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EXECUTIVE BRIEFING // SPRING 2016

Corporate Longevity: Turbulence Ahead for Large Organizations

Half of S&P 500 companies are expected to be replaced over the next 10 years, and a new survey points to organizational inertia and lack of long-term vision

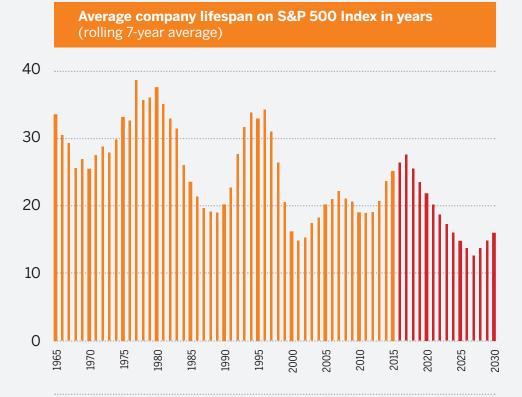
By Scott D. Anthony, S. Patrick Viguerie, and Andrew Waldeck



EXECUTIVE SUMMARY

We're entering a stretch of accelerating change in which lifespans of big companies are getting shorter than ever, according to Innosight's new study of turnover in the S&P 500. Key insights include:

- The 33-year average tenure of companies on the S&P 500 in 1965 narrowed to 20 years in 1990 and is forecast to shrink to 14 years by 2026.
- Record M&A activity and the growth of startups with multi-billion dollar valuations are leading indicators that a period of relative stability is ending and that an increasing number of corporate leaders will lose control of their firm's future.
- A storm warning to executives: at our forecasted churn rate, about half of the S&P 500 will be replaced over the next 10 years.
- In a related survey on strategic readiness, executives say that growth strategy is being undermined by day-to-day decisions inside companies and that too many companies lack a coherent vision of the future.



Data: Innosight analysis based on public S&P 500 data sources. See endnote on methodology.

Forecast: Turbulence Ahead for Corporate America

We're entering a period of heightened volatility for leading companies across a range of industries, with the next ten years shaping up to be the most potentially turbulent in modern history.

That is the conclusion of the latest Innosight study of companies on the S&P 500 list of most valuable public companies traded on a U.S. stock exchange.

Every year, a number of companies drop off the S&P 500 list and are replaced by other firms. In 2015, for instance, 28 companies were removed from the S&P 500 and 28 entered

Table 1: S&P 500 Churn Over the Past Six Years Sample companies that have exited and entered the index

EXITED THE S&P 500 ENTERED THE S&P 500 Family Dollar Dollar General Eastman Kodak Facebook Covidien Regeneron Computer Sciences Corp. Accenture Abercrombie & Fitch Fossil Inc. Level 3 Communications Sprint Activision Blizzard International Game Tech J.C. Pennev Trip Advisor National Semiconductor PayPal Universal Health Services Safeway H.J. Heinz Altera **US Steel Under Armour** Radio Shack Illumina **Dell Computer** Seagate Technology Avon **NRG Energy** The New York Times Netflix

the list. This turnover rate of 5.6% represents the highest rate of churn since 28 companies were switched out in 2009.

At the current and forecasted turnover rate, the Innosight study shows that nearly 50% of the current S&P 500 will be replaced over the next ten years. This projection is consistent with our previous analysis from 2012, which Innosight conducted with Creative Destruction author Richard Foster.

Over the past six years alone, the companies that have been displaced from the S&P list include many well-known names (see table 1). During that same time, we've seen the rise of other companies take their place on the list by creating new products and new markets.

By tracking all the additions and deletions from the S&P 500 over the past half century, our study shows that lifespans of companies tend to fluctuate in cycles that often mirror the state of

the economy and reflect disruption from technologies, ranging from biotech breakthroughs to social media to cloud computing. But over time, the overall trend line from more than 50 years of data is for average longevity to continue to slope downward—driven in part by economic cycles, intense M&A activity, and the "unicorn" phenomenon of highly valued startups.

There are a variety of reasons why companies drop off the list. They can be overtaken by a more quickly growing company. They can shrink and fall below the size threshold (currently that amount is about \$2.5 billion). Or they can enter a merger, acquisition or buyout deal with another firm.

The last reason is notable, because the current churn rate of 5.6% does not include the announced mergers and acquisitions that have yet to close. 2015 clocked in at an all-time record year for M&A, with more than \$5 trillion in announced deals. As acquired companies drop off the list and as the pace of M&A activity continues, we could be entering an unprecedented period of turbulence (see appendix on page 9).

