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PLAYING TO WIN: THE NEW GLOBAL COMPETITION FOR CORPORATE PROFITS

SEPTEMBER 2015

EXECUTIVE SUMMARY

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PLAYING TO WIN: THE NEW GLOBAL COMPETITION FOR CORPORATE PROFITS

SEPTEMBER 2015

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IN BRIEF

PLAYING TO WIN: THE NEW GLOBAL COMPETITION FOR CORPORATE PROFITS

For the past three decades, corporations have enjoyed record profit growth, new market opportunities, and declining costs. But this unprecedented run may be coming to an end. New rivals are putting industry leaders on notice as the business environment turns more uncertain and hypercompetitive.

- Across all global corporations, earnings before interest and taxes more than tripled in real terms from 1980 to 2013; net income after interest and taxes rose fivefold. Companies from advanced economies earn more than two-thirds of global profits, and Western firms are the world's most profitable. Multinationals have benefited from rising consumption and industrial investment, the availability of low-cost labor, and more globalized supply chains.

- The benefits of this corporate boom have not been shared evenly. Profits are increasingly shifting from heavy industry to idea-intensive sectors that revolve around R&D, brands, software, and algorithms. Sectors such as pharmaceuticals, media, finance, and information technology have the highest margins. They are developing a winner-take-all dynamic, with a wide gap between the most profitable firms and everyone else. Meanwhile, margins are being squeezed in capital-intensive industries, where operational efficiency has become critical.

- Emerging economies now account for 40 percent of global revenue, but their growth has also fueled the rise of hard-charging competitors, particularly in capital-intensive sectors. Now these firms are expanding globally, in part through aggressive M&A strategies, and they are proving to be hardy, risk-taking, and lean competitors. Many are state- or family-owned, and unlike widely held public companies whose shareholders typically focus on quarterly earnings, they can pursue longer-term strategies to build leading positions, such as prioritizing revenue growth over short-term profits and engaging in fierce price competition. Chinese firms, for example, have grown four to five times faster than Western firms in the past decade, yet their margins fell by more than 5 percentage points on average.

- Technology and tech-enabled firms represent another huge—and even more unpredictable—source of competition. Some have disrupted long-standing business models by diverting huge amounts of industry value to consumer surplus. By building powerful digital platforms and networks, the biggest technology and tech-enabled giants have reached never-before-seen scale in users, customers, revenue, and profits. These platforms can drive marginal costs to almost zero, enabling technology and tech-enabled firms to make rapid moves into new sectors. They can also serve as launching pads that give thousands of small and medium-sized firms immediate global reach.

- While competition from emerging-market companies and technology and tech-enabled firms is heating up, falling costs may have bottomed out. Although global revenue could reach $185 trillion by 2025, these pressures could slow profit growth and produce an after-tax profit pool of $8.6 trillion. Corporate profits, currently almost 10 percent of world GDP, could shrink to less than 8 percent—undoing in a single decade nearly all the corporate gains achieved relative to the world economy over the past three decades. Real growth in corporate net income could fall from 5 percent to 1 percent per year.

As profit growth slows, there will be more companies fighting for a smaller slice of the pie. Incumbent industry leaders cannot focus simply on defending their current market niche. Firms with vision, optimism, and agility can realize enormous opportunities—if they are willing to disrupt their own operations before some new challenger does it for them.

PLAYING TO WIN

PREPARING FOR THE NEXT PHASE OF CORPORATE COMPETITION

A three-decade trend of rising profits

1980
$2T profit
7.6%
of world GDP

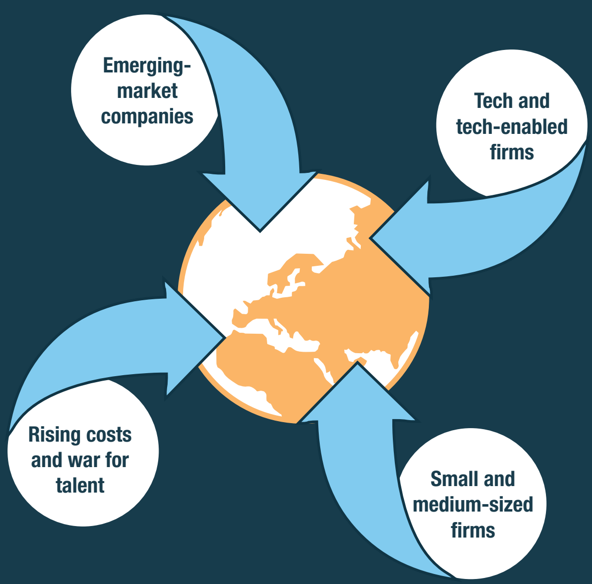
2013
$7.2T profit
9.8%
of world GDP

2013 profit % by region

Advanced	
North America	26
Western Europe	25
Japan & S. Korea	9
Australia & New Zealand	7
Other advanced	5

Emerging	
China	14
Latin America	6
ASEAN	5
India	1
Other emerging	5

A more competitive world



A more uncertain environment and slower profit growth

- Many more companies fighting for market share
- Volatility and swings in corporate performance
- Profits shifting to idea-intensive sectors, which produce big winners
- Margin pressures on capital-intensive firms

