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THE NEW RULES OF COMPETITION

- BE PARANOID
- DISRUPT YOURSELF
- GO TO WAR FOR TALENT

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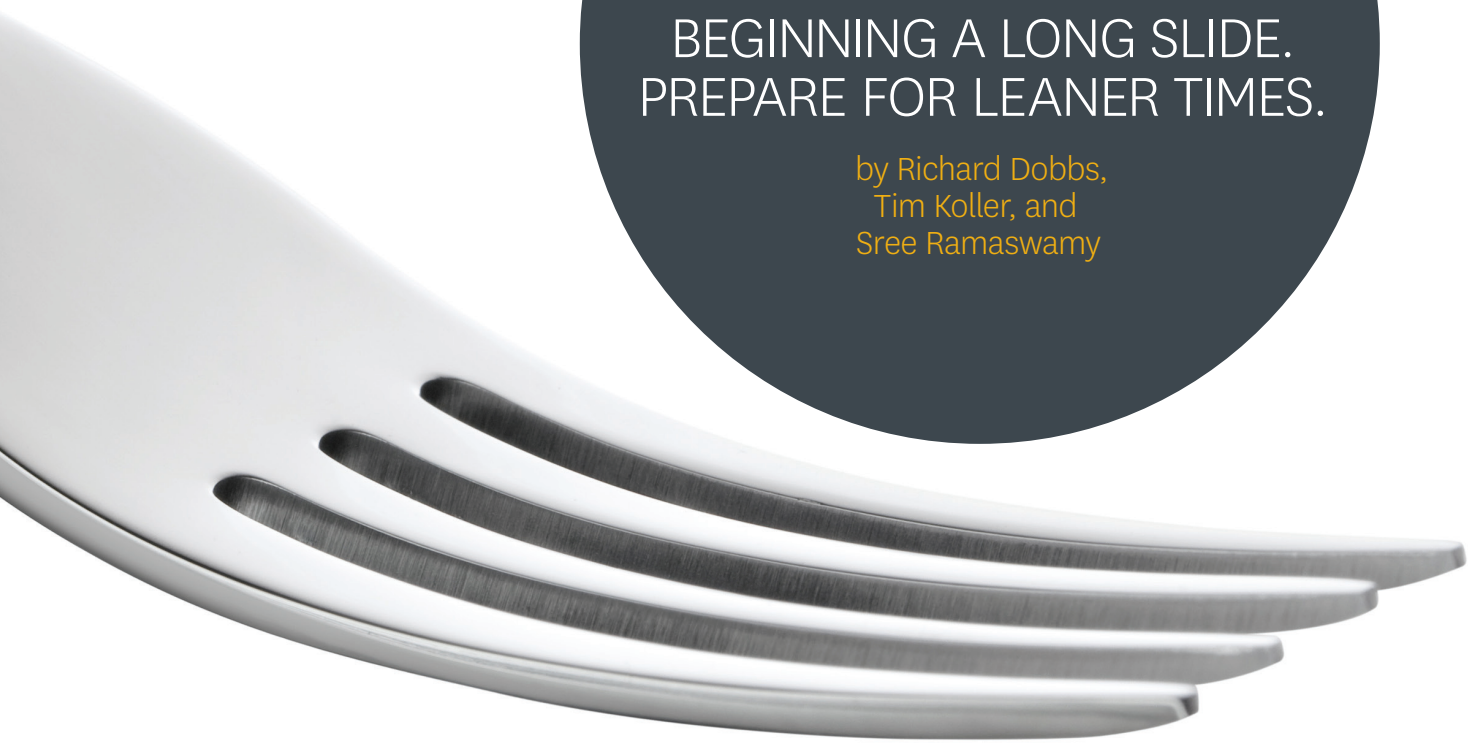
THE FUTURE AND HOW TO SURVIVE IT

CORPORATE PROFITS ARE BEGINNING A LONG SLIDE. PREPARE FOR LEANER TIMES.

by Richard Dobbs, Tim Koller, and Sree Ramaswamy



WE'D CALL IT THE OPPOSITE OF A PERFECT STORM: a set of external circumstances that together create an exceptionally favorable economic environment. The largest North American and European multinational corporations have been sailing through one for the past 30 years. In that time they have enjoyed their longest and strongest run of rising profitability in the postwar era, thanks to an environment that has supported robust revenue growth and cost efficiencies.

From 1980 to 2013 global corporate after-tax operating profits grew 30% faster than global GDP; today they stand at about 9.8% of global GDP, up from 7.6% in 1980. Corporate net income grew more than 50% faster than global GDP, from 4.4% of global GDP in 1980 to 7.6% in 2013. North American and Western European companies now capture more than half of global profits. North American firms increased their post-tax margins by 65% over the past three decades; today their after-tax profits, measured as a share of national income, are at their highest level since 1929. (See the exhibit "The Profit Boom" for a summary of key figures.)