Another force that portends displacement in the near future is the rise of so many disruptive startups with multi-billion dollar private valuations. While some may stumble, unicorns such

Detecting marketplace "fault lines" is essential not only for seeing the warning signs of industry upheaval, but to help shape your growth strategy for the future. as Uber, Airbnb, Dropbox, Spotify, and Snapchat may stage IPOs in the near future. Some newer public firms like Tesla Motors easily meet the valuation threshold for inclusion and will be added to the S&P 500 once they meet certain liquidity benchmarks.

Viewed as a larger picture, the lifespan chart serves as a barometer for marketplace change. And the stakes couldn't be higher. Shrinking lifespans are in part driven by a complex combination of technology shifts and economic shocks, some of which are beyond the control of corporate leaders. But frequently, companies miss opportunities to adapt or take advantage of change. For example, they continue to apply existing business models to new markets, fail to respond to disruptive competitors in low-profit segments, or fail to adequately envision and invest in new growth areas, which in some cases can take a decade to pay off.

Detecting marketplace fault lines

This has implications for corporate leaders today—and tomorrow. No business survives over the long-term without reinventing itself. To improve the odds of corporate longevity, senior leaders must be vigilant for potential "fault lines" in their industry that may signal weakness in tried-and-true business models, for example, or a shifting customer base.

"Knowing When to Reinvent," a recent *Harvard Business Review* article co-authored by two Innosight senior partners along with Aetna CEO Mark Bertolini, details a framework for detecting five fault lines that indicate whether successful companies are heading into a period of disruption and change that requires a new vision of the future and their company's role in it.

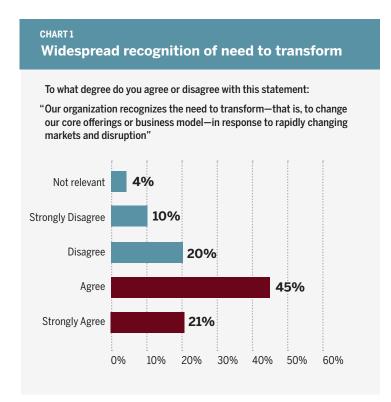
Leaders who define a vision for the future must follow it up with a commitment to invest in and manage long-term innovation and to build consensus for change among key stakeholders.

"Should we transform—and can we?"

How prepared are companies to respond to this increasing disruptive change? We recently surveyed executives and received responses from 91 companies with revenue greater than \$1 billion across more than 20 industries, including leaders of companies in automotive, consumer goods, computing and software, finance and insurance, healthcare, and professional services. Half of the firms are headquartered in North America, and half in Asia, Europe and elsewhere.

We asked respondents whether their organization needs to transform—that is, to change their core offerings or business model—in response to rapidly changing markets and disruption. A full 66% agreed or strongly agreed with the transformation imperative. (See chart 1.)

At the same time, more than 37% of respondents said they were not confident that they could achieve a transformation over the next 5 to 10 years. Only about 15% said they were "very confident."



What accounts for this confidence gap? One major factor is what we call the "shadow strategy," when organizations default to standard operating procedures that perpetuate flawed models at the expense of new growth strategies. In response to the question, "what is your organization's biggest obstacle to transform in response to market change and disruption?" 40% of survey respondents blamed "day-to-day decisions that undermine our stated strategy to change." (See chart 2.)

Lack of imagination stands out as another major culprit, as 24% said that a coherent vision for the future is what's missing most.

Assessing long-term growth strategy

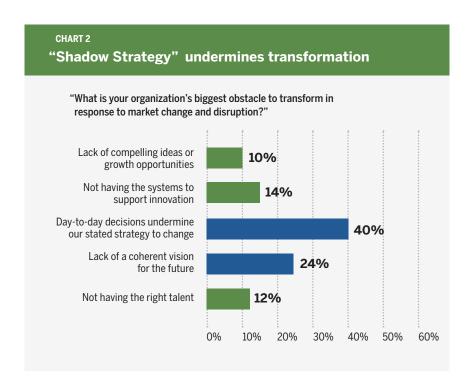
Innosight's survey looked at additional measures of strategic readiness. One is whether or not large companies have a growth plan that looks out beyond the short term. Only 24% reported having a growth strategy with a time horizon of beyond five years. Since transformational innovation often takes longer than five years to pay off, we believe those 24% are more likely to have a strategic advantage.