2025
$8.6T profit
7.9%
of world GDP

How companies can compete and win in this new landscape

Play offense, not defense

Go after fast-growing markets

Focus externally to spot disruption before it hits

Learn the nuances of emerging markets down to the city level

Be lean and agile

Winning firms are more productive

An asset-light footprint can minimize disruptions

Avoid strategic inertia

Plan ahead for resilience

Focus on the intangibles

Intellectual assets matter in all industries

The new weapons are software, data, algorithms, brands, and R&D

Fight for the best talent and consider M&A to gain capabilities

Play the long game

Many new competitors prioritize sales and scale over margin

Seek out institutional investors with long horizons

Create incentives for long-term value creation over short-term returns

EXECUTIVE SUMMARY

The past three decades have been uncertain times but also the best of times for global corporations—and especially so for large Western multinationals. Vast markets have opened up around the world even as corporate tax rates, borrowing costs, and the price of labor, equipment, and technology have fallen. Our analysis shows that corporate earnings before interest and taxes more than tripled from 1980 to 2013, rising from 7.6 percent of world GDP to almost 10 percent.[1] Corporate net incomes after taxes and interest payments rose even more sharply over this period, increasing as a share of global GDP by some 70 percent.

But this remarkable era may be coming to a close as profit growth slows. Between now and 2025, the corporate profit pool could decrease from 10 percent of global GDP to about 7.9 percent—practically reverting to its level in 1980, before the boom began.[2]

Global profit pool:
7.6%
of world GDP
in 1980,
9.8%
in 2013, and
7.9%
in 2025

Part of this decline will stem from the competitive forces unleashed by two groups of hard-charging competitors. On one side is an enormous wave of companies based in emerging markets. The most prominent have been operating as industrial giants for decades, but over the past ten to 15 years, they have reached massive scale in their home markets. Now they are expanding globally, just as their predecessors from Japan and South Korea did before them. On the other side, high-tech firms are introducing new business models and striking into new sectors. And the tech (and tech-enabled) firms giants themselves are not the only threat. Powerful digital platforms such as Alibaba and Amazon serve as launching pads for thousands of small and medium-sized enterprises, giving them the reach and resources to challenge larger companies.

New competitors are becoming more numerous, more formidable, and more global—and some destroy more value for incumbents than they create for themselves. Meanwhile, some of the external factors that helped to drive profit growth in the past three decades, such as global labor arbitrage and falling interest rates, are reaching their limits.

Companies that adapt quickly to these new realities can capture enormous opportunities. Over the next decade, rising consumption in the emerging world will create new markets. Technology will spur new products and services. Startups will be able to tap global investors, suppliers, and customers with little up-front investment. But companies will face intense pressure to grow, innovate, and become more productive—not only to seize these opportunities but merely to survive.

CORPORATE PROFITS HAVE SURGED TO RECORD HIGHS, WITH WESTERN FIRMS CAPTURING THE LION'S SHARE

The world's large companies, and particularly the biggest Western firms, have had an extraordinary three decades. By any measure, pre- or post-tax, profits are up sharply (Exhibit E1). In real terms, post-tax net profits, for instance, grew from $2 trillion in 1980 to $7.2 trillion in 2013, rising from 7.6 percent of world GDP to almost 10 percent.[3] Measured as a share of world GDP, they grew by some 30 percent. Corporate net incomes (after interest payments) rose even faster, increasing their share of GDP by more than 70 percent.

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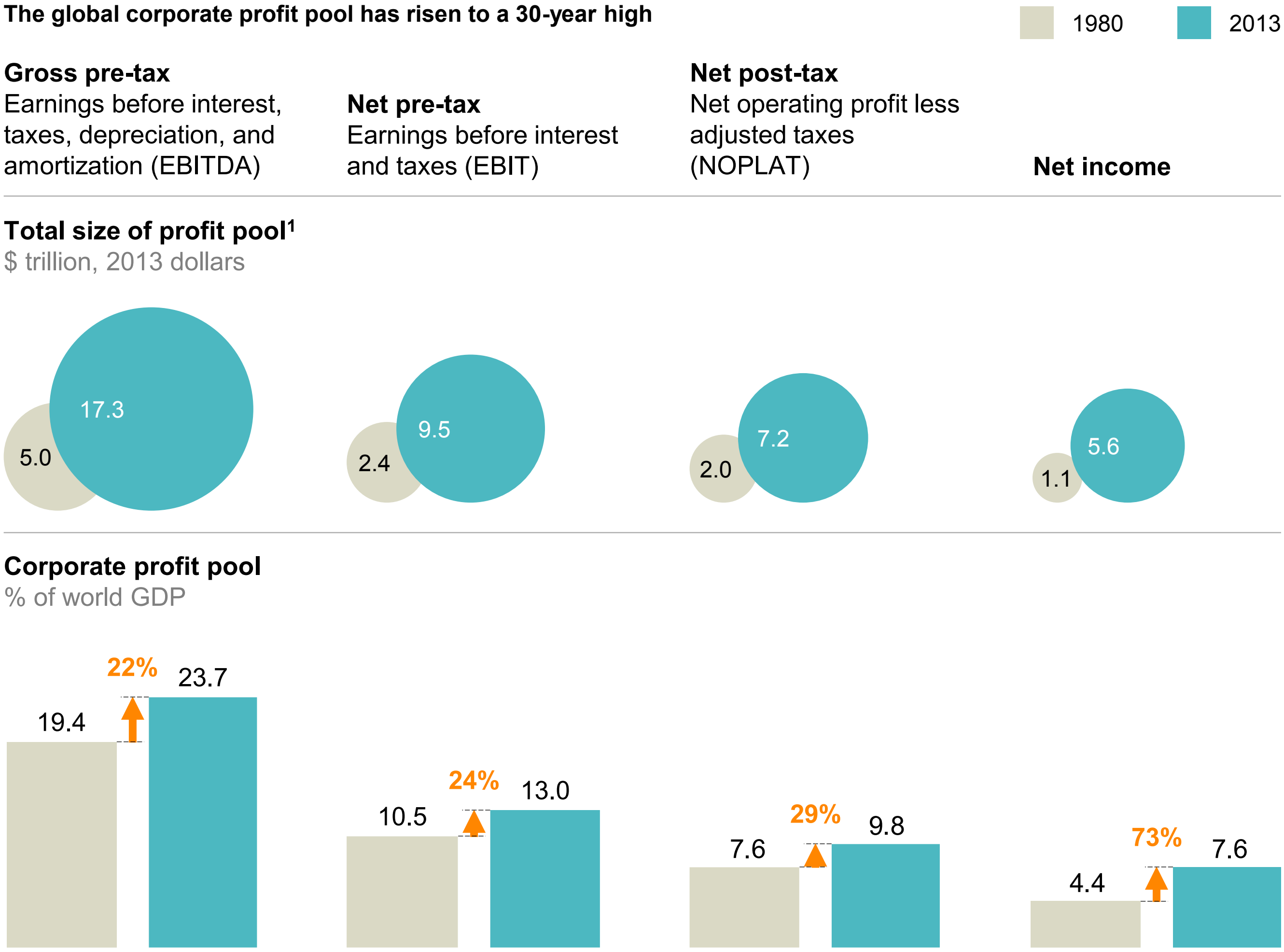
1 We analyzed more than 28,000 firms around the world, each with more than $200 million in annual revenue. The sample includes nearly 17,000 publicly listed firms and 11,400 privately held firms across 42 countries and 18 sectors. For more details on the sample, please see the technical appendix.

