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When Digital Disruption Strikes: How Can Incumbents Respond?

Volatility and Corporate Darwinism

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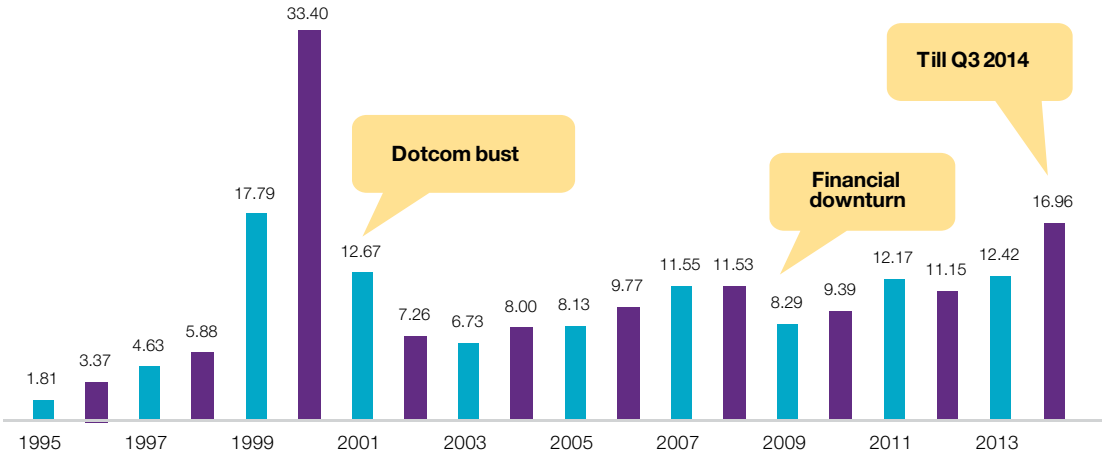
Since 2000, 52% of companies in the Fortune 500 have either gone bankrupt, been acquired or ceased to exist1. US corporations in the S&P 500 in 1958 remained in the index for an average of 61 years. By 1980, the average tenure of an S&P 500 firm was 25 years, and by 2011 that average shortened to 18 years based on seven-year rolling averages2. These are challenging times for companies as the speed, volume and complexity of change intensify.

While there are several reasons for companies vanishing from the radar or going bankrupt, technology disruptions are playing a big part in amplifying this development. One critical manifestation of this heightened volatility is the emergence of technology-driven startups across multiple sectors. Venture funding to startups is at historic highs. In just one startup hotspot, Silicon Valley, venture capital investment in the first three-quarters of 2014 was around $17 billion, a figure that is only surpassed by the peak of the dotcom era in 2000 (see Figure 1).

Digital innovation is shaking the core of every industry and incumbents are struggling to respond. The emergence of startups such as Uber – which disrupt entire sectors with their agile, innovative business models – is worrying traditional incumbents. In recent research by GE, two-thirds of respondents agreed that businesses have to encourage creative behaviors and must disrupt their internal processes in order to do so[3]. What does a successful strategy for responding to disruption look like? How fast have companies responded to digital disruptions? To understand more about how traditional incumbents respond to digital disruption, we conducted research spanning 100+ companies (see research methodology at the end of the article).

> *In most organizations, decision cycles lag technology cycles.*

Figure 1: Venture Capital Investments in Silicon Valley, 1995-Q3 2014 ($ Billions)



Source: NVCA, "National Venture Capital Association Yearbook", 2014

"In the Silicon Valley, venture capital investment in the first three-quarters of 2014 was only surpassed by the peak of the dotcom era in 2000."

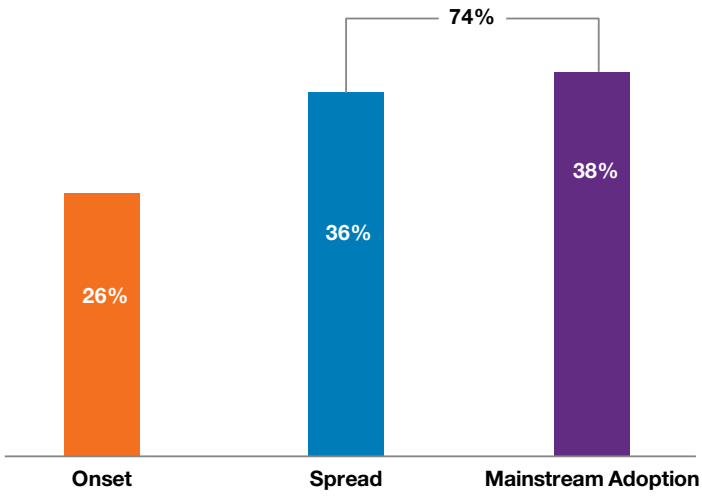
Three Quarters of Incumbents Responded Late to Digital Disruptions