Meanwhile, about 16.5% of executives report not having a formal growth strategy or any growth plan at all. When we asked why, a full 27% agreed that "we're too busy executing" and "really don't have time to focus on it." An even larger group, 33%, said "we don't have a good process for formulating a growth strategy that we're confident about."

Speed is also important, and that can be particularly challenging for large incumbents, compared with more nimble startups. When we asked respondents to describe the pace at which their organization is able to respond to marketplace disruption, a combined 54% said they were moving slower or somewhat slower than the market. And only 26% said they were moving at the same pace. Just 16% said they responded faster than the market. (For related research on the increasing pace of change, see "The Faster They Fall," in Harvard Business Review.)

Committing to long-term innovation

Yet some companies do manage to overcome those forces of inertia. On the positive side are the companies that say they are succeeding with long-term innovation. For the 50 large companies in the survey that report having launched a transformative innovation that was met with at least some success, strong leadership and commitment is a primary driver.



A solid majority of 58% of those executives cite committed leadership as the single biggest factor determining success in the marketplace.

Meanwhile, 18% cite strong processes and systems to keep it on track, 12% cite a strong culture of innovation, and 12% cite mechanisms to ensure continued funding in the budget. (See chart 3.)

Yet, as we detailed at the outset, the survey results more strongly highlighted how difficult it is for leaders to break free of the organizational inertia of existing mindsets and processes in large organizations. The CEO cannot lead by issuing a decree.

Leaders have to confront what might be called tensions, balances, or, even in extreme circumstances, paradoxes. They must optimize today, and discover tomor-

row. They must be decisive and bet on moonshots, and defer to experiments. They have to focus, and enable serendipity. They have to leverage the core, and break its constraints.

How churn takes its toll

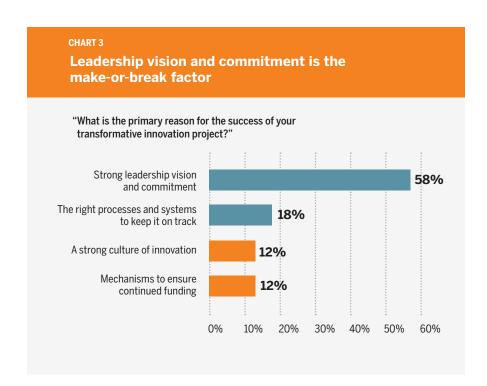
Very few companies have been able to embrace these best practices consistently over time. Overall, only 64 companies have endured on the S&P 500 list for all of the past 50 years.

Among them are industrial stalwarts like Caterpillar, Boeing and General Electric, consumer companies such as Coca-Cola, 3M, and Procter & Gamble, but almost no technology-based firms other than IBM. The rest of the list has turned over many times. Indeed, more than 1,600 companies have appeared on S&P 500 at one time or another.

Another group of companies have staged comebacks, to return to the S&P after years of being absent, including companies such as Delta Airlines and General Motors. The reemergence of iconic companies shows that turnarounds do happen, and that it is possible through smart strategy to both restructure costs and achieve new growth through innovation.

Typically, however, once a company falls, it falls for good. The story of U.S. Steel shows how a company that was once near the top of the list can decline below the threshold, as the once

iconic firm did this past year. Cofounded in 1901 by J.P. Morgan, U.S. Steel was the world's first firm to be valued with a \$1 billion market capitalization and in 1957 became an original member of the Standard & Poor's 500.



But over the decades, the Pitts-burgh-based company fell from a pillar of the economy to become a case study in how a giant can get disrupted by new technologies and startups with new business models. As recently as 1998, US Steel had a market capitalization of \$34 billion. Its current valuation of about \$1.2 billion is below the threshold for inclusion on the S&P 500.

Indeed, the American steel industry was a key case study that led Innosight co-founder Clay Christensen to develop the theory of disruptive innovation 20 years ago. But as he warned then, the rise and decline of U.S. Steel is not unusual. Its longevity was impressive compared to other companies that are now being disrupted, merged or acquired at a much faster rate.

Determining staying power

While the staying power of S&P 500 firms is often determined by technological and economic trends that are difficult to control, some companies have managed to succeed over time. The companies that have remained on the list and produced strong growth are largely a function of what we call long-view leadership.

For instance, firms such as Johnson & Johnson, General Electric, and Procter & Gamble have not only remained on the list for more than a half century but are currently in the top 12 in overall market cap (see table 2). What those three companies in particular have shown is that investment in long-term innovation pays off and that a strategy of making big moves to enter new markets and exit declining ones can help large organizations weather change over time.