2 For a companion article, see "The future and how to survive it," *Harvard Business Review*, September 2015.

3 Profit and revenue comparisons over time are given in real 2013 US dollars.

Exhibit E1

The global corporate profit pool has risen to a 30-year high



1 Calculated using macroeconomic data combined with financial data for 28,250 companies (16,850 publicly listed firms and 11,400 privately held firms) with more than $200 million in annual revenue.

SOURCE: World Bank; OECD; Bureau van Dijk; European Commission AMECO database; US Bureau of Economic Analysis; IHS; Oxford Economics; McKinsey Corporate Performance Analysis Tool; McKinsey Global Institute analysis

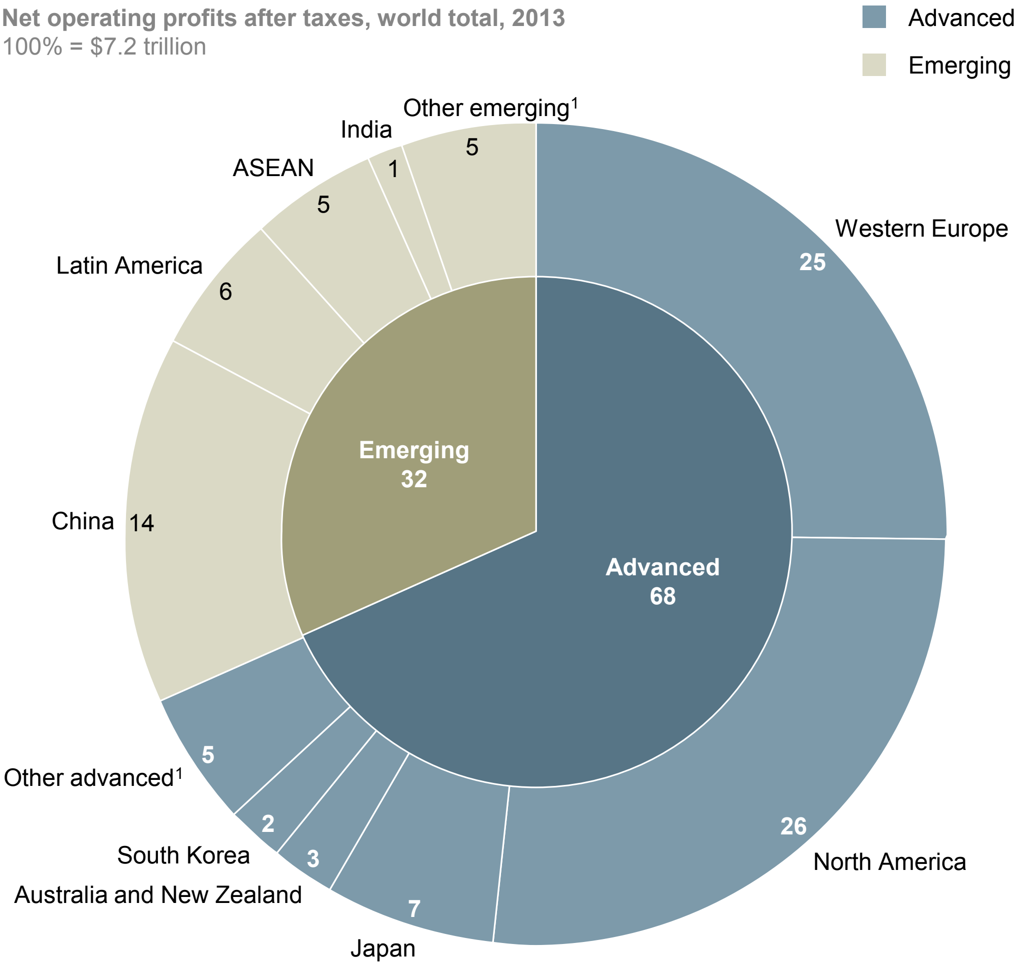
Companies from advanced economies still capture more than two-thirds of global profits (Exhibit E2). On average, publicly listed North American corporations, for example, increased their profit margins from 5.6 percent of sales in 1980 to 9 percent in 2013. In fact, the after-tax profits of US firms are at their highest level as a share of national income since 1929. European firms have been on a similar trajectory since the 1980s, though their performance has been dampened since 2008. Companies from China, India, and Southeast Asia have also experienced a remarkable rise in fortunes, though with a greater focus on growing revenue than on profit margins.

