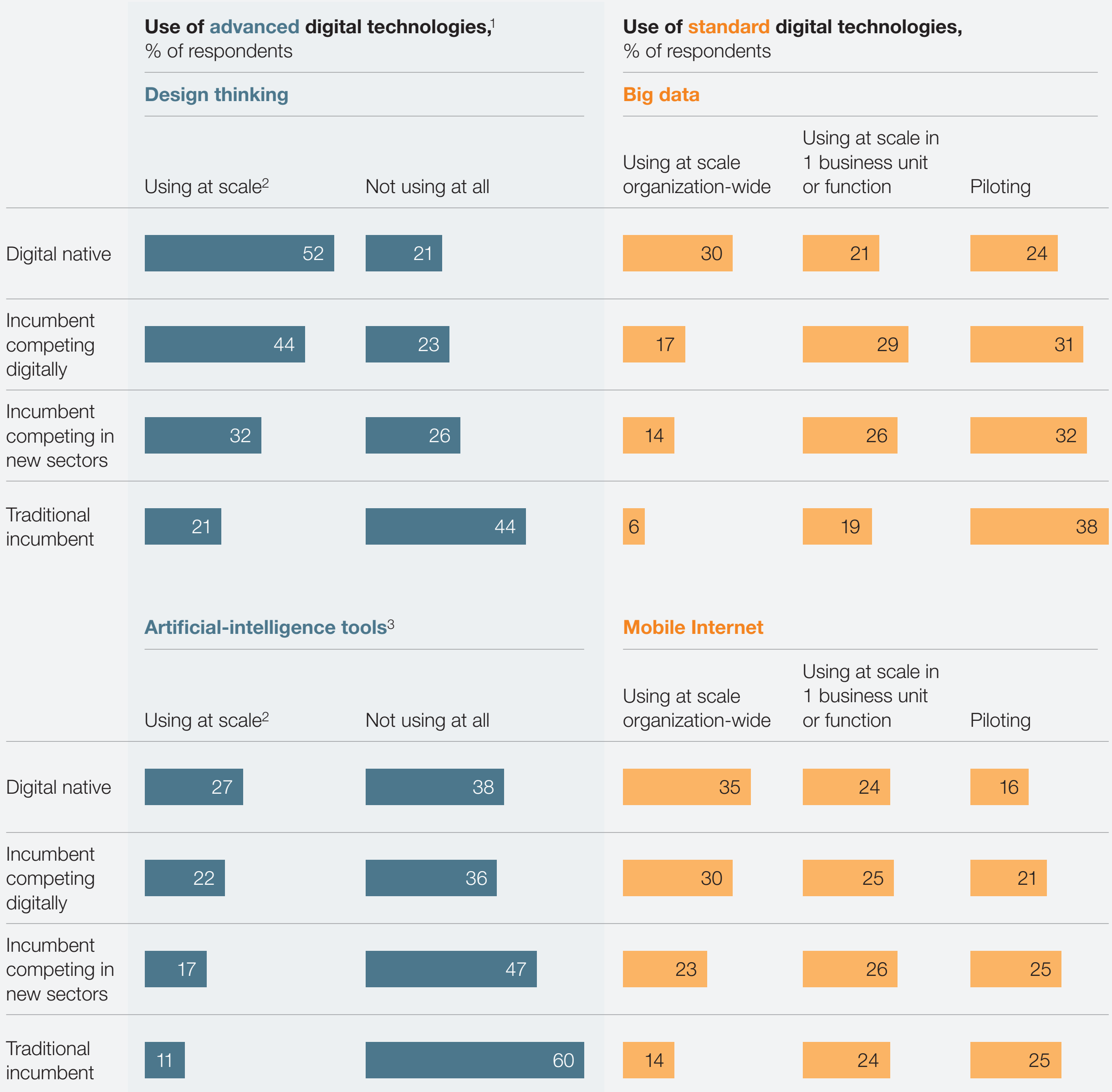
The practices of the reinventors differ from those of traditional incumbents in three critical areas: the approach to investments, the degree of innovation, and the application of digital technologies. The digital reinventors appear to be using these practices both to digitize their core businesses and to innovate through new business models.

- *Innovating the business model.* Rather than just making minor modifications to traditional business models, the digital reinventors are more likely than other companies to have made significant changes to both their strategies and the very nature of their core businesses (that is, by digitizing the core more fully and innovating with completely new digital businesses). Digital reinventors are at least twice as likely as traditional incumbents to report modifying their long-term strategies in response to digital-related changes. And when asked about specific actions taken to address digitization, the reinventors are much more likely than their peers to have launched new businesses and to have built new digital business models for their core businesses. Most notably, they are almost seven times more likely than their traditional counterparts to have fully digitized their core business models.