The staying power of those companies is even more impressive given the high turnover in the upper echelons. Out of today's top 12, three of them (Amazon, Google, and Facebook) were founded over the past 20 years and entered the list in the last decade.

In the end, the lessons from the existing firms as well as from those that have grown stronger are the same: Leaders need to evaluate the shifting ground beneath their organization not only to detect the warning signs but also to gather signals of what their growth strategy for the future should look like.

After all, we can't know for sure what the future holds. But companies can adapt to change by launching new growth ventures that move them beyond their historic core business. Our work shows that the companies that continually find ways to reinvent themselves are the ones that control their own destiny.

Table 2: A Dramatically Different Top Twelve					
TOP 12 IN 2015	MARKET CAP (\$B)		TOP 12 IN 2000	MARKET CAP (\$B)	
Apple	\$710		General Electric	\$474	
Alphabet/Google	\$449		ExxonMobil	\$302	
Microsoft	\$368		Pfizer	\$290	
ExxonMobil	\$334		Citigroup	\$287	
Wells Fargo	\$297		Cisco	\$275	
Johnson & Johnson	\$274		Wal-Mart Stores	\$287	
Facebook	\$272		Microsoft	\$231	
General Electric	\$259		AIG	\$229	
JP Morgan Chase	\$255		Merck	\$216	
Amazon.com	\$247		Intel	\$202	
Wal-Mart Stores	\$230		Johnson & Johnson	\$181	
Procter & Gamble	\$218		Coca-Cola	\$164	

^{*2015} valuations as of 7/24/15

About the authors

Scott D. Anthony is managing partner, S. Patrick Viguerie is president, and Andrew Waldeck is a senior partner at Innosight.

Special thanks to Evan I. Schwartz and John Van Landeghem for the preparation of this report.

About the methodology

The S&P 500 turnover analysis is based on data compiled from public sources and is inspired by research conducted by former Innosight director Richard Foster. Churn rate is calculated by dividing the number of exiting companies in a given year by the total companies in S&P 500. To smooth out anomalous years and show overall trend lines, we calculated 7-year average rates, using the formula: (6 years preceding + current year) (1/7)-1. Average tenure is calculated by 1/(7-year average rate). This calculation is done for each year for the chart on page 2. Forecast is based on peak and trough CAGRs. The Strategic Readiness Survey was taken by a sample of subscribers to Innosight's Strategy & Innovation newsletter in October 2015. Out of a total of 471 respondents, 91 were from companies with revenue at \$1 billion or greater, and that more focused sample is the basis for the survey results.

About Innosight

Innosight is a growth strategy consulting firm focused on helping organizations design and create the future, instead of being disrupted by it. We work with clients across a range of industries to build new growth ventures, develop innovation capabilities, and accelerate organizational change. For more information, visit us at www.innosight.com.

APPENDIX

Record M&A activity signals volatility

In 2015, merger and acquisition announcements exceeded \$5 trillion in a single year, a new record, according to data from Dealogic. When so many large, established companies are delisted and subsumed into even larger organizations, it serves as a signpost for what's ahead.

The previous record was set in 2007, for instance, when \$4.6 trillion in deals were announced. Adjusted for inflation, that figure becomes \$5.27 trillion in today's dollars, making the years roughly comparable. What was notable about M&A activity in 2007 was that it signaled turbulent times ahead economically. The three following years were some of the most volatile years of corporate turnover.

The largest categories in M&A last year were in the health-care and tech sectors, with \$723.7 billion and \$713.1 billion in announced deals, said Dealogic. The biggest deal of the year was the \$160 billion merger of Pfizer and Allergen. And at \$66 billion, the privately held Dell takeover of EMC is the biggest tech deal of all time (see table 3).

And there appears to be no letting up. "After a record-breaking year for acquisitions," says Bloomberg Business, "executives are looking for more."

Table 3: The 10 Biggest M&A Deals of 2015				
ACQUIRING COMPANY	TARGET	DEAL VALUE (IN \$B)		
Pfizer	Allergan	\$160.0		
Anheuser-Busch InBev	SABMiller	\$117.4		
Royal Dutch Shell	BG Group	\$81.5		
Charter Communications	Time Warner Cable	\$79.6		
Dow Chemical	DuPont (merger of equals)	\$68.6		
Dell	EMC	\$66.0		
HJ Heinz	Kraft Foods	\$62.6		
Anthem	Cigna	\$55.2		
Energy Transfer Equity	Williams Cos.	\$55.0		
Cheung Kong Holdings	Hutchison Whampoa	\$53.1		

DATA: DEALOGIC