There are three broad and linear stages to disruption[a]. The first stage, Onset, is typically within the first year of the arrival of disruption. That is marked by the entry of a disruptive startup that either brings forth a new technology, or a new technology-enabled business model. The next stage, Spread, typically takes place two or three years post the arrival of a disruptive technology/company. In this stage, the main disruptor starts growing in popularity, and there are multiple me-too services that mimic the disruptor. The final stage – Mainstream Adoption – is when the disruption reaches large-scale acceptance and is over four years from its arrival.

Our research found that nearly 74% of companies responded to digital disruptions only after the second year of their occurrence. Worryingly, over 38% of incumbents responded[b] to the emergence of a disruptive company after the fourth year. This is the period when the disruption starts to move more mainstream (see Figure 2). Our research also showed that the vast majority of companies that went bankrupt responded only when the digital disruption had already firmly taken root.

"Nearly 74% of companies responded to digital disruptions only after the second year of their occurrence."

Figure 2: Response of Incumbents to Digital Disruptions by Stage



Source: N=100

Source: Capgemini Consulting Analysis

A response is an action taken specifically to ward off the disruption/disruptive startup, such as the acquisition of the disruptor or the development of a new business model.

[a] Adapted from Steven Sinofsky, Board Partner, Andreessen Horowitz; http://recode.net/2014/01/06/the-four-stages-of-disruption-2/.

[b] A response is an action taken specifically to ward off the disruption/disruptive startup, such as the acquisition of the disruptor or the development of a new business model.

Why Incumbents Struggle to Respond to Digital Disruptions

In most organizations, decision cycles lag technology cycles. However, that is not the only reason why incumbents struggle to respond to digital disruptions. We found five root causes behind incumbents' slow responses.

Slow Decision Cycle

Old-school approaches to designing change – such as annual strategy meetings – are too cumbersome for a non-linear, fast-paced digital world. Technology cycles are becoming shorter than corporate decision cycles4 as technology progression accelerates. Organizations are finding it increasingly hard to match the pace of rapid technology changes. Thirty-seven percent of respondents in a global survey of industry executives reported being worried that their organizations would not be able to keep pace with technology changes and as a result, lose their competitive edge5.

> *"One key reason for organizations becoming complacent is management inertia – failure to sense the need to change."*

Complacency about Existing Business Models

One of the biggest challenges in responding to disruption is complacency. When disruption strikes, companies find it difficult to keep pace with the fast-moving and changing world as they cling on to the old successful business model. One key reason for organizations becoming complacent is management inertia – failure to sense the need to change. INSEAD's Professor Serguei Netessine believes that organizations do not ask enough hard questions of their business models. As he explains: "I like to compare it to financial auditing, which every organization does every year, many times. Often, a public company will do it once a quarter. But then you ask the same company how often [it examines] its own business models, they'll tell you, 'Well, I don't know. Twenty years ago? Thirty years ago?'"6.

There are many examples of such complacency. Consider the case of RIM/ BlackBerry. For years, BlackBerry was the product leader in enabling secure push mail on mobile phones, earning a committed following with corporate users. However, while RIM continued to focus on its lead product, Apple was reinventing what a mobile phone could be. Apple's iPhone married email functionality to tools that up until then were only possible on a PC. BlackBerry's core users began to migrate in droves. RIM believed its dominance of the enterprise market was impregnable, but trends such as Bring Your Own Device and the growth of smartphones caused massive challenges. It saw its market share of the smartphone OS market reduce from a high of 20% in Q1 2009 to as low as 0.8% in Q3 of 20147.