It has been a remarkable era, but it's coming to a close. Although corporate revenues and profits will continue to rise, the overall economic environment is becoming less favorable, and new rivals are putting the Western incumbents on notice. Many of the new players are from emerging markets, but some are surprise intruders from next door, either tech companies or smaller technology-enabled enterprises. Those competitors often play by different rules and bring an agility and an aggressiveness that many larger Western companies struggle to match. In this new world, corporate performance will no longer outpace the global economy. We forecast that in the decade ahead, although operating profits will continue to grow in absolute terms, they will fall to 7.9% of global GDP—around what they were when the boom began. In other words, the stratospheric gains of the past 30 years could all but vanish in just 10.

In the following pages we'll explain what is changing in the global economic and competitive environment and consider how today's leaders can be tomorrow's as well. To set the context for that, let's look at the main drivers of success so far.

WHY PROFITS ROSE

The start of the profit boom coincided with the spread of deregulation and privatization around the world. That trend first took hold in Western countries and moved on from there; in the early 1990s India, China, and Brazil all undertook varying degrees of privatization. The movement introduced private-sector competition to vast swaths of global business, from automobiles, basic materials, and electronics to infrastructure industries such as telecom, transportation, and utilities—all of which had a strong legacy of state ownership. In 1980 those infrastructure industries, most of which were tightly regulated, generated more than $1 trillion in revenue. By 2013 they were generating more than $10 trillion, two-thirds of which was open to private-sector competition. (All revenue and profit figures for 1980, 2013, and 2025 are in 2013 U.S. dollars.)

During the same period a huge wave of urbanization and industrialization in emerging markets contributed to the growth of the global consumer class (which includes people with disposable income exceeding $10 per day). That segment has grown from around one billion in 1980 to around 3 billion today, creating new markets for the offerings of Western multinationals and spurring global investment in infrastructure, factories, and housing. In China alone, capital investment grew from 29% of GDP in 1980 to 47%, or $4.3 trillion, in 2013, and countries across Asia have undertaken ambitious capital projects, from oil refineries and power plants to steel mills and cement plants. Globally, fixed capital formation has nearly tripled in real terms since 1990, with the private sector accounting for a vast majority of the increase. For Western multinationals,

Idea in Brief

THE CHALLENGE

In the decade ahead global profits will fall back from just under 10% of global GDP to about 7.9%—about the level they were in 1980. Hardest hit will be North American and Western European companies, which currently account for more than half of global profits.

THE REASON

The economic environment is becoming less favorable, and new rivals from emerging economies and the tech sector are putting Western incumbents on notice. The newcomers play by different rules and bring an agility and an aggressiveness that many Western companies struggle to match.

THE RESPONSE

To maintain their lead in the coming years, big North American and European companies must:

- Be paranoid
- Seek out patient capital
- Overcome inertia
- Build new intellectual assets
- Go to war for talent

those investments have more than made up for declining capital investment at home: Publicly traded companies from advanced economies have poured almost $4.5 trillion into the build-out, much of it across the emerging world, just since 2000.

The multinational companies that have been best placed to exploit those factors have come mostly from North America and Europe. Although Japanese and Korean companies accounted for nearly 10% of global profits in 2013, their margins haven't risen as much as those of their Western rivals, which dominate the more profitable sectors: idea-intensive industries such as pharmaceuticals, media, finance, and information technology, which account for about 22% of revenues but 41% of profits.

The strong position of multinationals from developed countries rests on three advantages:

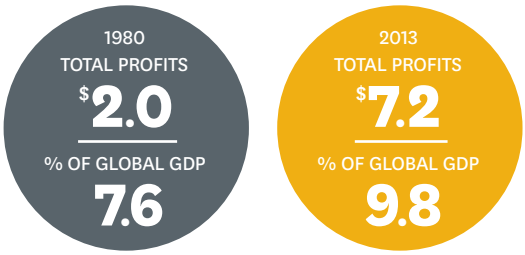
Scale. In some industries—even idea-intensive ones—the bigger a company, the higher its profit. Just 10% of public companies accounted for 80% of the profits generated by all such firms in 2013. In North America, public companies with annual sales of $10 billion or more captured 70% of the profits in 2013, up from 55% in 1990 (after adjusting for inflation). Here, developed countries had a head start because they were home to the world's biggest businesses. They still are. Some of these companies are as large as nations: Walmart's profits are comparable to Botswana's GDP, and its workforce is bigger than the population of Latvia or Slovenia. Exxon Mobil's profits are the same as Bolivia's GDP. At nearly $750 billion in early 2015, Apple's market capitalization was almost as large as the whole of Russia's stock market.