The most successful companies have grown as large as entire nations. Walmart's workforce is larger than the population of Latvia or Slovenia. ExxonMobil's profits are equivalent to the GDP of Bolivia or Jordan. When Apple's market valuation hit some $750 billion in early 2015, it approached the size of the entire stock market in Russia or Spain.

Exhibit E2

Firms from advanced economies capture more than two-thirds of the global profit pool

Net operating profits after taxes, world total, 2013
100% = $7.2 trillion



1 "Other advanced" refers to Hong Kong, Taiwan, and Middle Eastern countries such as Israel and the UAE; "other emerging" refers mainly to Russia, Eastern Europe, and Africa.
NOTE: Numbers may not sum due to rounding.

SOURCE: World Bank; OECD; Bureau van Dijk; European Commission AMECO database; US Bureau of Economic Analysis; IHS; Oxford Economics; McKinsey Corporate Performance Analysis Tool; McKinsey Global Institute analysis

10%
of publicly held companies account for
80%
of profits

Size matters, because large firms (those with more than $1 billion in annual revenue) have an outsized economic impact—and they have been the biggest beneficiaries of this extended bull run. They account for nearly 60 percent of global revenue and 65 percent of market capitalization. Moreover, relatively few firms drive the majority of value creation: among the world's public companies, just 10 percent of firms account for 80 percent of profits, and the top quintile earns 90 percent.

Companies once reinvested most of their earnings, but they are increasingly holding on to their profits. Since 1980 corporate cash holdings have ballooned to 10 percent of GDP in the United States, 22 percent in Western Europe, 34 percent in South Korea, and 47 percent in Japan. With low borrowing costs and plenty of available cash on hand, companies in some industries have engaged in a massive wave of mergers and acquisitions. The biggest names are getting even bigger.

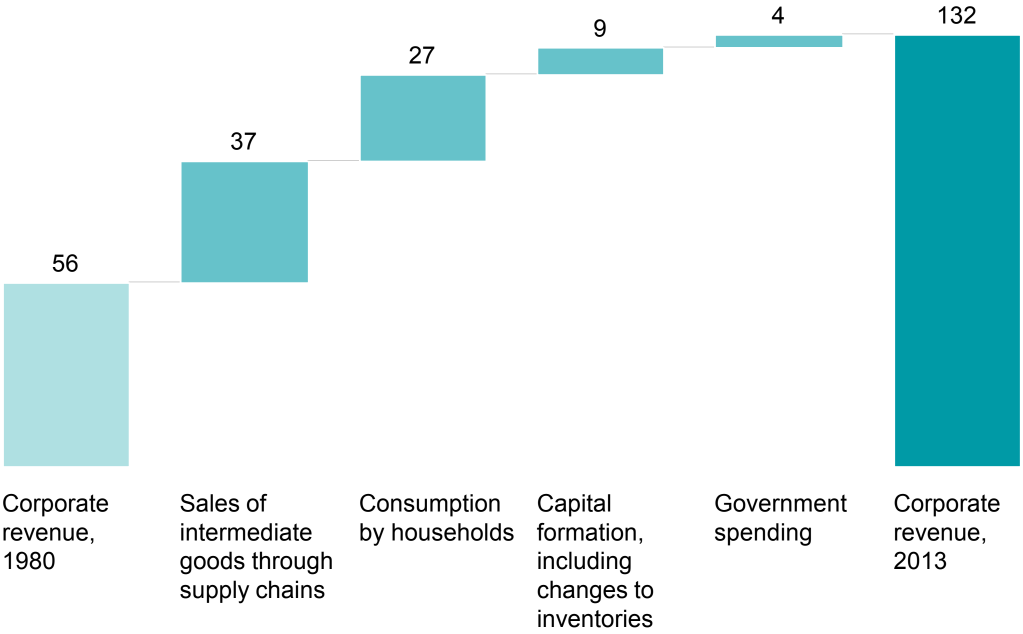
The revenue pool has expanded rapidly, with growth shifting to emerging markets

A remarkable rise in global revenue paved the way for this record profit growth. In real terms, the global revenue pool increased from $56 trillion in 1980 to more than $130 trillion in 2013, thanks to growth in consumption, investment, and international supply chains (Exhibit E3). Emerging economies are driving much of this momentum. In 1980, only 20 percent of global revenue came from the emerging world, but by 2013, that share had doubled to 40 percent.

Exhibit E3

New consumers, the globalization of supply chains, and a wave of industrial and infrastructure investment have driven up corporate revenue

Global corporate revenue, 1980–2013
$ trillion, real



NOTE: Numbers may not sum due to rounding.