Fear of Cannibalizing Existing Business

The threat of cannibalizing existing business can prevent incumbents from going to market with innovative offerings. Take the case of Kodak. Kodak, an innovator in photography, invented the world's first digital camera in 1975. Despite its solid lead in the film business, it failed. Kodak had most of the patents for the digital photography technology, but did not commercialize them aggressively as it feared cannibalization of its film business. Instead, other firms licensed Kodak's technology and commercialized it. This restricted Kodak from leading the digital camera race8. As Rita McGrath, professor at Columbia Business School says, "Kodak continued to focus and invest in film-based technologies in the 1980s and 1990s, while Fuji was systematically extracting itself from film-based photography and shifting massive resources, both financial and human, to the new and unproven digital technology. By 2003, Fujifilm had 5,000 digital processing labs in chains stores through the U.S. At that time, Kodak had less than 1009."

A company that has embraced cannibalization as a very successful business strategy is Apple. The company has launched a variety of products (iPod, iPhone, iPad) that have cannibalized one another. Apple's CEO Tim Cook explains, "Our core philosophy is to never fear cannibalization. If we don't do it, someone else will[10]."

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Lower Margins in the Transition

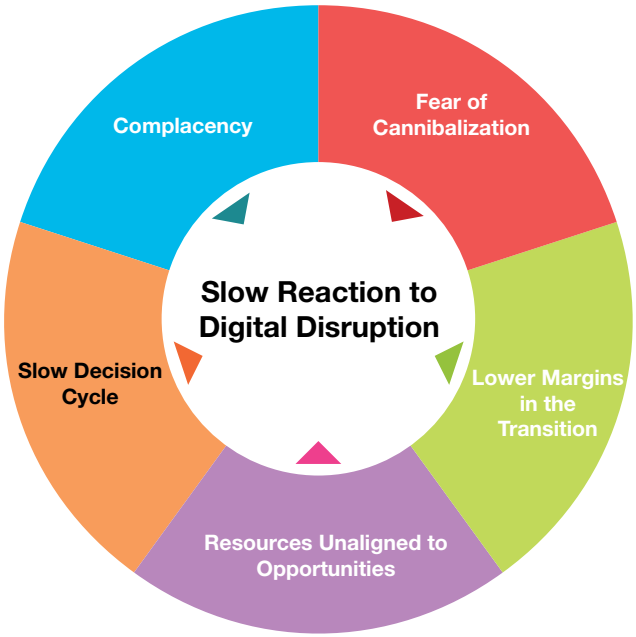
In industries where digital business has lower margin than traditional business, taking the digital path is often perceived as a significant bet on the company's future revenues. Incumbents hesitate to take the plunge. The newspaper industry, for example, has largely depended on advertising revenue to subsidize low subscription revenues. To transition to digital, where advertising rates are a fraction of what they are on print, has a significant impact on profitability. This can blind management to the potential opportunities of digital for new business models and sources of revenue.

One company that has successfully tackled this challenge is the Financial Times. Today, over two-thirds of the FT's audience is online. Mobile readership drives 50% of total traffic and 20% of digital subscriptions. The total circulation, across print and online, for the paper at the end of Q3 2014 was 690,000, the highest in its 126-year history. One key reason for this, according to its manager of marketing and audience development, is that the FT thinks of itself as "a premium brand with high quality content", and not as a newspaper[11].

Key Resources Unaligned to Opportunities

In most organizations, people are treated as resources tied to divisions, products, services and business units. Managers are typically reluctant to let go of resources assigned to them for fear of any potential diminishing of their authority. Similarly, organizations tend to try and retro-fit new opportunities into existing organizational structures. These political challenges pose significant hurdles when it comes to digital disruptions that, more often than not, cut across the entire organization.

Figure 3: Major Causes Behind Incumbents' Slow Responses



Source: Capgemini Consulting Analysis

> *"Kodak had most of the patents for the digital photography technology, but did not commercialize them aggressively as it feared cannibalization of its film business."*

Successful Responses to Digital Disruptions

> *48% of successful companies relied on hiring specialist digital talent in the wake of a disruption.*

We studied the strategies adopted by organizations that have successfully withstood digital disruptions (see research methodology at the end of the article)[c]. We found four dominant responses to disruptions adopted by these organizations: acquiring digital talent, mimicking the competition, acquiring the disruptor/ competitor and taking a judicial approach. Most successful companies adopt a combination of these responses to ensure a robust and well-rounded approach. In this section, we examine each of these winning responses in detail.