- *Embedding technology innovatively and at scale.* Our results indicate that the digital reinventors are more likely to use cutting-edge digital technologies—and to use them at scale—than are their counterparts, which tend to spread investments thinly across technologies, without scaling them up. Forty-four percent of incumbents playing digitally say their companies use design thinking at scale either across the organization or within functions or business units, but the same percentage of traditional incumbents haven't even started to pilot it (Exhibit 5). Incumbents playing digitally are twice as likely as their traditional-incumbent counterparts to be using artificial-intelligence tools across the organization, a trend that is active across several of the more advanced technologies we asked about.

Digital reinventors are at least twice as likely as traditional incumbents to report modifying their long-term strategies in response to digital-related changes.

Exhibit 5 **Compared with traditional incumbents, digital reinventors use advanced technologies at scale more often.**



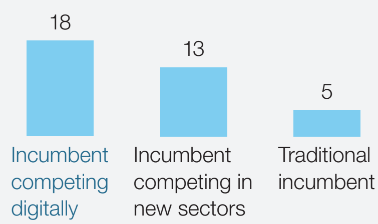
[1] The question asked about organizations' use of 12 digital technologies, 8 of which are not shown.
[2] At scale in 1 business unit or function, or organization-wide.
[3] Such as virtual assistants, computer vision, voice recognition.

- *Investing more decisively.* Responses show that the digital reinventors are likelier to invest more—and to invest more decisively—in digital than traditional incumbents are. The percentage of annual revenues invested by incumbents playing digitally (which have the greatest market share) is more than three times as high as that of traditional incumbents (Exhibit 6). But successful digitization is not only about spending more; the digital reinventors are making bolder investment moves, too. They are much more likely to divest business lines being made obsolete by digital, sometimes even before the full pain is felt. They are

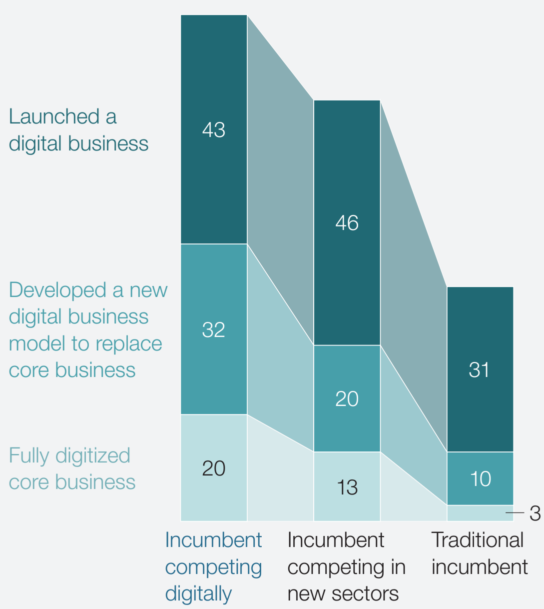
Exhibit 6

Incumbents competing through digital invest more boldly and make more meaningful changes than traditional incumbents do.

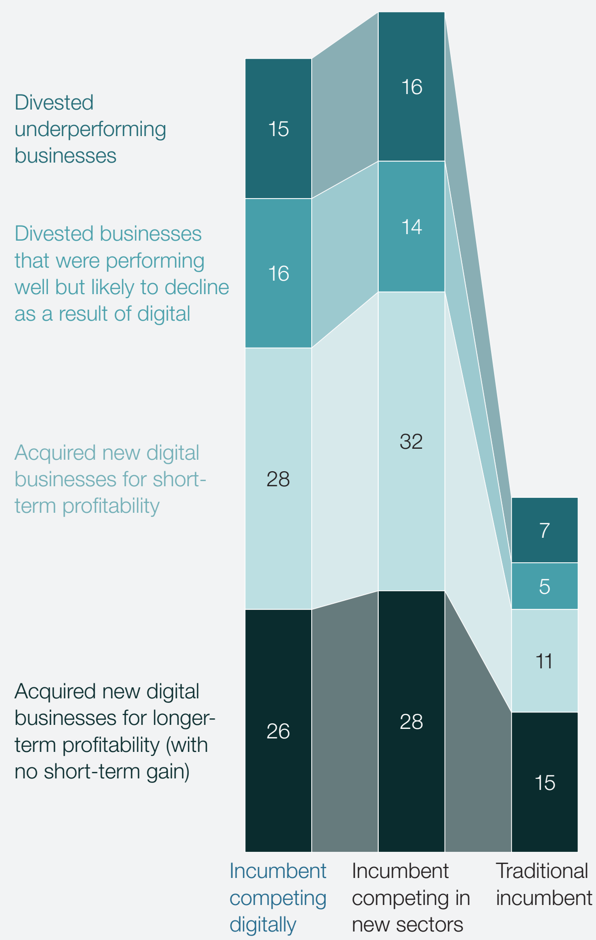
Annual revenues spent on digital initiatives in past 3 years,
% of revenues



Portfolio changes made in response to digital,
% of respondents



Actions taken in response to digital,[1]
% of respondents



[1] Out of 6 actions that were offered as answer choices. The question also asked whether companies had acquired new digital businesses that were related to, or that would diversify, their core businesses.

also more likely to make long-term digital acquisitions. Just 15 percent of respondents at traditional incumbents say their companies have, in the past three years, acquired new digital businesses that would be strategically important to their longer-term digital strategies even if these businesses did not contribute to short-term revenues. By contrast, 26 percent of respondents at the digital incumbents and 28 percent at incumbents moving into new sectors say they have made such acquisitions.

