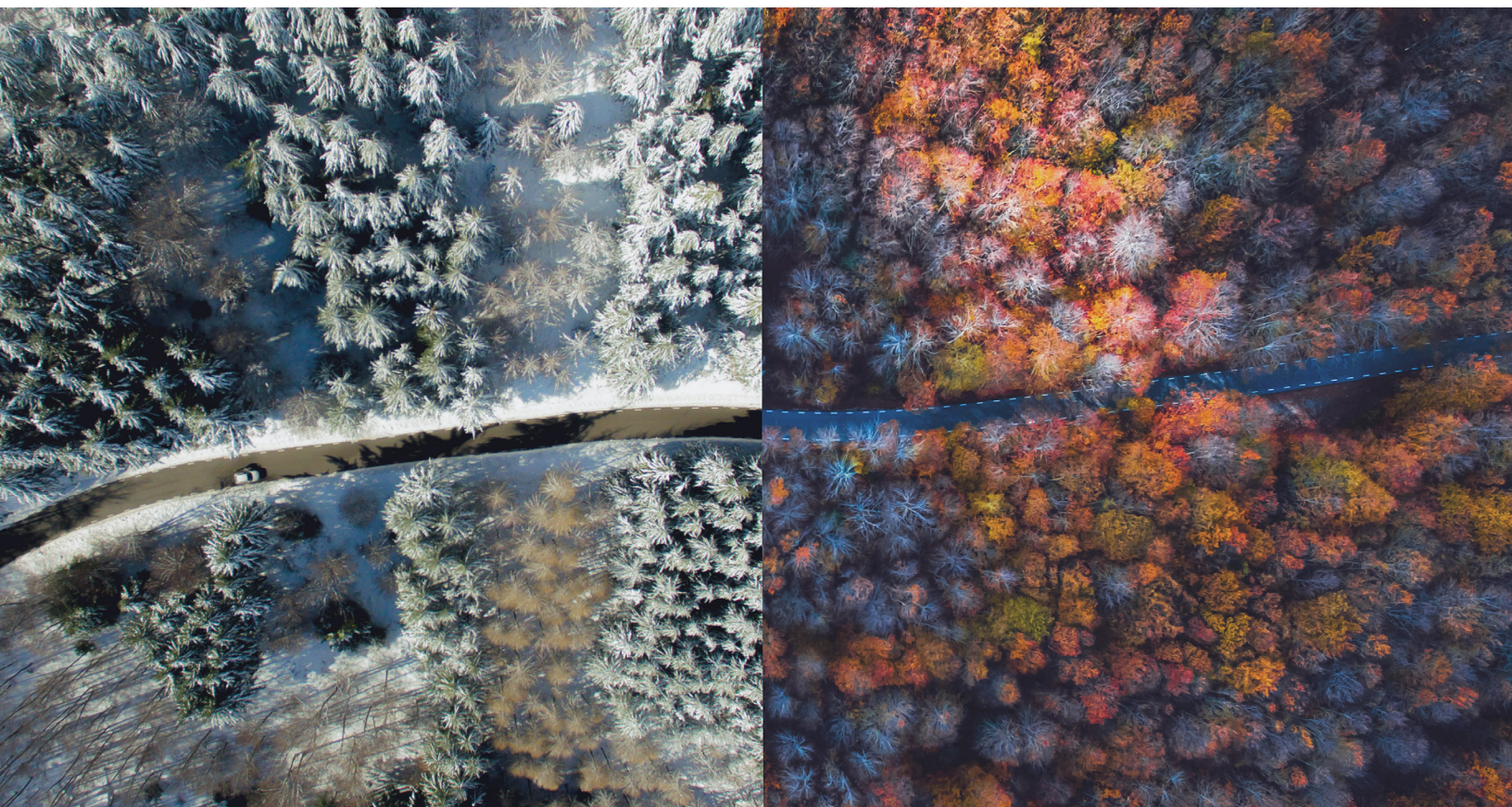


Strategy & Corporate Finance Practice

How CFOs should drive digital transformations

The chief financial officer is uniquely positioned to ensure a company moves boldly toward a shared digital goal



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In this episode of the *Inside the Strategy Room* podcast, senior partners Tanguy Catlin and Kate Smaje discuss their recent work on digital reinventions at established companies, and the role CFOs should play in them. In their conversation with communications director Sean Brown, they share their insights from recent research on the factors that separate digital winners from the also-rans. This is an edited transcript. For more conversations on the strategy issues that matter, subscribe to the series on Apple Podcasts or Google Play.