SOURCE: World Input-Output database; World Bank; IHS; McKinsey Global Institute analysis

The biggest contributor to corporate revenue growth has been the expansion of trade. Multinationals drive 80 percent of global trade, and cross-border supply chains account for 60 percent of it, creating a competitive battleground for suppliers of intermediate goods and services.[4] Global consumers have been another engine of revenue growth. From 1990 to 2010, the world added some 1.2 billion consumers, and 1.8 billion more are expected to join their ranks by 2025, with nearly all of the growth coming from emerging economies.[5]

4 *Global flows in a digital age: How trade, finance, people, and data connect the world economy*, McKinsey Global Institute, April 2014. Also see *World investment report 2014,* United Nations Conference on Trade and Development (UNCTAD), June 2014.

5 Defined as those with incomes exceeding $10 per day. See *Urban world: Cities and the rise of the consuming class*, McKinsey Global Institute, June 2012.

Capital-intensive industries have also benefited from industrial and infrastructure investment. Even as their investment has declined closer to home, listed firms from advanced economies have poured nearly $4.5 trillion into build-outs around the world since 2000, with much of it directed toward projects in emerging economies. These countries are building massive oil refineries, power plants, steel mills, and factories. Waves of deregulation and privatization have opened more of these sectors to global competition, including telecom, transportation, and utilities, which have strong legacies of state ownership and regulation. Government spending has also driven corporate revenue growth, though to a much smaller extent. More than 60 percent of revenue growth related to public spending is in advanced economies. Companies in the public and quasi-public sectors of health care, education, and infrastructure have been the major beneficiaries.

40%
emerging economies' share of global revenue

Emerging economies may be a large factor behind revenue growth, but firms from advanced economies have a head start in establishing the kind of global reach needed to penetrate fast-growing markets. North American and Western European firms post a higher share of foreign revenue than those from other regions and generate 56 percent of global outbound foreign direct investment.[6] Nearly 60 percent of companies from these regions report having suppliers or facilities in more than ten countries.

Corporations have benefited from a shrinking cost base and rising productivity

While new markets were opening around the world, large companies gained another boost from a remarkable convergence of external factors. Statutory corporate tax rates have declined in most OECD countries since 1980, in some cases by up to 50 percent; effective tax rates are even lower. An ultralow interest rate environment has reduced the cost of borrowing to near zero in real terms today.

Many companies created production bases in the emerging world to take advantage of low-cost labor. Between 1980 and 2010, the global labor pool gained 1.2 billion people, most of them in emerging markets that have become better connected to global supply chains. Meanwhile, technology has grown cheaper even as it has become immensely more powerful. The gap between the cost of industrial robots and the cost of labor shrank by 50 percent over the same period, for instance. Productivity growth in advanced economies has been steady, but while revenue and profits have been climbing, employment and wages have lagged. Across advanced economies, labor's share of national income has fallen from 76 percent to 66 percent since 1980.

For corporations, though, this period of record profit growth has come at a price: turbulence.

INTELLECTUAL ASSETS AND INORGANIC GROWTH HAVE ASSUMED NEW IMPORTANCE IN A MORE UNCERTAIN CORPORATE LANDSCAPE

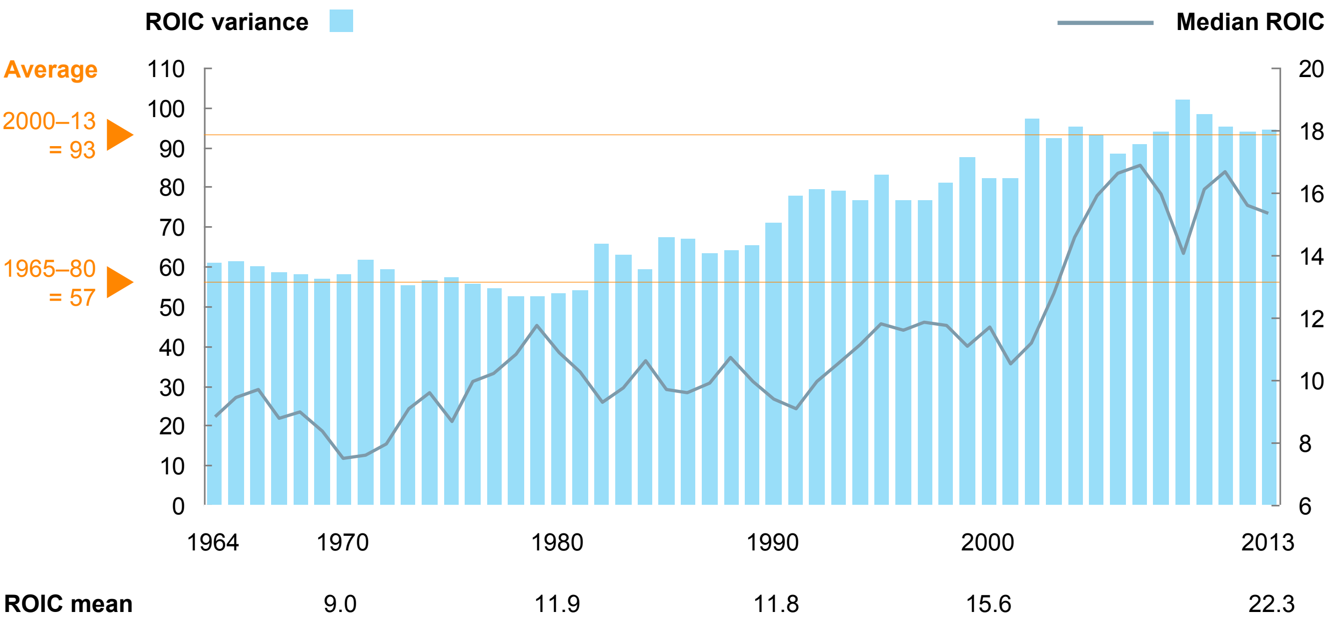
Even as corporations have posted record growth, the competitive landscape has grown more complex and dynamic. Some of these trends have been building for a decade and are accelerating. There are twice as many multinational firms active today as in 1990, and the majority of that growth has occurred since 2000. The average variance in returns on capital for North American firms has been more than 60 percent higher than the levels that prevailed from 1965 to 1980 (Exhibit E4). Not only are profits rising, but in some industries, the leading firms are winning bigger than ever before.