Acquiring Digital Talent Brings in Fresh Thinking

Often, incumbents resort to acquiring select digital talent so they can start to build more coherent responses in-house. Travel agent Thomas Cook was one of the early companies to be disrupted by the advent of online booking sites. The company, as part of its multi-pronged approach to this digital disruption, hired a series of executives with backgrounds in digital technology as digital 'gurus' to join its Digital Advisory Board[12]. These executives were specialists in areas such as innovation management, customer experience management, user interface design and intelligent systems[13]. In our research, we found that 48% of successful companies relied on hiring specialist digital talent in the wake of a disruption (see Figure 4).

Mimicking Enables Incumbents to Have a Ready Offering

We found that 32% of successful companies launched services that mimicked those of a disruptive competitor (see Figure 4). In some cases, the incumbent can throw significant resources at creating competing solutions. For instance, even though Apple's iPod, iPhone and iPad are known to be path-breaking and breakthrough innovations, they were not the first of their kinds. A number of digital music players existed before the iPod was launched[14]. Similarly, a number of tablet PCs were launched in the 1990s and early 2000s, but it was the entry of the Apple iPad in 2010 that sent the tablet market soaring[15]. Apple's focus on creating products that dramatically improve on competing offerings from disruptors in its industry has enabled it to continually stay ahead of competition.

> *32% of successful companies have resorted to using the legal route to slowing down disruption.*

Acquisitions Help Incumbents Compete and Scale-Up

A common response to disruption is to acquire one of the leading disruptors. Our research found that 36% of successful companies relied on acquiring companies as a tactic to access disruptive technology/ innovation (see Figure 4). Once it has completed an acquisition, the incumbent might either choose to absorb the disruptor in its operations or continue with business-as-usual.

> *32% of successful companies launched services that mimicked those of a disruptive competitor.*

An example of the former category is Walmart. The company, through its Walmart Labs arm, has over the years acquired multiple startups in innovative fields and subsequently folded the teams into their operations. Luvocracy is an example. The startup was an online community of half a million members that allows consumers to discover and buy products recommended by other people. Walmart subsequently closed the service and absorbed its key technologies into existing and proposed Walmart platforms[16].

In other instances, the acquirer allows the innovator to continue to do business without much interference. For instance, car sharing is disruptive to car rental firms such as Avis and Hertz. Realizing this, Avis paid over $500 million to buy Zipcar, a rent-by-the-hour startup[17]. The company continues to operate independently and leverages Avis' global network.

Another key driver for acquisitions is consolidation, which gives the incumbent more scale to fight back. The music industry, which suffered significant disruption from digital music, is a good example. The six major labels that existed pre-digital have now become three, with the healthier labels acquiring their struggling brethren. By doing so, these labels have increased scale, expanded their rosters of top-selling artists and increased their holdings of recording and publishing copyrights.

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[c] Successful companies are those that have maintained and/or improved their market position

A Judicial Approach Slows Down Disruptors

Digital technologies, because they are so new, are often not covered in existing regulatory legislation and base their competitive model on a disruptive approach that was not anticipated by policy-makers. Incumbents can thereby respond by suing disruptive startups, citing unfair advantage under the regulatory framework that governs their industry. Other legal concerns that incumbents typically raise against startups include the evasion of taxes, and the exposure of consumers to new risks due to disruptive platforms. Our research found that over 32% of successful companies have resorted to using the legal route to slowing down disruption (see Figure 4).

Aereo, for example, was a disruptor that offered live-streams of broadcast TV over the Internet. Since traditional broadcasters and distributors were cut-off from any monetization opportunities in this model, they sued Aereo in the US courts. The case went all the way to the Supreme Court, which ruled that Aereo was ultimately in violation of existing regulation. The company subsequently went into bankruptcy and shut down[18].

"Ultimately, if the disruptive technology has real customer value, the legal route has the effect of delaying the disruptor development but it rarely stops the technology development over time."

Similarly, Uber, the taxi-services app, has seen significant pushback from local taxi services in many cities across the world. In Spain, for instance, a local court ruled that Uber was illegal and Uber had to suspend its operations in the country. Similarly, the company has also been sued or legally questioned in several US states including California, Colorado,

Portland and Oregon[19]. However, the startup has only been going from strength to strength. It recently raised a billion dollars in venture capital and is valued at over $40 billion[20].

Ultimately, if the disruptive technology has real customer value, the legal route has the effect of delaying the disruptor development but it rarely stops the technology development over time.