Sean Brown: From McKinsey's Strategy and Corporate Finance practice I'm Sean Brown. Welcome to *Inside the Strategy Room*. At a recent CFO Forum in London, we caught up with Tanguy Catlin and Kate Smaje, two senior partners who presented at the conference, to get their thoughts on the role CFOs should play in digital transformations. Tanguy works with major financial institutions and is one of McKinsey's leading experts on digital strategy. He is based in Boston. Kate, based in London, helps consumer-facing companies transform their businesses through strategy, marketing, operational, and organizational initiatives.

Tanguy, in your discussion today, you talked about the fact that during past disruptions, the majority of incumbent companies didn't survive. Is the current disruption, spearheaded by digital technology, going to be equally grim?

Tanguy Catlin: Well, you are correct. Disruption is not new. If you look back, there were many significant disruptions and, on average, about 80 percent of the incumbent companies were no longer around afterward. And that has been true across geographies and types of disruptions.

We are still in the very early days of this digital disruption. I don't have a crystal ball, but we did an interesting survey two years ago asking 2,500 CEOs and CFOs whether they felt they would be able to maintain their current level of performance over the next three years with their current strategies and business models. Ninety-two percent of the respondents did not have that confidence.

Sean Brown: So, what are some of the things a company must do to make it through to the other side of a disruption?

Kate Smaje: There are a few pitfalls we would highlight, and the first is about getting clear on the definition of digital. Because everyone will have a different definition, depending on the type of company and transformation they want to undergo. Someone might say, "That's what the IT guys used to do, it's just a different version of it." Someone else might say, "Lean toward more digital marketing." Others might talk about customer or omnichannel experience. That's fine on one level, but when you translate that to the boardroom, you end up with a complete misalignment and people pulling in different directions.

Sean Brown: Typically, CFOs are involved in reporting and analytics. What role should they play in terms of establishing that definition and promoting it throughout the organization?

Kate Smaje: When you think about planning processes and so on, it's the CFO who is asking where growth will come from and how to think about it relative to previous years. But the more progressive CFOs are also asking more provocative questions like, "How aligned are we, really? And if I'm managing my business plan on this definition of digital, are the commercial officer and the operations guy too? Do they all agree with that definition?"

Tanguy Catlin: You need to have alignment of the full executive suite on the definition of digital, and that requires the leaders having the conversation. Then they need to articulate that definition in a simple way that the entire organization can rally around—typically, by deploying digital strategies or digitizing their businesses in waves, starting with smaller places and expanding.

As for the role of the CFO, there are two lessons worth emphasizing. The first one is, CFOs understand macroeconomics extremely well. What's new with digital is that the marginal cost is zero: you can instantly and at no cost replicate an offering. It

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leads to massive shifts in the supply and demand curves. It means that economies of scale take on whole new proportions, which leads to the rise of ecosystems. So, I think the CFO’s first role is to explain to business leaders how the economics of their businesses are changing. It is quite dramatic. You ask yourself very difficult questions once your marginal cost is zero.

The second lesson for CFOs is congruence. How much money do we spend on digital, and how do we report on the effectiveness of our digital efforts, and is that congruent with what we are trying to accomplish? The CFO becomes the evangelist helping people understand this digital economy, and then the architect for fitting the pieces together in a way where performance can be measured.

Sean Brown: You mentioned the economics of digital. What are some of the implications for the CFO in terms of planning and running a business that recognizes the new economics?