[6] Estimate based on 2011–2014 data from World Bank and UNCTAD.

Exhibit E4

Variability in corporate earnings has nearly doubled

Variance in return on invested capital (ROIC) for North American firms, 1964–2013[1]
%



1 Firms included in this analysis had more than $200 million in revenue in at least one year during this period as well as ROIC between zero and the 95th percentile. "Variance" is defined as the ratio of standard deviation to mean.

SOURCE: McKinsey Corporate Performance Analysis Tool; McKinsey Global Institute analysis

Profits are shifting to idea-intensive sectors

This trend toward greater variability in corporate performance is playing out at the sector level as well. Today sectors such as pharmaceuticals, media, finance, and information technology have the highest profit margins, and Western firms remain the dominant players within these industries. Asset-light, idea-intensive sectors accounted for 17 percent of the profits generated by Western companies in 1999. Today that share is 31 percent. Value is increasingly created from patents, brands, trademarks, and copyrights rather than industrial machinery or factories.

Many of these industries have developed a winner-take-all dynamic. The gap between the most profitable firms and everyone else is growing—and the top performers are significantly more R&D- or brand-intensive than median firms.

They are also much bigger. The most profitable firms in pharmaceuticals, medical devices, IT services, and technology hardware, for instance, are 40 to 110 percent larger than the median firm in these industries. Size does not guarantee market position for long, however, particularly in fast-moving fields such as technology. Over the past 15 years, the list of top tech firms by revenue share has continued to turn over.

While profits are flowing to idea-intensive sectors, a very different story is playing out in capital- and labor-intensive sectors. Margins are being squeezed in industries such as automobiles, machinery, and retail (Exhibit E5). Emerging-market firms with massive scale have intensified price competition, driving down marginal costs throughout whole industries. In 1990, Chinese aluminium producers made up only 4 percent of global production; by 2014, their share had increased to 52 percent. As this unfolded, marginal costs fell by 32 percent, driving more than half of Western producers out of business.

Exhibit E5

Idea-intensive sectors see higher margins and spreads than most sectors

Top quartile | Second quartile | Third quartile | Bottom quartile

Group	Sector archetype	Selected sectors	Knowledge intensity	Labor intensity	Capital intensity	Profitability: Average profit margin NOPLAT over sales, %	Profitability: Profit margin spread[1] Percentage points
Idea-intensive goods and services	Intellectual property–intensive	Pharma/medical devices	Top quartile	Bottom quartile	Third quartile	19.8	32
	Technology-intensive	Technology hardware	Top quartile	Second quartile	Third quartile	7.8	33
		IT and business services	Top quartile	Third quartile	Bottom quartile	11.7	29
		Media	Second quartile	Third quartile	Third quartile	12.4	36
Labor-intensive consumer goods and services	Local consumer-facing	Consumer discretionary products	Second quartile	Top quartile	Bottom quartile	5.0	23
		Consumer staples	Third quartile	Second quartile	Third quartile	9.3	22
		Hospitality services	Third quartile	Top quartile	Third quartile	8.5	23
		Health-care services	Third quartile	Top quartile	Bottom quartile	3.9	19
		Retail	Third quartile	Second quartile	Third quartile	3.5	14
Capital-intensive goods and services	Capital goods	Construction	Third quartile	Top quartile	Second quartile	4.4	17
		Automobiles	Third quartile	Second quartile	Second quartile	5.4	12
		Machinery	Second quartile	Third quartile	Second quartile	6.8	17
		Processing	Third quartile	Third quartile	Second quartile	6.6	20
	Infrastructure	Transportation	Bottom quartile	Top quartile	Second quartile	6.0	42
		Telecom	Second quartile	Bottom quartile	Second quartile	13.4	35
		Utilities	Third quartile	Bottom quartile	Top quartile	8.5	36
		Extraction	Bottom quartile	Bottom quartile	Top quartile	5.8	42

1 The profit margin spread refers to the percentage-point different in NOPLAT margins between firms in the 5th percentile and firms in the 95th percentile of performance.

SOURCE: McKinsey Corporate Performance Analysis Tool; IHS; US Bureau of Economic Analysis; US Bureau of Labor Statistics; McKinsey Global Institute analysis

Companies are using M&A to achieve growth and scale

Faced with the need to muscle out competitors, companies are increasingly pursuing M&A strategies to capture new markets and add new business lines. The corporate world has experienced spikes of mergers and acquisitions in the past, but nothing like the recent wave of deal-making. In 1990, there were 11,500 M&A deals whose combined value was equivalent to 2 percent of world GDP. Since 2008, there have been some 30,000 deals a year totaling roughly 3 percent of world GDP. The total value of worldwide deals in 2014 was $3.5 trillion, up 47 percent from the previous year. Ninety-five deals exceeding $5 billion were announced in that year alone.[7]

[7] *Mergers & acquisitions review: Financial advisors: Full year 2014*, Thomson Reuters, December 2014.

Emerging-market companies have been major players in this trend as they seek to expand globally. They accounted for less than 10 percent of M&A deal value in 2008 in consumer products such as food, beverages, and household durables; by 2014, their share was almost 30 percent.

