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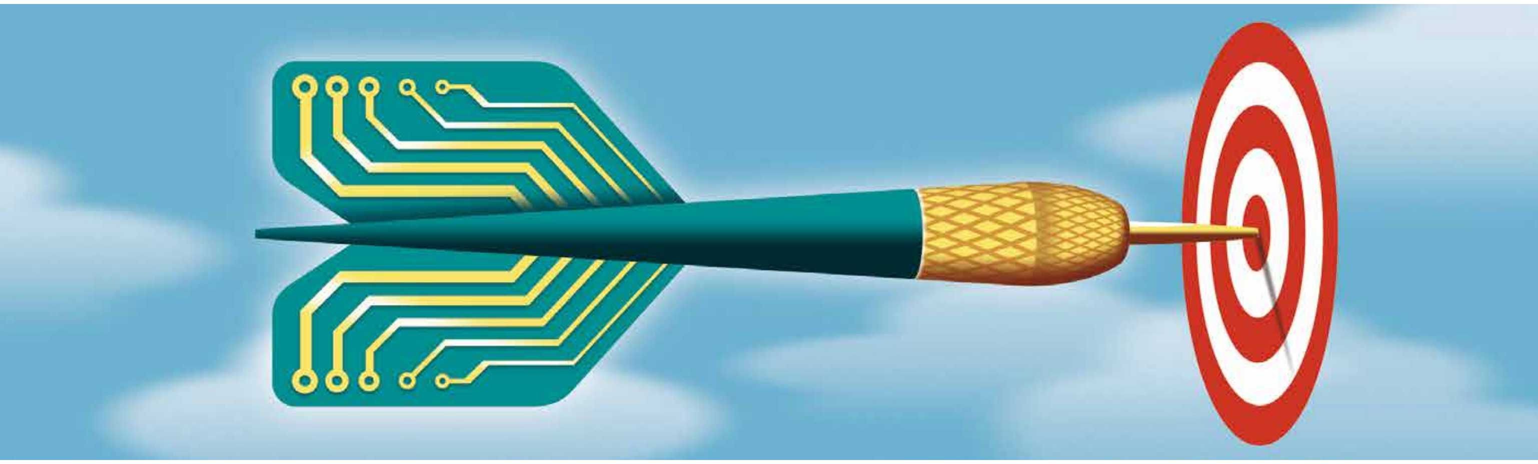


Lloyd Miller

Finding your digital sweet spot

The potential impact of digital technology varies widely by industry, but most enterprise leaders share an important challenge: how to get beyond the small share of the prize they are capturing today by looking for impact across the whole value chain.

’Tunde Olanrewaju and Paul Willmott

While online sales, social networking, and mobile applications have received most of the buzz when it comes to digital, our recent research finds that the greatest bottom-line impact may come where most companies aren’t looking—from cost savings and changes beyond the interface with customers. Our yearlong study shows that, across the industries we examined, the average bottom-line impact that can be realized from digital sales over the next five years is 20 percent: a significant opportunity to be sure, but much less than the bottom-line impact from cost reductions, which average 36 percent. (See sidebar, “Calculating the economic impact of digital transformation.”)

A too-narrow focus on distribution channels means organizations are getting only a small share of the full value that digital transformation can provide. That narrow focus may also be leaving organizations vulnerable to new entrants and agile incumbents that can translate operational improvements across the full value chain, combined with innovative operating models, into better, cheaper, more customized products, faster service, and an improved customer experience. For organizations that can step back and apply their digital investments in such a holistic way, the prize is significant.

Of course, not all industries face the same opportunities or the same threats. Hotels and airlines, for instance, are greatly exposed to the disruptive potential of digital, with our research showing that over the next five years their share of sales via digital channels will rise to 50 percent in mature markets. This will clearly disadvantage digital laggards. Large grocery chains, on the other hand, could be less affected. Their share of sales via digital channels is expected to rise to just 10 percent. With an expense base dominated by the cost of goods sold, the potential for digital to radically transform their economics is somewhat constrained.

To capture the value available, organizations will need to assess the value at stake, invest proportionally to that value, and align their business and operating models accordingly.

How digital transformation drives business value

Technology drives value in businesses in four ways: enhanced connectivity, automation of manual tasks, improved decision making, and product or service innovation (exhibit). Tools such as big-data analytics, apps, workflow systems, and cloud platforms—all of which enable this value—are too often applied selectively by businesses in narrow pockets of their organization, particularly in sales and marketing.