Tanguy Catlin: Well, we looked at a few thousand companies over the past couple of years and tried to separate the winners from the losers in terms of the impact of digital disruption, and we found several lessons. The first one is that many companies fail to recognize the massive threat associated with the fact that a big part of the value creation now accrues to the customer much more than them. Think about all the industries with intermediaries, and all those places where there was no price transparency. Think about all the products and services that we used to bundle. All of those are going away with digital, and

those profit pools are unlocked to the customer, not to the incumbent. That requires companies to ask themselves very difficult questions—not only “Where is the growth opportunity?” but “What part of my business am I at risk of losing?”

The second thing is that the value pool is no longer distributed as equally among the incumbents. We see an aggregation to fewer winners. We call it the winners-take-all economy. The implication for the CFO is that a strategy that says, “We’re going to move from No. 9 to No. 8 in our industry position” is just suicide if, at the end of the day, there will only be two or three big winners.

Third, it turns out that first movers have a big advantage in digital. They learn more and faster. That, again, means the CFO has to be willing to learn quickly and double down on a bet that seems to be paying off. Finally, with the rise of ecosystems, industry boundaries are becoming meaningless, and therefore companies need to ask a new set of strategy questions: How do you expand beyond your industry, and what types of partnerships and M&A deals are needed to achieve that expansion? Those, once again, put the spotlight on the CFO.

Sean Brown: With ecosystems, does being a first mover also help you gain a prominent role in an ecosystem or even start one up yourself?

Kate Smaje: Yes, for sure. It’s back to what Tanguy said about the ability to learn as fast as you possibly can. The people who go out as first movers are often on version three, four, five of whatever they are

doing before the followers, no matter how fast they are, come up with the first version of the me-too proposition. And so, in a world where you are cycling at that rate, it's no wonder that first movers are typically the leaders.

The other point is, there are only so many partnerships to be made within these ecosystems, so if you are not fast out of the blocks in figuring out what your role and partners should be, someone else will grab that land, as it were. So, there are lots of reasons why being out in front—or at least a very, very fast follower—makes a huge difference in this space.

Sean Brown: You talked in your presentation about the duality of digital. Can you explain how that can lead to strategic misfires?

Kate Smaje: It's easy to say, "Go figure out an entirely new business model, disrupt your category and disrupt your industry, then, you know, figure out what to do after lunch." In reality, it's very tricky because you need to maintain the current business and, if you are a lead incumbent, you are controlling the market. Finding the right balance between how much time, investment, and resources to put against the core business versus innovative models is the real crux of the challenge. I don't think any of us has the perfect answer, but it comes down to having an ongoing dialogue that's often fueled by the CFO saying, "Have we got the mix right?" You might start out with 80 percent on the core business and 20 percent on the new initiatives, but then you may spot something that's got promise. So, you always have to be asking the question, how are we doing on that duality? Have we put our money where our mouth is? I see a lot of people say, "Yeah, we're spending time on this," but when you look at the capital and resource allocation, it doesn't match the words. You need to keep shifting the mix and asking, what do I know now that I didn't know six months ago, or even three weeks ago, that might shift the balance one way or the other?

Sean Brown: On that point about duality, how much of incumbents' digital activity is driven by M&A versus starting up new businesses themselves? And do you think digital M&A is unique in any way?

Tanguy Catlin: When we looked at established companies that seem to be outperforming their peers by investing in digital, we found that they tend to do a lot more M&A than traditional incumbents. Their M&A mix is also different: you see capability-based M&A—that is, not focusing just on expansion into new markets or products but on acquiring talent and competencies. It could be an "acqui-hire" deal, it could be gaining access to certain types of technology. So, yes, you tend to see M&A being a bigger lever and the type of M&A being different. The second shift we have observed is in where these companies deploy talent and investments: it is less about digitization of existing products and services and more about launching new ones.