A global presence. Successful Western companies have used their size to expand aggressively abroad, thus capturing the increase in global revenue driven by economic development in China,

THE PROFIT BOOM

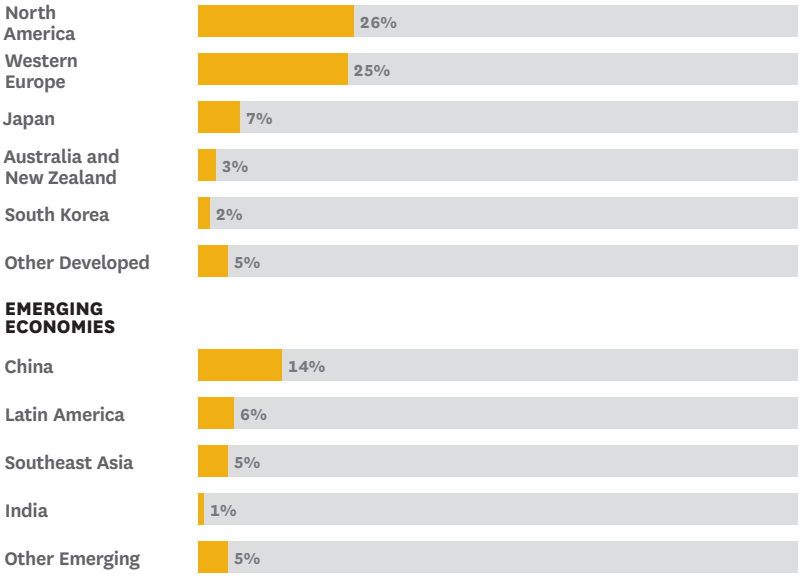
Since 1980 corporate profits have grown at an unprecedented rate, increasing their share of global GDP by 30%.

GLOBAL CORPORATE AFTER-TAX OPERATING PROFITS (2013 US$ TRILLIONS)



Multinationals from North America and Western Europe have been the biggest beneficiaries.

% OF GLOBAL PROFITS, 2013



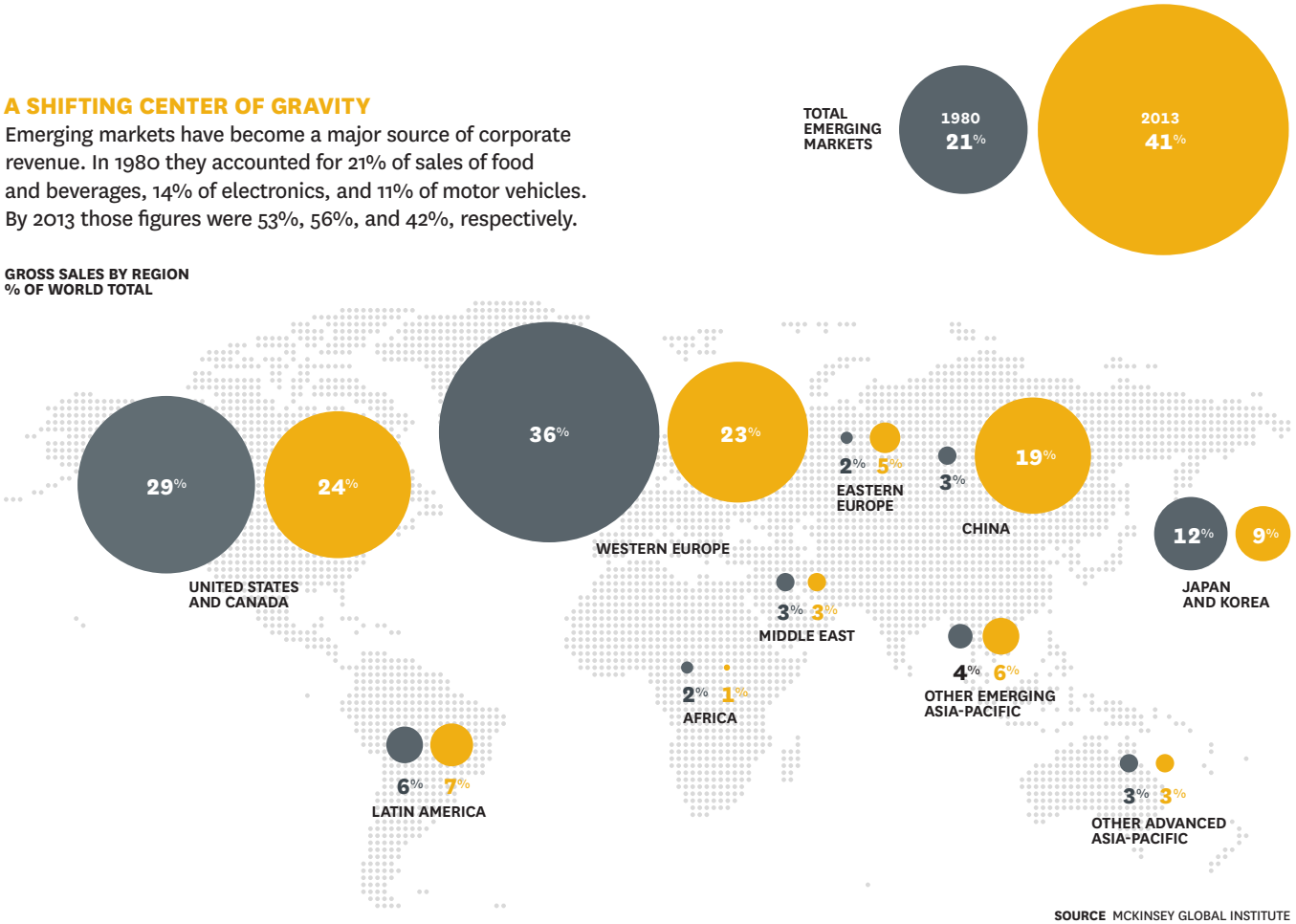
SOURCE MCKINSEY GLOBAL INSTITUTE; DATA IS FROM 16,850 PUBLICLY LISTED FIRMS AND 11,400 PRIVATELY HELD FIRMS, EACH WITH MORE THAN $200 MILLION IN ANNUAL REVENUE.