Idea-intensive industries also account for a large share of M&A activity. And the bigger firms get in these industries, the more they tend to use M&A to grow.[8] The deals in these industries tend to be larger, and the giants driving them have higher EBIT (earnings before interest and taxes) margins than smaller firms.[9] These trends are mutually reinforcing, and valuations have risen dramatically as a result.

The tech sector, in particular, has seen a wave of M&A activity as larger players use acquisitions to expand their portfolios and stay on the cutting edge. When Facebook acquired Instagram in 2012, for instance, it paid $1 billion—or $30 for each of the service's 33 million users. Just two years later, the company acquired WhatsApp for $19 billion. While the valuation caught many by surprise, it came to $42 for each of the messaging app's 450 million users, many of whom were located in markets where Facebook hoped to expand. The acquisition gave the company immediate capabilities and scale in the messaging market.

NEW COMPETITORS POSE A MOUNTING THREAT TO INDUSTRY INCUMBENTS

Industry incumbents, already grappling with growing variability and shifts in profits, are being hit with competitive challenges on two major fronts. Formidable emerging-market companies and fast-moving high-tech and tech-enabled firms both bring an agility and aggressiveness to the game that many long-established names will struggle to match.

Many emerging-market giants are gaining global scale

Many companies with their roots in emerging economies now rank among the world's largest. Their track record is uneven, but their presence—in sheer size and numbers—is game-changing. Chinese firms already make up some 20 percent of the Fortune Global 500, while the share of US and Western European companies dropped from 76 percent in 1980 to 54 percent in 2013.

Ownership structures directly influence the growth strategies and operating style of these emerging-market companies. Half of the world's largest state-owned firms are in China, and another quarter are in other emerging economies. In contrast, most of the world's widely held public companies are found in North America and Northeast Asia. Emerging markets are also home to many large family-controlled firms in which the founders' influence remains strong. A firm with a controlling shareholder—whether family, founder, or state—is more likely to focus on building a leading position and is able to take a longer-term view about the growth and investment needed to accomplish that goal. In contrast, widely held public firms must answer to shareholders every quarter and are more focused on maximizing earnings in the immediate term. Controlling shareholders in China also tend to hold twice as much share in their own companies as shareholders in Western Europe, which may contribute to more aggressive pursuit of growth. Family-controlled firms from emerging economies are also quickly expanding their M&A activity.

These new emerging-market competitors tend to put revenue growth and scale ahead of maximizing returns on invested capital (Exhibit E6). Some of these firms are national champions that benefit from government support in their expansion. Many others are family-owned, diversified conglomerates that enter new businesses at a rapid pace, taking advantage of access to talent and capital while allocating family assets across several

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8 Werner Rehm, Robert Uhlaner, and Andy West, "Taking a longer-term look at M&A value creation," *McKinsey Quarterly*, January 2012.

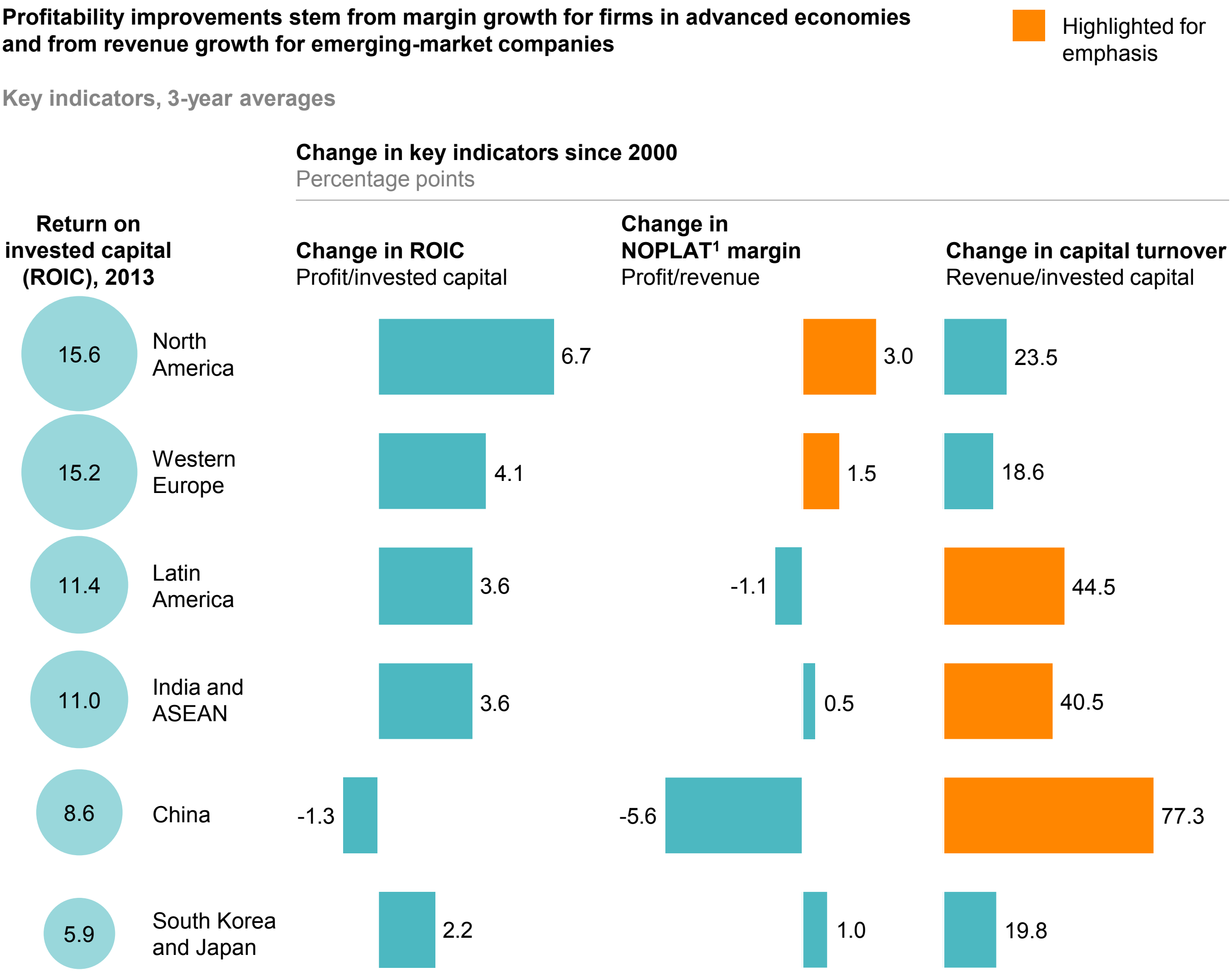
9 *M&A 2014: Return of the big deal*, McKinsey & Company, April 2015.