Sean Brown: You spoke earlier about incrementalism being another potential pitfall in digital reinvention. Can you elaborate on why that is a big problem for incumbents?

Kate Smaje: If you put yourself in the shoes of the CFO or the CEO, it's easy to see why there may be a short-termist tendency. We know that CEO tenures are going down. We know that markets are impatient with financial results. But we also know that digital transformation takes time. Tanguy always talks about how disruptions often take decades before you see the full impact on business performance. So, it's not surprising that there is a level of incrementalism around digital initiatives, because that feels safer. It's risk-averse. It's what my incentive plan actually tells me to do in the next six months. That creates a real challenge in terms of being sufficiently bold in shifting the investment and focus. Some of our recent research talks not only about how much more adaptable CFOs and CEOs of digital winners are, but also when they make shifts, these shifts are likely to be two times greater than for those lagging behind.

Sean Brown: I believe the research you just mentioned comes from a new article, “The drumbeat of digital: How winning teams play.” Can you talk a bit more about the insights?

Tanguy Catlin: What we did was ask about 3,000 companies to explain how they run their day-to-day operations: the type of management meetings they have, their frequency, the nature of the decisions, and, equally important, the outcome of the decisions. So, if you decide to redeploy talent, which talent and in what proportions? Then we correlated the responses with performance relative to peers within and across industries.

Two themes emerged very strongly. The first one is, the winners move much faster, on all decisions. It's not only in talent redeployment but also on capital deployments and other moves. Remarkably, they are four times faster. That's a stark contrast. What is it that allows those organization to be four time faster? The second interesting thing is, as Kate mentioned, when they decide to make a move on M&A or relocating talent or a similar initiative, the magnitude of that move is double that of traditional incumbents.

Sean Brown: Sounds like they operate very differently from traditional incumbent companies.

Tanguy Catlin: That's right. They are bolder, and they are much faster. The organizations that outperform their peers typically make decisions on a quarterly basis that other incumbents make on an

annual basis, or on a weekly basis when others do it on a monthly basis. That means they are able to revisit their talent or capital allocation more often and learn from any experiments, then adjust faster. So, if you combine the twice bolder moves with four times faster speed, there is a ten-time differential between the winners and the rest, which makes it very difficult for those others to compete.

Sean Brown: So how does a CFO help put that kind of mentality in place? I mean, reducing cycle times of budgets is not something you can do by just waving a magic wand. What are some things that you have seen incumbents do successfully?

Kate Smaje: Part of it is a choice at the start. Am I going to transform the finance function, not just the business? We see a lot of companies trying to apply what they see in the technology space, whether it's agile or other methodologies, to their financial-planning processes and saying, “For us to work with the technology teams, we also have to change the way we think about investment horizons, about capital release over time, and redefine what success looks like.” We are seeing companies start to move away from their annual planning cycle. There is still an annual element, but it's a genuine step back and rethink about what the horizon needs to be.

The second thing I'm seeing is this notion of short term versus long term. Yes, I need to come up with the annual numbers, I need that mid-term horizon on how the business evolves, but people are also

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looking at the ten-year-plus horizon and saying, “If I take that version of what we are going to be, what our industry will look like, and I play it back to today, are there things in my current plan that I should change?” That is a good way to see if you have been incremental. I have yet to be in one of those planning sessions where that ten-year version doesn’t make everybody stop in their tracks and say, “Oh, we missed that.”

Tanguy Catlin: I agree. I would add that to be able to address both the short and long term, the CFO needs to make resources more fungible in the organization. So, if you want to redeploy talent, and talent is defined as belonging to a business unit, you will have no redeployment. It’s similar with capital. Making your operations and assets very fungible for redeployment is critical.

You also need to follow the money. Often, as CFO, you have budgets, and the budgets align with the strategy, which may be, “I want to transform the end-to-end journey.” It becomes critical to rework how you report the organization’s real performance, so you can make the trade-off in redeploying those resources along dimensions that are digitally centric—customer journey, core processes. For instance, if you combine the operational budgets with technology budgets, what happens oftentimes is the business starts spending a lot more on technology because it can get more cost out of operations. That’s hard to do when you see IT as a cost center. So, there is a big rewiring of the management of the assets that the CFO is responsible for in order to execute both the short-term bets and the long-term elements.