other parts of Asia, and Latin America. In 1980 just 21% of global corporate revenue came from the emerging world; by 2013 that had almost doubled, to 41%. (See the exhibit "A Shifting Center of Gravity.") In response, large Western corporations have transformed themselves from predominantly national corporations into truly global ones. GE, for example, generated $4.8 billion in revenue outside the United States in 1980, but by 2014 that figure had climbed to about $80 billion, more than half the company's total. The story was similar at other firms: By 2010 nearly half the revenues of the S&P 500 came from outside the United States.

Falling costs. Developed-world multinationals have exploited unprecedented opportunities for reducing costs. The biggest sources of savings have been falling labor costs and the higher productivity of both capital and labor. Greater automation has gone hand in hand with falling technology prices; since 1990 the gap between the cost of industrial robots and the cost of labor has decreased by 50% in advanced economies. Since 1980 the global workforce has grown by 1.2 billion people, most of them from emerging markets that have become more connected to the rest of the world through supply chains and migration. Falling tax rates and borrowing costs have accounted for about 15% of the total gain in net income. Since 1980 corporate tax rates have dropped by as much as half (from a high of 45% to 60%) in a range of nations, including Australia,

A SHIFTING CENTER OF GRAVITY

Emerging markets have become a major source of corporate revenue. In 1980 they accounted for 21% of sales of food and beverages, 14% of electronics, and 11% of motor vehicles. By 2013 those figures were 53%, 56%, and 42%, respectively.



SOURCE MCKINSEY GLOBAL INSTITUTE

Canada, Germany, and the United Kingdom. At the same time, the cost of borrowing has tumbled. Back in 1982 the yield on 10-year U.S. Treasury notes was nearly 15%. Today it's about 2%, and U.S. firms have seen a full percentage-point decline in interest expenses relative to revenue. Similar dynamics have been at work in Europe and Japan, where benchmark interest rates are close to zero.

So, what has changed?

GROWTH AND COSTS HAVE BOTTOMED OUT

Powered by the twin engines of a growing workforce and increasing productivity, the global economy has expanded by about 3.5% annually since 1980. In contrast, annual GDP growth averaged less than 2% in the 100 years prior to World War II. However, as populations age in the developed world and China, workforce growth is slowing and even declining in some regions. Absent a step change in productivity growth, GDP growth will fall to 2.1% globally and 1.9% in developed countries within the next 50 years.

In addition, the favorable cost drivers that Western multinationals were able to exploit have largely run their course. Interest rates are now so low in many countries that borrowing costs simply can't fall much further and might even be starting to rise. The big tax-rate decline of the past three decades also seems to have ended. Indeed, tax inversion schemes, offshoring, and the use of transfer pricing are drawing political flak in several deficit-ridden countries.

As for labor costs, wages in China and other emerging markets are rising. Rather than continuing to reap gains from labor arbitrage, companies will fight to hire skilled people for management and technical positions. New jobs require disproportionately greater skills, especially in science, engineering, and math. In China, once the main source of new workers, the demographic pressures of an aging population and falling birth rates could further increase the country's labor costs. And most other emerging markets do not yet have the high-quality rural education systems required to build a disciplined workforce.

Aging is also a big problem in the Western multinationals' home markets. One-third of today's workers in advanced countries could retire in the next decade, taking valuable skills and experience with them. In countries such as Germany, Japan, and Korea, nearly half the workers will be over the age of 55 in another 10 years, and replacing them with younger individuals would require politically challenging changes in immigration policy.

Talented people in emerging markets now have more options. The most coveted jobs used to be with Western multinationals, but that is changing. As companies from China, India, Brazil, and elsewhere in the emerging world become global firms themselves, they are closing the gap in terms of remuneration and opportunities for career growth. They tend to have young, skilled, and highly motivated workers who are willing to put in long hours or work nonroutine shifts—and some have exported that model to their foreign acquisitions.

COMPANIES IN THE EMERGING WORLD ARE CATCHING UP with Western multinationals on pay and career opportunities.