Our research found that the number of companies taking the judicial route has increased significantly. While 8% of incumbents used this approach over the 2000-2010 period, in the 2010-2013 period, it has risen to 27%.

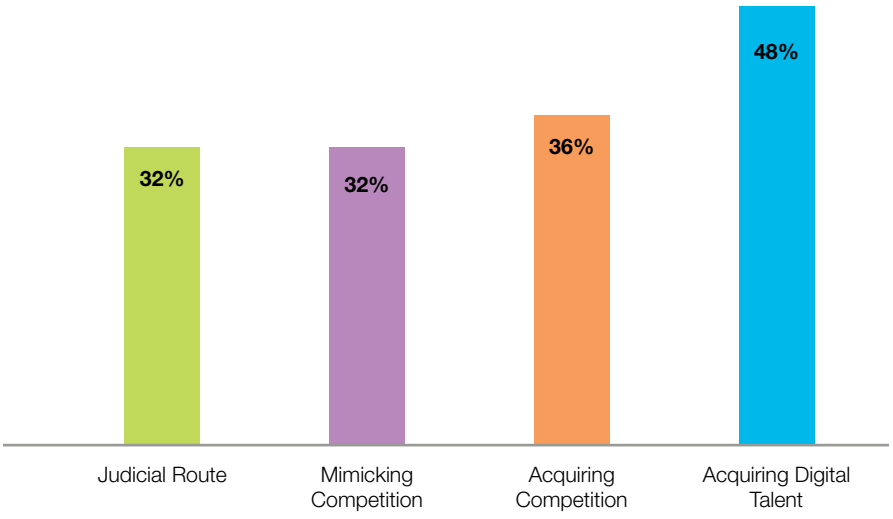
Establishing the Right Mix of Responses

Drawing lessons from incumbents that have successfully tackled disruption – retained their market position or have improved it – can help organizations establish the right mix of responses (see Figure 4).

Successful companies have a relatively even spread across different tactics. They have acquired competition, hired digital talent and gone down the legal route too. Overall, the best approach is a balanced one that uses a mix of tactics (see Figure 5 for a comparison).

"Over the years Walmart has acquired multiple startups in innovative fields and subsequently folded the teams into their operations."

Figure 4: Response Tactics of Successful Incumbents



Source: Capgemini Consulting, "Big Data Survey", November 2014

Making the Most of Digital Disruption

> *Incumbents need to constantly revisit their business model to ensure it is not outdated.*

As technology cycles keep getting shorter, disruptions will become more prevalent. And as the world increasingly becomes software-driven, competitors will emerge from adjacent industries rather than just the 'home' industry of the incumbent. Does this spell the end of the centuries-old corporation? Not necessarily. Incumbents need to position digital innovation at the heart of their business. To achieve this, they can take a series of practical steps.

Proactively Identify Customer Pain Points

One of the biggest entry points that disruptive startups take is to identify customer pain points. Resolving these customer pain points then becomes the unique selling proposition of the disruptor. Startups such as Airbnb, Uber and Lending Club, which are based on a peer-to-peer economy, have been successful because they have identified gaps in what customers want and what incumbents provide. Rachel Botsman, leading expert on the collaborative economy, highlights how these startups disrupt existing markets by solving real customer problems, "Many collaborative startups find ways to simplify complex and frustrating customer experiences. For example, Uber and Lyft have simplified an otherwise complex and unreliable experience for customers of taxi services[21]." While some incumbents react to the emergence of the pain point by denying its importance, the market has been created.

Question the Status Quo and Constantly Audit Your Business Model

As INSEAD's Serguei Netessine explains, "Business models and the advantages that flow from them are transient. What is a competitive strength today might be a burden tomorrow22." It is vital for a company to keep questioning the status quo. Blockbuster's innovative idea of sharing revenues with the studios, instead of paying the studio for each product, revolutionized the video and DVD rental market. Blockbuster's market share skyrocketed. However, they failed to look ahead and anticipate the impact of streaming and eventually went bankrupt. Netflix, on the other hand, thrived because it adapted and actively cannibalized its DVD business. Organizations will constantly have to question the status quo and pose 'what-if' questions of their core operating model.

Many incumbents typically stick to the same strategy playbook that has served them for years. However, the pace of technological change has made this approach dangerous. Incumbents need to constantly revisit their business model to ensure it is not outdated.

