The Truth About Corporate Transformation

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Corporate transformation sits atop the strategic agenda for many CEOs. While transformation is ideally undertaken preemptively, in practice it is much more commonly a reaction to changing — and challenging — circumstances. Such transformations represent a fundamental and risk-laden reboot of a company, with the goal of achieving a dramatic improvement in performance and altering its future trajectory.

Given the stakes, we were startled to find that the research underpinning the design and execution of corporate transformations is surprisingly thin. As a result, transformations are often guided by beliefs that, while seemingly plausible, are more anecdotal than empirical in nature. It’s time for a more evidence-based approach.

To study corporate transformation and its success factors, we analyzed financial and nonfinancial data of all U.S. public companies with $10 billion or more market cap between 2004 and 2016. We identified companies with a demonstrated need for fundamental change, namely, those companies with an annualized deterioration, relative to their industry average, in total shareholder return (TSR) of 10 percentage points or more over two years. This definition provided us with a large data set for empirical analysis including more than 300 companies across different industries over more than a decade.

Further, we trained a proprietary algorithm to quantify the strategic orientation of companies, based on semantic patterns within the “Management’s Discussion and Analysis” section of 70,000 10-K filings. We built a prediction model to identify formalized transformation programs, based on restructuring costs and major corporate announcements (as reported by Standard & Poor’s Financial Services LLC). And we conducted a multivariate regression analysis to determine the impact of a number of factors on change in TSR during transformations.
Empirical Patterns of Transformation

Our analysis reveals that leaders must be ready to transform their companies: At any given point in the 12-year period we studied, 32% of all large companies were experiencing a severe deterioration in TSR, and that share has stayed roughly constant in recent years. We also found that successful recovery from a severe episode of deterioration is the exception rather than the norm: Only one-quarter of the companies were able to outperform their industry in the short and long run after the point of deterioration. Moreover, transformations appear to be getting somewhat riskier over time, as the rate of success fell from approximately 30% in 2001 to 25% by 2012. This pattern of frequent failure in turnarounds is striking.

A few other significant patterns emerged from the evidence. For one thing, the need for transformation and its risks were higher when digital disruption was involved. The need for transformation was strongest in the technology industry, with 41% of companies suffering severe TSR deterioration. Moreover, tech companies were among the least likely to outperform their industry following a corporate transformation, along with the companies in the consumer sector, which also has experienced a high level of digital disruption.

Our analysis also revealed that companies with the most severe downturns — a two-year TSR deterioration of 20+ percentage points — were especially unlikely to succeed at transformation. More than 95% of these organizations failed to return to their prior level of performance; instead, they became stuck at a lower level or continued to decline still further. This pattern suggests that leaders must recognize performance deterioration early and act quickly, because if they wait for a point of deep crisis, their company may never recover.

Finally, we found that patterns of transformation differ by competitive volatility, as measured by changes in industry sales ranking. Companies in turbulent competitive environments (that is, in industries located in the top quartile of changes in sales ranking) were more likely to require corporate transformation and more likely to fail at it than organizations in stable competitive environments. Thirty-seven percent of large companies in turbulent environments experienced severe TSR deterioration compared to 30% of large companies in stable environments. And transformations were also riskier for companies in turbulent environments, with a lower chance of recovery (-5 percentage points) in the long run.

Five Evidence-Based Factors in Transformation Success

Considering the increasing pace of technological change and volatility in many industries, the patterns suggest that the need for transformation is rising, while the chance of successfully achieving it is falling. On the positive side, our empirical research also reveals a number of factors that can help large companies beat the odds.

1. Efficiency and investor expectations are key to short-term success in transformations... As might be expected, our analysis found that organizations that successfully recovered from severe TSR deterioration relied on cost-cutting as a principal driver during the first year of their turnaround effort. But more surprisingly, investor expectations (as measured by company valuation relative
to earnings) were a slightly stronger driver of short-run TSR recovery than costs, accounting for 37% of outperformance.

This suggests that to get a transformation off on the right foot, simply cutting costs is not enough. Leaders also must regain investor confidence, by telling a convincing story about how they will leverage their newfound flexibility for future success. In doing so, they can ensure that the company remains viable and resists short-term market pressures, funding the journey for future stages of transformation.