The result is an intensifying global war for talent. In a recent McKinsey survey of 1,500 global executives, fewer than one-third said that their companies' leaders have significant experience working abroad—but two-thirds said that kind of experience will be vital for top managers in five years.

EMERGING-MARKET COMPETITORS HAVE CHANGED THE RULES

There are now twice as many multinational corporations as there were in 1990—85,000 is a conservative estimate. Although two-thirds are still headquartered in advanced economies, the balance is quickly shifting. In 1990, 5% of the *Fortune* Global 500 came from emerging markets. In 2013, 26% did. By 2025, we estimate, more than 45% will.

These new competitors are growing more than twice as quickly as companies in advanced economies, both in their home markets and beyond, eroding the traditional Western advantage of scale. Although their track records for profit and performance are uneven, the most successful of these players are now as big as or bigger than competitors from the U.S. and Europe. For example, the world's three largest makers of domestic appliances as measured

by profits are Chinese: Gree Electric Appliances, Midea Group, and Qingdao Haier, with combined revenues of $60 billion and profits of $4.5 billion. So are the three largest banks: Industrial and Commercial Bank of China, China Construction Bank, and Agricultural Bank of China. The Indian telecommunications firm Bharti Airtel has about 310 million subscribers worldwide—more than the populations of France, Germany, the United Kingdom, and Spain combined.

The growth of these players has been supported by their ownership models. Major U.S. and European companies' broad public ownership, board structure, and stock exchange listings typically enforce a sharp focus on near-term profitability and cost control. But many emerging-market firms are state- or family-owned and so have different operating philosophies and tactics. (See the exhibit "A Different Breed of Owner.") Many of the new competitors take a longer-term view, focusing on top-line growth and investment rather than quarterly earnings. Growth can be more important than maximizing returns on invested capital: Chinese firms, for example, have grown at a blistering pace—four to five times as fast as Western firms over the past decade, particularly in capital-intensive industries such as steel and chemicals.

Aggressive mergers and acquisitions are often the means to achieving growth. In 2013 Chinese firms completed 198 overseas deals worth $59 billion—one-third the total value of their acquisitions that year. Over the past four years, Chinese firms' share of global deal value has exceeded their share of global revenue by almost 30%. But China is not alone. India's Sun Pharmaceutical Industries, for example, has made a stream of acquisitions since the 1990s to become one of the world's largest generics companies. The Tata Group, based in Mumbai, encompasses 19 companies with more than 50,000 workers in the United Kingdom alone, making it one of that country's largest private-sector employers. Brazil's JBS has become the world's biggest meat producer through a series of acquisitions, including U.S.-based Swift & Company and Pilgrim's Pride.

What's striking is that size doesn't necessarily lead to a loss of speed and agility. Indeed, a few of the most globally competitive emerging-market giants have managed to stay lean. Some of the newer competitors, even in durable goods manufacturing, operate with greater capital efficiency and higher asset turnover than industry incumbents in advanced economies. For example, Hyundai, founded in the late 1960s, has a larger average plant size and fewer legacy factories—and produces more vehicles per worker—than longer-established companies such as Volkswagen and Toyota.

Some of the new players focus on responding rapidly to the market, recombining technologies, and squeezing out costs. Others are adept at capturing new growth opportunities or reaching underserved markets with low cost structures and no-frills products. And all of them have the tenacity to operate in other fast-growing emerging markets. South Africa's MTN and Kenya's Safaricom, for example, provide mobile financial services to millions of customers who have no bank accounts, credit card histories, or identification numbers. Indonesia's Indofood has successfully introduced its Indomie noodles across Africa, becoming the most popular brand in the huge Nigerian market.

The scale equation has clearly shifted in favor of the new players. In 1990 Chinese companies represented only 4% of the global production of aluminum, and the marginal cost throughout the industry (averaged across producers in 2014 U.S. dollars) was approximately $2,500 a ton. By 2014 Chinese smelters represented 52% of global production and had lowered the average marginal cost in the industry to less than $1,900 a ton—driving out more than half the Western producers that were active in 1990.

Of course, it would be a mistake to think of emerging-market companies as a monolithic group, since they tend to reflect their home countries' business climate, market structure, corporate culture,

HYUNDAI, FOUNDED IN THE 1960S, HAS A LARGER AVERAGE PLANT SIZE AND PRODUCES MORE VEHICLES PER WORKER than longer-established companies such as Volkswagen and Toyota.

A DIFFERENT BREED OF OWNER

State- and family-owned firms are much more prevalent in emerging economies than in developed economies. Companies in consumer-facing industries (such as retail and IT) are usually family owned, while those focusing on infrastructure (such as transportation) tend to be government owned.

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and endowments. Understanding such differences is crucial to understanding how these firms compete.