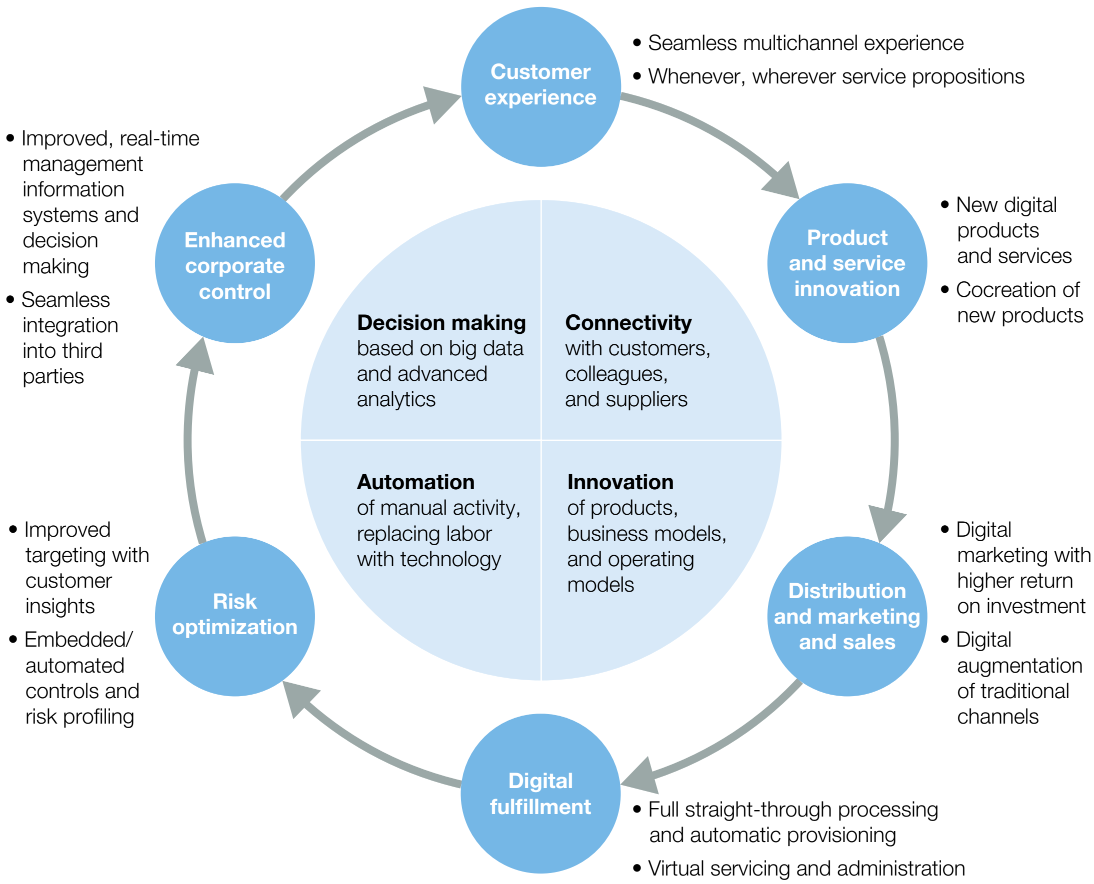
This creates missed opportunities to gain maximum advantage from digital investments. Big-data insights, for example, can be used to enhance customer targeting and adjust pricing in real time, but they can also be used for better forecasting of operational-capacity needs to boost asset and resource utilization. Likewise, app technology that is typically focused on improving customer interactions can also be applied to a broad range of internal interactions, such as HR and procurement requests. Smarter and more complete application of digital investments not only delivers concrete improvements within a given function but can also unlock "trapped" value by improving information flows and reducing waste across the organization. For example, one bank found that upgrading the digital channel drove a significant improvement in customer-data richness and quality, which increased marketing effectiveness and drove better lending decisions by reducing risk and enabling the automation of previously labor-intensive fulfillment processes. When used well, digital expands the improvements delivered in one part of an organization across the whole value chain.