2. ...but revenue growth is the primary driver of long-run success. While cost-cutting and investor expectations are necessary to ensure transformation viability in the short term, after year one of a transformation, our research reveals that revenue growth becomes an increasingly important driver of TSR success. By year five, it outweighs each of the initial primary drivers of success. (See “Revenue Is the Main Driver of Long-Term Success.”)

Revenue Is the Main Driver of Long-Term Success

Investor expectations are the strongest driver of short-run TSR recovery, while revenue is the most important component in the long run.

Note: Graph excludes negative contributions.

1. Based on TSR growth relative to industry over given time frame from turnaround sample. Revenue contribution = sales growth; cost contribution = (earnings growth – sales growth); expectations contribution = (share price growth – earnings growth); cash yield contribution = dividend yield including share repurchases; all benchmarked to industry averages; based on 70th- to 95th-percentile performers (to exclude outliers).

Source: S&P Capital IQ, BCG Henderson Institute analysis

Thus, transformation efforts cannot focus solely on short-term, operational improvements. They also must introduce a new strategy for growth, the “second chapter” of transformation. The second chapter requires that leaders challenge the foundations of the company’s business model, create a new vision for growth, and commit to see the program through. This is especially important in an era of secular change, when companies cannot rely on a cyclical bounce-back to restore performance, but instead, must learn how to thrive in a new environment.
3. Long-term strategy and research and development (R&D) investment support transformation success, especially in turbulent environments. Multivariate analysis revealed that transforming companies with an above-average long-term strategic orientation (as determined by a natural language-processing algorithm) outperformed those with a below-average orientation by 4.8 percentage points. This finding was even more pronounced when transforming companies were operating in turbulent environments. In such environments, a long-term orientation is associated with a TSR increase of 7 percentage points.

Another manifestation of a forward-looking orientation that predicts transformation success is R&D investment. Our analysis found that during transformations, companies with above-average R&D spending perform substantially better (+5.1 percentage points TSR impact) than those with below-average spending. 5

There, however, is a limit to how much transforming companies can achieve by increasing the intensity of R&D investment alone. Our analysis shows that the returns on R&D diminish quickly as investment levels rise above the industry average.

Capital expenditures are also a performance driver in transformation, but to a lesser extent than R&D spending. We found that transforming companies with above-average capital expenditures (relative to industry peers) perform slightly better over a five-year period, but that effect is only one-third as large as the effect of R&D. This further reinforces the need to invest in a strategic way for the long term, because capital expenditure investment is often aimed at improving the existing model (for example, upgrading production machinery), as opposed to finding new sources of growth.

4. New, external leadership improves the odds of transformation success. Our analysis of transforming companies found that only 24% of them changed CEOs. This is a slightly higher rate than CEO changes at all other companies (19%), but it is surprising that more than three-quarters of troubled companies stuck with their current leaders in this era of increasing investor activism and performance pressure.

Nevertheless, the long-term effect of changing CEOs in transforming companies was positive. New CEOs increased TSR by 9.2 percentage points over a five-year span, compared to 4.6 percentage points for incumbents. But there is a price to be paid for top leader transitions in the short run: New CEOs performed worse (-3.9 percentage points TSR impact) than incumbent CEOs in the first year of recovery.

Beyond the CEO, change in the broader leadership team is also a predictor of transformation success. We found that only 20% of transforming companies had high executive turnover (defined as more than 20% of officers) immediately after severe TSR deterioration. But the high turnover had a positive impact (+4.4 percentage points TSR) on transformation success.

The source of a new CEO — internal or external — is another critical choice in companies facing transformation. Here again, there are trade-offs, which have been clearly articulated by Harvard Business School professor Joseph Bower: “Insiders know the company and its people but are often blind to the need for radical change — they’ve drunk the Kool-Aid. Outsiders see the need for a new approach but can’t foster change because
they don’t know the company or industry sector well enough.”