In our research, we have found some clear regional patterns. Asian companies, for instance, have been the most aggressive in expanding abroad, while Latin American firms tend to focus on their home markets. The industry mix in China resembles that in Japan and Korea, reflecting a similar legacy of using massive investments to drive growth; for instance, four of the five most profitable iron and steel companies in the world are from those three countries. Even the overall corporate performance of firms from those countries is similar; the margins of Chinese firms appear to be falling toward the 3% to 4% range of their Northeast Asian counterparts in most industries, compared with about 8% for Western companies.

THERE'S AN INTERNET OF THREATS

Technology has created another source of competition for Western incumbents. The total revenue of the tech sector has grown from $600 billion to more than $6 trillion over the past three decades, spawning a new generation of firms, some of which have rapidly attained unprecedented scale in terms of revenues, assets, customers, and profits. Vast digital platforms or networks give these new players massive reach. Every minute, 300 hours of video are uploaded to YouTube. In November 2014 Alibaba processed more than $9 billion in sales in a single

24-hour period on its e-commerce marketplaces. The number of Facebook users around the globe is now on par with the population of China.

For companies with digital platforms that reach such "hyperscale," the marginal cost of storing, transporting, and replicating data is very low. That allows the new tech giants to quickly add interactions and business lines. As has been well documented, these firms can leverage their cost structures, data, and algorithms to disrupt a range of industries, from advertising to transportation.

Consumers often capture much of the value, paying little or nothing for services that traditional businesses provide for a fee. Skype, for example, saved consumers around the world about $37 billion in international phone charges in 2013 alone. Traditional intermediaries are often the casualties. Some go out of business altogether, unable to compete with the lower prices, greater choice, and new conveniences available online. Think of the bookstores shuttered by Amazon, the video stores wiped out by Netflix, and the travel agents rendered obsolete by Expedia.

Tech firms share some intriguing similarities with the new emerging-market giants. Both can be brutal competitors, and both often have tightly controlled ownership structures that give them the flexibility to play the long game. Many tech firms are privately held by founders or venture capital investors who prioritize market share and scale rather than profit. Amazon, Twitter, Spotify, Pinterest, and Yelp are on the growing list of companies that focus on increasing revenue or their user networks even while losing money over extended periods. That mindset—and the control of founders—sometimes persists even after the companies go public. Among NASDAQ-listed software and internet companies, founder-controlled firms have 60% faster revenue growth and 35% to 40% lower profit margins and returns on invested capital than do publicly held firms.

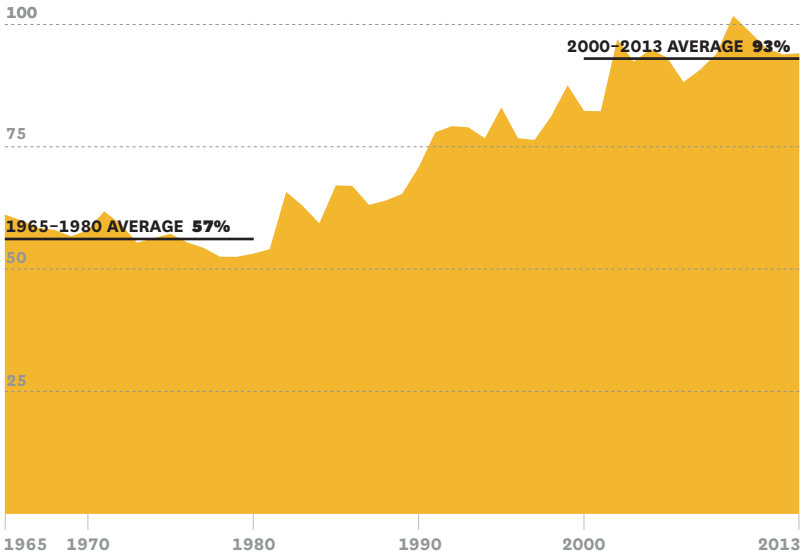
Incumbents are often caught flat-footed when tech firms move into markets where nobody expected them. The Chinese e-commerce giants Alibaba, Tencent, and JD.com have expanded into financial services, including small-business lending, consumer finance, and money market funds. They are able to use data about their vendors and customers to achieve loan performance ratios that are better than the financial industry average. In Brazil the telecommunications company Oi joined with the British analytics firm Cignifi to generate credit scores for customers on the basis of their mobile-phone use. Oi uses that information to extend lending services to unbanked customers through its SMS-based credit-card system.

But it's not just the new tech giants that pose a threat—it's also the businesses they enable. A universe of small vendors competes with much larger companies by piggybacking on global e-commerce platforms such as Amazon, Alibaba, the UK government's G-Cloud, and Airbnb. Pebble, a smartwatch start-up, raised $20 million in just one month on Kickstarter, an online crowdfunding platform that attracts 37% of funds from outside the United States. Thousands of small and midsize Chinese businesses now sell to overseas customers on B2B marketplaces that have millions of registered buyers. Etsy, a digital marketplace for artisanal goods, supported $2 billion in sales in 2014, more than one-third of which were

THE HIDDEN PERIL OF VOLATILITY

The dramatic increase in corporate profits has masked a decrease in their predictability. Since 2000 the average level of volatility of returns on invested capital has been about 60% greater than the levels that prevailed from 1965 to 1980.