Digital reinventors don't differ from their peers only in their use of cutting-edge tools and techniques. They also differ in how they deploy the basic digital technologies, such as big data, cloud computing, and the mobile Internet. Respondents at digital reinventors are more likely than those at traditional incumbents to report the organization-wide adoption of these technologies rather than their use in a single function or business unit or in a piloting stage.

And while investing in and scaling new technologies might sound expensive, digital reinventors are also coming out ahead on that front. The returns on their digital investments are double or more than what the traditional incumbents see on theirs, according to respondents.

Looking ahead

For the companies that are not yet digital reinventors, the survey results suggest three starting points for focusing digitization efforts:

- *Take a dual approach to business-model innovation.* To find success and sustain growth, incumbents must do two things at once: digitize their core businesses while also innovating with new digital ones. Making small changes to the edges of your business model is insufficient in an increasingly digital world. To digitize the core while developing new digital businesses, a company needs a strategy much more complicated than it would need focusing on a single path. Digital strategies must create a road map for continuing to invest in and energize the core, while finding both the mind share and capital resources to innovate with new business models. Success at this game requires a tight link between strategies and the overall operating model (including IT's operating model) to ensure realistic investment projections and estimates of time to impact.

- *Be bold in experimenting with new technologies.* To make sure they get the most out of digital investments, companies need to scale up their technology investments once they have been tested. To keep pace with digital change, companies will also benefit from being more proactive in seeking and evaluating new technologies and digital advances for potential use. This requires a partnership with IT at a strategic level and continual efforts to educate business-unit leaders on the fundamentals of the latest digital technologies, so they understand how to embed those technologies at scale into their businesses to capture the value of digital.

- *Make decisive investments.* Companies that invest boldly and at scale do better than companies that are tentative. Therefore, the more hesitant companies (more specifically, the traditional incumbents) need to recraft their investment decision-making processes and their overall cultures. To make more decisive—and effective—digital moves that will drive the business forward and capture the benefits of digitization at scale, they can take a venture-capitalist approach to investing. This means moving faster to both fund and defund initiatives and being more comfortable with changes to the overall business portfolio. Since the culture of many companies is risk averse and relatively siloed,[7] a bolder approach to investments will prove to be a significant challenge if traditional incumbents don't address their culture directly. Incumbents must embrace a test-and-learn mind-set to help drive innovation and appropriate risk taking at all levels of the organization. Breaking down siloed mind-sets and behavior through more integrated, cross-functional teams—as well as a unified view of customers and what they need—can help foster a more agile culture, enabling companies to learn from experiments at a pace fast enough to respond to their rapidly changing markets. ■

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[1] The online survey was in the field from June 20 to July 10, 2017, and garnered responses from 1,619 C-level executives and senior managers representing the full range of regions, industries, company sizes, and functional specialties.

[2] We define digitization broadly as the use of digital technologies (for instance, those that connect people and devices) and data to create revenue and to improve businesses, replace or transform business processes, or both.

[3] Jacques Bughin, Laura LaBerge, and Anette Mellbye, "The case for digital reinvention," *McKinsey Quarterly*, February 2017, McKinsey.com.

[4] As measured by the shares of the organization's sales from products, services, or both sold through digital channels; of core products, services, or both that are digital in nature (for instance, virtualized or digitally enhanced); of core operations that are automated, digitized, or both; and of the volume in the organization's supply chain that is digitized or moves through digital interactions with suppliers.

[5] As measured by the r^2 correlation factor.

[6] Jacques Bughin and Nicolas van Zeebroeck, "The best response to digital disruption," *MIT Sloan Management Review*, Summer 2017, sloanreview.mit.edu.

[7] Tanguy Catlin, Jay Scanlan, and Paul Willmott, "Raising your Digital Quotient," *McKinsey Quarterly*, June 2015, McKinsey.com.

The contributors to the development and analysis of this survey include **Jacques Bughin**, a director of the McKinsey Global Institute and senior partner in McKinsey's Brussels office; **Tanguy Catlin**, a senior partner in the Boston office; and **Laura LaBerge**, a senior expert in the Stamford office.