Digital's bottom-line value varies by industry

Digital will be highly disruptive to some industries, affecting not only revenue and cost structures but also shaking up the core business and operating models. The music-retailing industry has already been down this path. Others are nosing into the eye of the storm. Some sectors may see less dramatic but still important shifts. We see three clusters of industries that will face varying levels of change.

Long-term multichannel. For these industries, there is unlikely to be a wholesale shift to a fully digital model in the medium term. Examples include grocery retailing and apparel. Despite innovations, such as new digitally enabled store formats, in-store digital kiosks, and highly functional e-commerce offerings, digital-sales volumes will likely remain relatively low. We project that 10 percent of grocery and 24 percent of apparel sales are likely to be online by 2018. (The average for sectors in this cluster is 20 percent.) One reason for their modest online-sales growth is that grocery retail and apparel both have persistent consumer behaviors and habits. In many categories, shopping is a highly social experience, and social-media networking to share purchases is not a sufficient substitute for in-person interaction. Digital capabilities in the near term can only go so far in simulating the

Exhibit
Digital can reshape every aspect of the modern enterprise.



Source: Expert interviews; McKinsey analysis

experience of trying on clothes or choosing fruit and vegetables. In addition, these sectors have cost structures that are less amenable to digitally driven transformation. For example, most of the costs of a large grocery retailer are the goods it sells. However, this is only half the story; we see a large opportunity for savvy competitors to drive digitally influenced sales within their physical footprint by leveraging highly targeted promotions, mobile apps with prebuilt shopping lists, and other conveniences that combine seamlessly with their traditional offerings to transform the customer experience. Given the typically tight margins in these industries, digital leaders can significantly boost profitability and command a clear performance advantage.

Eye of the digital storm. These industries are likely to see a more transformative effect from digital. Retail banking, property-and-casualty insurance, and mobile telecommunications offer virtual rather than physical products and, as such, have a cost base largely focused on processing and servicing, making them highly susceptible to digital transformation. We project digital-channel use in these sectors to average 35 percent and total cost-base potential reductions to average 20 percent. Companies in these sectors have their work cut out for them as they absorb the business-model changes taking place while fending off new digital entrants. The onus will be on the companies to act decisively and quickly, streamlining and repurposing their physical distribution and redirecting the freed-up capital to build out their digital-channel capabilities. There will also need to be a concerted focus on automating core activities to boost self-service and "straight

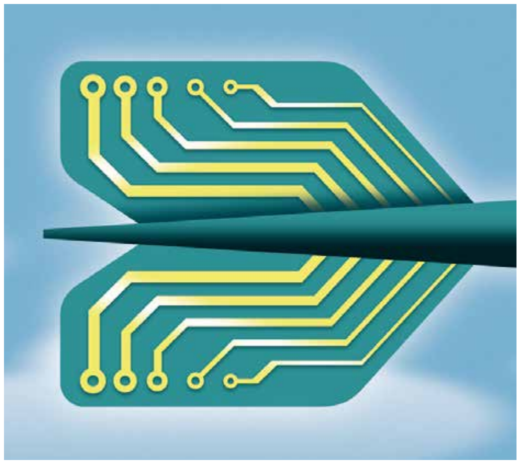
Calculating the economic impact of digital transformation

Digital transformation can make a big difference. To calculate just how big, we examined ten industries: retail banking, mobile telecommunications, airlines, consumer-electronics retailing, apparel, property-and-casualty insurance, hotels, supermarkets, pay-TV broadcasting, and newspaper publishing.

To get at costs, we recut the expense categories of these sectors on an apples-to-apples basis and computed the difference that fuller use of digital channels, greater automation, better analytics, and innovative virtual models—such as remote freelance call-center workers—might yield, using metrics such as reduced head count and improved productivity. On automation, for instance, we assessed the typical distribution of human resources across processes in a service-operations function and identified which labor-intensive activities could be done by technology. For sales, we compared the sales outperformance of selected digital leaders in each sector against the industry average, forecasting the likely digital advantage such companies could build up over the next five years. Combining this analysis with online-penetration growth rates in each industry and average margins, we were able to estimate bottom-line impact.