VARIANCE IN RETURNS ON INVESTED CAPITAL FOR NORTH AMERICAN FIRMS



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outside the United States. The UK government's introduction of G-Cloud, in 2013, allowed small companies to compete with the larger traditional players for government contracts to supply cloud IT services. The smaller players have been winning about half the government's spending on cloud services, compared with just 10% of other government business. These digital platforms in turn create a new form of competitive advantage: strong communities of users and developers who reinforce the attraction of the platform.

OVER THE PAST 30 YEARS, MANY EXECUTIVES in large Western corporations have been focusing internally.

The pooling of small players that the new platforms enable represents an existential threat in some industries. Airbnb, for example, which allows individuals to make money from spare rooms and properties, has emerged as a challenger to traditional hotels. The $340 billion in fixed commercial assets such as hotels owned by the U.S. hospitality industry is dwarfed by the more than $17 trillion of residential assets in the hands of private owners that now have the potential to be rented out, thanks to the platform. Other tech firms are applying a similar principle to assets such as cars, bicycles, textbooks, and toys.

THE OUTLOOK

We foresee no letup in the reshaping of industries by technology and globalization. We also foresee no shortage of opportunities for companies. Consumption in emerging markets will continue its rapid growth. From 1990 to 2010 some 1.2 billion people entered the consumer class. By 2025 another 1.8 billion are projected to join, and global consumption is expected nearly to double, to $64 trillion.

We estimate that global revenue could increase by more than 40%, to $185 trillion, over the next 10 years. More than half that growth will come from emerging markets, and nearly two-thirds of that will be fueled by capital-intensive sectors. While this increase would be slightly less than in the past decade—consistent with various projections for slower growth in China, for instance—it will still be a remarkable opportunity for corporations.

But whereas the outlook for revenue growth is good, the profits picture looks less promising. Consumers could be the big winners, as could some workers—especially those in emerging markets and those with digital and engineering skills, which are in short supply. As we've seen, many companies' profit margins are being squeezed. Hospitality, transport, and health care have all experienced price declines in recent years because of the emergence of new platforms and tech-driven competitors. Similar effects could soon play out on a larger scale and expand to sectors such as insurance and utilities. Nobody is immune, but companies particularly at risk include those that rely on large physical investments to provide services or that act as intermediaries in a services value chain. Large emerging-market firms in less traded capital-intensive industries such as extraction, telecom, and transportation have been relatively protected so far, but that is changing, in part because of greater deregulation. Profits are not only shrinking but also becoming more uncertain. Since 2000 the return on invested capital has been about 60% more volatile than it was from 1965 to 1980. (See the exhibit "The Hidden Peril of Volatility.")

While they will most likely continue to grow in absolute terms, corporate profits could shrink from 9.8% of global GDP and 5.6% of revenue to 7.9% and 4.7%, respectively. (See the exhibit "A Leaner Outlook for Profits.") Several factors could play into this slowdown. As emerging markets and their local competitors—Chinese firms, especially—account for a greater proportion of the corporate universe, they could lower overall profitability, reducing corporate profits by $800 billion to $900 billion over the next decade. The impact of technology disruption and the resulting consumer surplus could reduce profits by an additional $600 billion to $700 billion. Moreover, our analysis suggests that rising labor costs could reduce profits by a further $800 billion.

We project that all told the after-tax profit pool could reach $8.6 trillion in 2025. And the impact of the above factors could be intensified if, following a slowdown in China, firms in capital-intensive sectors see slower revenue growth than they did over the past decade and are therefore unable to

compensate as much for lower profit margins as they have so far.

The big Western incumbents that have done so well over the past three decades must now constantly look over their shoulders. The share of the profit pool captured by firms from advanced economies could decline from 68% today to roughly 62% in 2025. That's still larger than the projected 50% share of advanced economies in world GDP, but we may be understating the magnitude of the coming drop. If Chinese, Indian, and other emerging-market companies make inroads in idea-intensive industries—through acquisitions, organic growth, or aggressive moves by tech companies—they will quickly capture a larger share of overall profits.

PUSHING BACK

The challenge for the big North American and European companies is to maintain and even extend their lead in the face of much tougher and more varied competition and a less favorable environment. We anticipate several possible responses to the trends we have set out above.

Be paranoid. Let's face it—over the past 30 years many executives in large Western corporations have been focusing internally. Even among those who could list their potential emerging-market, tech, or smaller competitors, most would struggle to quantify the cost or agility gap between their organizations and those rivals and to describe how such companies have successfully attacked other large Western corporations. The emerging-market attackers play by rules honed at home, so part of the challenge is to better understand their home environment—just as they have worked to understand the strengths, weaknesses, and operating environment of Western companies. Half of world GDP growth over the next decade, and many of the new competitors, will come from smaller cities in the emerging world—places such as Kochi and Kumasi—that most Western executives would be hard-pressed to locate on a map. Even the most global firms retain a strong local bias in their operations, making close to half their revenue at home. The local market also influences how firms choose to innovate, the products they create, their supply chains, and their investment strategies. For Western executives, an "emerging-market" view or even a view of the "Chinese" or "Indian" market is not enough.