The last thing is, CFOs are used to asking deterministic questions: tell me how much it’s going to cost, or, how many points of market share am I going to gain? What’s going to happen to my margin? Increasingly, they also need to ask, what is it that we will learn? What are you going to test? How will we measure whether, a month from now, the lessons suggest we should spend more money there? Those are very different questions and

metrics, and they require a CFO reskilling. If the CFO doesn’t understand technology, don’t even start. The CFO has to be able to have intelligent conversations with his or her peers about what technology can and cannot do.

Kate Smaje: To that point, when CFOs see every part of the business as part of the planning cycle, they can take a theme like blockchain or Internet of Things (IoT) and ask the same question of every business, and in this way start to build up a picture of what the company’s approach to IOT is and how it’s thinking about that in the operations versus the technology, group versus commercial. CFOs are often the only people, apart from maybe the CEO, who can really ask those transversal questions.

Sean Brown: How should an incumbent that’s competing against pure-play digital companies, which don’t seem to care about profit, talk to investors?

Tanguy Catlin: It’s a real challenge. I think you need the courage to have a conversation with your investors on two fronts. The first one is what you could lose if you were not making those digital investments. Too often, you try to convince your investors that there is a great pot of gold ten years out without having the courage to say, “I’m being attacked. Those are the profit pools, those are the pain points in my customer experience that attackers are going after, and if I don’t invest a lot of money, that profit pool is going away.” So be willing to talk about the negative, not only about the positive.

The second thing is laying out a road map and a journey against this duality of digitizing the existing business versus building new ones, where the investors feel they are brought along and can understand the milestones and track the progress. Turns out that when it’s done properly, investors may be willing to give you the credit for the end of the journey early on, including the opportunity for you to invest even more and faster.

Kate Smaje: Just to build on that, a common mistake incumbents make is to see themselves as these underdogs with shrinking profit pools in a disruptive world. Actually, that's not true in most sectors. They are the ones with the brand, they are the ones with the customers, they are the ones with all this built-up equity. A resurgent incumbent in your sector is significantly more damaging than many of the digital attackers. It's easy to think about disruption by focusing on how that young person in their garage in San Francisco is going to eat your lunch, whereas you should be worrying about what your biggest competitors are doing. If they get their act together fast enough, you could be in real trouble.

Sean Brown: So, it sounds like a CFO should also be paying close attention to incumbent competitors' forays into digital and perhaps have some sort of a sensing mechanism. Any tips on how to do that effectively?

Tanguy Catlin: One is to hack your own business. Try to put yourself in the shoes of your competitors: what would you do to go after your own customer, after your own profit pool? It's very enlightening.

Bring your customers into the room and ask them what they would do. It's shocking how many top executives have never spoken to a single customer.

Kate Smaje: And bring some of your younger high-potential people into the room as well, because it's easy to get group-think around the management table. Having somebody who doesn't see the world in the same way that you see it provides that independence or diversity of thought.

Tanguy Catlin: You're exactly right. Follow the money and follow the talent. There is a lot of funding going into new areas. Understand where others are putting their chips. Talent-wise, it is very easy to map where your competitors' employees are migrating. The classic example is Apple hiring dozens of the best engineers from car manufacturers years ago—you could easily track that through LinkedIn and figure out what's at play. I think competitive intelligence is becoming a lot more analytically driven and sophisticated.

Sean Brown: Kate, Tanguy, thank you very much for taking the time with us today.

Tanguy Catlin is a senior partner in McKinsey's Boston office, and **Kate Smaje** is a senior partner in the London office. **Sean Brown** is the firm's global director of communications for the Strategy and Corporate Finance practice, also based in the Boston office.

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