On average across the sectors we examined, we found that digital transformation can boost the bottom line by more than 50 percent over the next five years for companies that pull all levers. This ranged from 20 percent in pay-TV broadcasting to more than 200 percent in music retailing, with most sectors clustered in the 30 to 60 percent range. These headline figures are underpinned by a few critical insights:

most sectors are expected to double their share of sales coming from digital channels over the next five years. Additionally, digital leaders are on average growing their digital sales at 2.5 times that of their sector peers, with as high as a 9 times multiple seen in newspapers, for instance. Furthermore, we found that companies can, on average, cut the total cost base by 9 percent, resulting in average bottom-line impact of 36 percent, through shifting customer interactions to digital channels and automating paper-heavy processes. This ranged from 3 percent of total costs in grocery retailing to 20 percent in retail banking—substantial impact, which passes directly to the bottom line and reshapes the economics of competition across these sectors.



through" transaction processing. Such change may come with a stiff price tag, but these industries may have little choice but to step up in a sustained way since the trajectory suggests they are headed toward greater disruption from digital.

New digital normal. These are the industries that are visibly going through or have completed several rounds of digital disruption. Sectors like music retailing, consumer-electronics retailing, airlines, and hotels have seen their business and operating models permanently changed. They have experienced the "double whammy" of digital enabling very different sales trajectories and altering cost structures. For instance, digital sales for music retailing and consumer-electronics retailing is expected to exceed two-thirds of these two industries' total sales in five years' time. This will continue to radically reshape the distribution model for companies in this cluster. Such companies can also expect further price transparency and margin compression but will have more opportunities for real-time price changes and targeting of offers based on an increased ability to truly understand their customers. On the cost side, fundamentally different expense structures have emerged. For example, iTunes has no physical distribution, and even asset-heavy industries such as airlines are using automation to cut customer-interaction costs (for example, with e-check-in and automated departure gates). These industries will need to pursue automation in new areas; for instance, companies can leverage big-data analytics to boost supply-chain efficiency and improve asset utilization (through smarter maintenance scheduling, for example). Companies in this cluster that succeed will be those that recognize the long-term trajectory of their current model and make bold bets to reshape themselves accordingly. Given the typically thin margins in these industries, even reducing costs by a few percent will translate into significant bottom-line impact.

Investments should be proportional to the value at stake

The clear message from our research is that companies need to fully embrace digital but should do so in line with their own unique opportunity. Why build a gleaming digital empire if more targeted improvements will suffice? Conversely, why dabble with small-ticket experiments when the value at stake can radically transform your bottom line? To assess and act on the digital-transformation opportunity, we recommend four steps.

1. Estimate the value at stake. Companies need to get a clear handle on the digital-sales and cost-reduction opportunities available to them. Digital—and digitally influenced—sales potential should be assessed at the product level and checked against observed internal trends, as well as competitor performance.

On the cost side, administrative and operational processes should be assessed for automation potential, and distribution should be rightsized to reflect digital-sales growth. The aggregate impact should be computed and turned into a granular set of digital targets to monitor progress and drive value capture.

2. Prioritize. Most organizations don't have the ability, resources, or risk tolerance to execute on more than two or three big opportunities at any one time. Be selective. Figure out what areas are likely to deliver the greatest return on investment and the best customer outcomes and start there. While digital requires some experimentation, too many ad hoc demos and showcases lead to scattershot investments that fail to deliver sustained value. One retailer, for instance, ended up with 25 subscale digital offerings by not culling in the right places.

3. Take an end-to-end view. One financial-services firm built a world-class digital channel but failed to update the paper-based processes that supported it—processes that were prone to error. That false veneer of speed and efficiency eroded trust and turned off customers. The moral? Although it may seem counterintuitive, overinvestment in a slick front end that is not matched with the corresponding high-quality fulfillment that customers now expect may actually lead to increased customer frustration.

4. Align the business portfolio accordingly. In the long run, some lines of business will simply be destroyed by digital. Hanging on and tweaking them is futile. Companies need to act purposefully and divest where it makes sense, identifying what holdings are likely to be cannibalized or likely to underperform in the new environment and sloughing them off. Conversely, some areas will clearly need new capabilities and assets, which companies often do not have the luxury to build up organically over time. One retailer used targeted acquisitions to rapidly build out its e-commerce capabilities, allowing it to focus on defining strategy and aspirations rather than tinkering with the "plumbing."

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Capturing the value of digital transformation will be important in most industries—and critical for survival in some. Business leaders must assess their own company's value at stake, invest proportionally to address key opportunities and risks, and keep in mind that the greatest digital value may reside beyond their customer-facing functions.

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