Seek out patient capital. As we've seen, emerging-market firms and some technology companies often take a long view, building their market share over years at the expense of short-term profit growth. Some Western multinationals yearn to be able to do the same: In a McKinsey survey of more than 1,000 board members and C-suite executives, 63% of respondents said the pressure to demonstrate short-term financial performance has actually increased since the 2008 crisis, and 86% believe that using a longer time horizon to make business decisions would improve returns, innovation, and other aspects of corporate performance. Big public companies will continue to be subject to market moods, but CEOs and boards have an opportunity to adopt longer-term strategies and target communications to investors who are more focused on the long run.

Radically self-disrupt. In this era of tech disruption, companies need to be willing to disrupt themselves before others do it to them. That requires overcoming the fear that a new product or channel will cannibalize an existing business. Many companies struggle with legacy assets and productivity gaps in their own operations (some firms have a 40% gap between their most and least productive sites), and companies will need to get much better at overcoming strategic inertia. A McKinsey study of capital expenditure allocations from 1990 to 2005 across business units in more than 1,600 firms found that each year's capital allocation correlated

A LEANER OUTLOOK FOR PROFITS

Although global corporate revenue could increase by more than 40% over the next decade, to $185 trillion, profit margins will tighten overall. As a percentage of global GDP, corporate profits are likely to drop almost to where they were in 1980, when the profit boom began.

GLOBAL CORPORATE AFTER-TAX OPERATING PROFITS (2013 US$ TRILLIONS)

SOURCE MCKINSEY GLOBAL INSTITUTE

closely—more than 90%—with the previous year's. (Our experience is that the correlation between year-to-year decisions for other resources, such as talent, is even higher.) However, firms that were able to reallocate capital in response to changing conditions had substantially higher growth rates and returns to shareholders. To break the inertia, some companies have a "harvesting" rule that involves putting a percentage of assets up for sale every year unless a compelling case can be made to keep them. Others have established internal disruption teams and charge them with developing plans to attack the core.

Build new intellectual assets. Given the profitability of idea-intensive businesses, intellectual capital should be seen as a prime asset. Half the world's most valuable brands are in idea-intensive sectors—and their value is increasing. Assets such as data, algorithms, and software are also becoming more valuable, and within those broad categories, some assets are more valuable than others. For instance, data on consumer behavior and decision making could be more strategically important than customer transaction or location data. Some firms build their intellectual assets by creating communities of users, suppliers, and innovators. Apple's universe of app developers and Google's of Android developers are prime examples—and the more creativity and innovation arise from these crowds, the greater the developers' loyalty to the underlying brand or platform. Other ecosystems revolve around social media platforms, and they don't have to be limited to the tech world. AstraZeneca, for instance, created an open innovation platform to work with universities, nonprofits, and other partners across all stages of drug discovery.

Go to war for talent. Finding and nurturing ambitious, hard-driving, and international-minded managers and technical staff are major challenges for multinationals and will become ever more crucial. HR operations at many companies have traditionally been seen in terms of compliance, record keeping, and support. But as talent shortages grow more acute in idea-intensive industries, human capital management should become a much higher strategic priority. Companies need to rethink organizational structures, workplace flexibility, and job definitions for a new era. The increasing prevalence and sophistication of digital tools for talent management give companies an opportunity to improve recruiting, screening, onboarding, compensation, engagement, retention, and leadership development. Companies that move quickly to integrate those technologies and use them in a strategic way increase revenue and productivity by up to 9% and lower talent and HR costs by up to 7%, a recent McKinsey Global Institute report found. But online platforms are also giving employees new mobility—and handing competitors new tools for poaching top performers. To win in the war for talent, a company will need to create an engaging workplace environment and maintain a solid reputation as a good employer. This might include giving employees a greater ownership stake in the company to build commitment.

WESTERN MULTINATIONALS HAVE PLENTY OF REASONS TO REMAIN UPBEAT, but the competition will be relentless.

NORTH AMERICAN AND EUROPEAN multinationals have enjoyed an exceptional three-decade ride, and they have plenty of reasons to remain upbeat as they look ahead. New market opportunities are still opening up around the world as emerging economies continue to urbanize and industrialize. The global consumer class will continue to expand its ranks and ramp up its spending. Companies will be able to harness new technologies to improve operational efficiency and develop new products and services. But to maintain or increase profits, they're going to have to shake things up. The competition will be relentless and less predictable, and the operating environment not nearly as supportive. Vigilance, agility, and optimism have always been prized characteristics of successful companies. Over the next decade they will be doubly so, as headwinds break up the perfect non-storm.

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