Our analysis revealed that most companies opt for the Kool-Aid: More than 80% of new CEO hires during transformations came from within the corporation. But on average, external hires performed better in the long run during transformation (+4.5 percentage points TSR impact, controlling for other factors). That said, we also noted that outsiders had a wider range of positive and negative outcomes than internal hires. This suggests that transforming companies should carefully consider their risk tolerance before selecting a new leader from outside the organization.

5. Formalized transformation programs are helpful, as long as they have sufficient scope and scale. Our analysis shows that large, publicly announced transformation programs are common, but not universal, among companies with a demonstrated need for transformation. More than half (57%) of the companies launched a formal transformation within one year of experiencing a severe TSR deterioration. Furthermore, their programs increased their odds of transformation success in the short and long run.

In the short run, formalized programs boosted investor confidence. Programs announced within a year of severe deterioration were followed by increases in TSR due to increased company valuation relative to earnings. In the long run, they led to sustainable improvements in the business, as evidenced by a higher increase in TSR over five years (+5 percentage points on average). This suggests that investors are right to increase their expectations after the announcement of a formal program, because these efforts lead to change that cannot be matched by merely flexing regular operating procedures.

However, it is critical that formalized programs have adequate scope and scale. Among companies with formalized programs, 46% ran their programs for five consecutive years or more (either as one continuous program or as an unbroken series of overlapping programs), a share that has been increasing over time. Those long-term efforts were especially effective at driving success for transforming companies in turbulent environments, with a 10-percentage-point increase in five-year TSR change, compared to shorter programs.

Similarly, transformation programs are most effective when their magnitude sufficiently addresses the challenge. Larger programs (those involving restructuring costs of at least 2% of sales) have a larger impact on long-run success, compared to smaller-scale efforts, with a 5 percentage points greater change in five-year TSR.

Playbook for Transformation Success

All of the success factors detailed in this article bolster the odds of success in corporate transformation individually. But when they are used jointly, most of them yield an additional impact — one that is greater than the sum of their individual parts.

For instance, our analysis shows that companies that changed CEOs also received a positive impact of 7.7 percentage points from formalized programs, compared to just 1.4 percentage points for companies with incumbent leaders. The combination of a long-term strategic orientation and above-average R&D investment also packs a substantially more powerful wallop. The
positive impact of R&D spending is nearly twice as large for long-term-oriented companies than it is for short-term-oriented companies.

This suggests that the optimal playbook for transformation should involve combining several success factors, such as reorienting strategy for the long term, investing in R&D, redesigning the leadership team, bringing in external perspectives, and formalizing the change program. Indeed, when we analyzed the results of the small minority of companies that used at least four of the success factors in their transformations, we found that they achieved the largest increase in TSR: +17.4 percentage points over five years (see “Companies Incorporating Multiple Factors Have Outsized Results”).

Companies Incorporating Multiple Factors Have Outsized Results
Combining multiple success factors results in an increased performance.

1. Five-year change in TSR compared to two-year deterioration window, benchmarked to industry average.
2. Long-term orientation, R&D, CEO change, outsider CEO, formalized transformation program.
3. Only includes companies reporting R&D.

Note: U.S. public companies, excluding energy with $10B+ market cap from 2004-2011, and two-year TSR deterioration of 10 percentage points.

Source: S&P Capital IQ, BCG Henderson Institute analysis

Of course, not every success factor will be relevant in every corporate transformation. But given the high stakes in these initiatives, leaders need and deserve evidence-backed recommendations. As we’ve shown, empirical analysis reveals not only the significant factors in transformation success, but the patterns that emerge in their aggregation. Sometimes this analysis supports conventional wisdom, and sometimes it contradicts it, but either way, companies can’t afford to ignore it.
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References

1. Excluding the energy sector, due to outsized impact of volatility in energy prices.

2. Defined as one year and five years after the point of deterioration.

3. Using S&P Capital IQ data, we determined the average change in competitive ranking (by sales) for all companies within each industry group. The type of environment is based upon that average change. The changes are weighted by rank so that shifts at the top have a higher impact (e.g., going from 1 to 3 is a larger change than going from 11 to 13).


5. We define “above-average R&D spending” as having a higher ratio of R&D/sales than the industry average based on our analysis of S&P Capital IQ data.

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