Reorganize Resource Allocation around Opportunities

Most organizations are typically organized by business units or market units. Resources are subsequently tied into what are in reality independent fiefdoms. Responding to digital disruptions requires that organizations move to a resource allocation that is centrally governed and organized around opportunities, not existing structures. As Columbia Professor Rita McGrath says, "In companies [that have been able to survive disruptions], employees tend to worry less about organizational roles and structures.[23]"

> *As the world increasingly becomes software-driven, competitors will emerge from adjacent industries rather than just the 'home' industry of the incumbent.*

Figure 5: Pros and Cons of Response Types

Response to Digital Disruption	Pros	Cons
Acquiring Disruptor/ Competition	▪ Enables a certain level of 'control' over spread of disruption ▪ Gives the incumbent a head-start over its competition	▪ Does not rule out the possibility of other "me-too" services that operate like the acquired disruptor ▪ Requires large investments that may be hard to justify to investors
Acquiring Digital Talent	▪ Brings in fresh thinking into the company ▪ A more robust approach that prepares the incumbent for future disruptions	▪ Hard to hire certain digital skills, e.g. analytics ▪ Requires a dedicated strategy to attract and retain digital talent
Mimicking Competition	▪ Ensures incumbent has offerings matching the disruptor ▪ Helps reduce customer churn in the short-term	▪ Risk of comparison with disruptors and falling short of customers expectations ▪ Challenges of replicating a true disruptor within existing legacy operations
Judicial Approach	▪ Allows incumbents to gain time to prepare a more coherent response	▪ Likely to antagonize existing/prospective customers

Source: Capgemini Consulting Analysis

> *"Responding to digital disruptions requires that organizations move to a resource allocation that is centrally governed and organized around opportunities, not existing structures."*

Move to an Open Innovation Model

Large companies need to learn to spot the early warning signs of disruption to avoid being surprised by their impact at a later stage. This requires a shift to an open innovation model that allows them to stay tuned to sources of disruptive innovation. An open innovation model entails engaging closely with the startup ecosystem by setting up innovation labs and incubators and partnering with startup accelerators. As David Cohen, founder of leading startup accelerator Techstars says, "Being around the disruption at the early stages – and spotting it before others do – gives you a competitive advantage and you can help the startup grow at the same time[24]."

Digital disruptions are a fact of economic life in the twenty-first century. New digital technologies do not care for organizational history or tradition. In fact, they sweep aside existing approaches and models, creating a new world order. Digital disruptions are in many ways a very democratic force and they can just as well originate within a two-person startup as they can in a $100 billion organization. While that prospect might make many incumbents feel vulnerable and uncomfortable, the secret is to see it as an opportunity.

Checklist: Are you in a Position to Successfully Negotiate Digital Disruption?

How do you spot disruptions?

- We actively look out for new technologies that can impact our industry
- We gain insights into customer behavior by actively monitoring sentiment on social media sites, understanding emerging behavior of millennials and tracking new startups globally
- We have a good view of our customer's pain points
- We have a set of leading indicators (patent filings, consumer behavior etc) that we track to foresee disruptions

How do you rate your organization's agility in responding to disruptions?

- Our leadership team has a digital vision that encompasses all organizational units
- We can quickly pull together pilots based on new technologies and get them off the ground
- We are ready to buy a disruptor if it makes strategic sense
- We have a high-level roadmap for digital transformation, which is flexible based on changing market scenarios
- We revisit our business model regularly

What is your approach to scouting for opportunities outside of your business?

- We have a 'labs' setup where we encourage investments in emerging technologies and trends
- We invest our time and effort in hiring and nurturing digital skills
- We have partnered with/ funded startups at various stages
- We encourage our partners/ customers to contribute to our product development process

Research Methodology

We conducted a comprehensive study of 100 leading companies in North America and Europe to understand how they negotiate digital disruption. For our study, we selected 10 leading players across 10 industry groups that have been digitally disrupted. The industry groups included Public Transport, Healthcare, Hospitality, Education, Publishing, News and Media, Photography, Music, Banking and Travel. All of these industries were carefully selected on the basis of disruption witnessed at various stages. The incumbents that we studied have been leading players in these industries for over two decades.

In our research, 84 companies had been successful in withstanding digital disruptions – success implies that they have maintained and/ or improved their market position – while 16 had been unsuccessful – these are companies that went bankrupt. Our focus was to understand the various strategies used by successful incumbents to respond to digital disruptions.

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