industries.[10] Chinese firms, regardless of their ownership structure, have grown at four to five times the rate of Western firms in the past decade, particularly in steel, chemicals, and other capital-intensive industries. Yet their margins fell by more than 5 percentage points on average from 2000 to 2013.

Exhibit E6

Profitability improvements stem from margin growth for firms in advanced economies and from revenue growth for emerging-market companies

Key indicators, 3-year averages



1 Net operating profit less adjusted taxes.

SOURCE: McKinsey Corporate Performance Analysis Tool; IHS; World Bank; McKinsey Global Institute analysis

The most globally competitive of these emerging-market firms might be giants, but they have managed to stay lean and agile. Newer competitors, even in durable goods manufacturing, tend to operate with greater capital efficiency and a higher asset turnover ratio than industry incumbents in advanced economies. A relatively young company such as Hyundai has larger average plant sizes and fewer legacy factories than longer-established names such as Volkswagen and Toyota—and it produces more vehicles per worker than they do. Some emerging-market firms are more adept at rebalancing their portfolios to capture new growth opportunities.[11] Many newer competitors focus on the value segment,

[10] Asa Bjornberg, Heinz-Peter Elstrodt, and Vivek Pandit, "The family business factor in emerging markets," *McKinsey Quarterly,* December 2014. Also see Martin Hirt, Sven Smit, and Wonsik Yoo, "Understanding Asia's conglomerates," *McKinsey Quarterly,* February 2013.

[11] Yuval Atsmon, Michael Kloss, and Sven Smit, "Parsing the growth advantage of emerging-market companies," *McKinsey Quarterly*, May 2012.

and their innovation efforts are focused on responding rapidly to the market, recombining technologies, and squeezing out costs.

This new breed of company takes a hardy, risk-taking, and hard-nosed approach to competition. Having cut their teeth in difficult operating climates, these companies value agility and have a natural advantage in other, fast-growing emerging markets. In the past decade, the 50 largest firms from emerging economies have doubled their share of revenue from overseas activity from 19 percent to 40 percent.

Many emerging-market competitors are vertically or horizontally integrated, and they bring different cost structures or even entirely new business models to the game. Brazil's Vale and India's Reliance Group, for example, have developed competencies beyond their core sectors (metals and petrochemicals, respectively) to activities such as power generation and distribution, construction, railroads, and logistics.

It would be a mistake to think of "emerging-market companies" as a monolithic group. Companies tend to reflect their home country's business climate, market structure, corporate culture, and endowments. Some clear regional patterns have emerged from our research. Emerging Asian firms, for instance, have been the most aggressive in expanding beyond their home country, while Latin American firms tend to be significantly less outward-looking. The Chinese corporate sector has a capital-intensive sector mix that resembles that of Japan and South Korea, reflecting a similar legacy of using massive investments to drive growth; the falling margins of Chinese firms appear to be heading toward the 3–4 percent range of their Northeast Asian counterparts in most industries.

New tech players are blurring sector boundaries and disrupting business models

Technology firms represent another huge—and more unpredictable—source of competition. The biggest tech players have reached "hyper" scale in revenue, assets, customers, workers, and profits (Exhibit E7). Indian telecommunications firm Bharti Airtel has around 310 million subscribers worldwide, a number that approaches the population of the United States. Facebook's monthly active user base is on a par with the population of China, and Google processes some four billion searches a day. Alibaba recorded more than $9 billion in sales on its platform in just 24 hours during its 2014 "Singles Day" promotion. Xiaomi has grown at triple-digit rates to become the world's third-largest smartphone vendor—even though it does not sell phones in Europe or the United States.

For tech giants, achieving massive scale goes hand in hand with building and operating a platform or network. In many cases, strong communities of users and developers reinforce the attraction of the platform.

This phenomenon poses two distinct types of competitive threats. The first is from the platform operator itself. Digital platforms can drive down the marginal cost of storing, transporting, and replicating data, giving the operator the ability to add new interactions and business lines quickly. As tech and tech-enabled firms look for expansion opportunities, they can make rapid moves into adjacent sectors. Chinese e-commerce giants Alibaba, Tencent, and JD.com have moved into financial services, including small business lending, consumer finance, and money market funds.

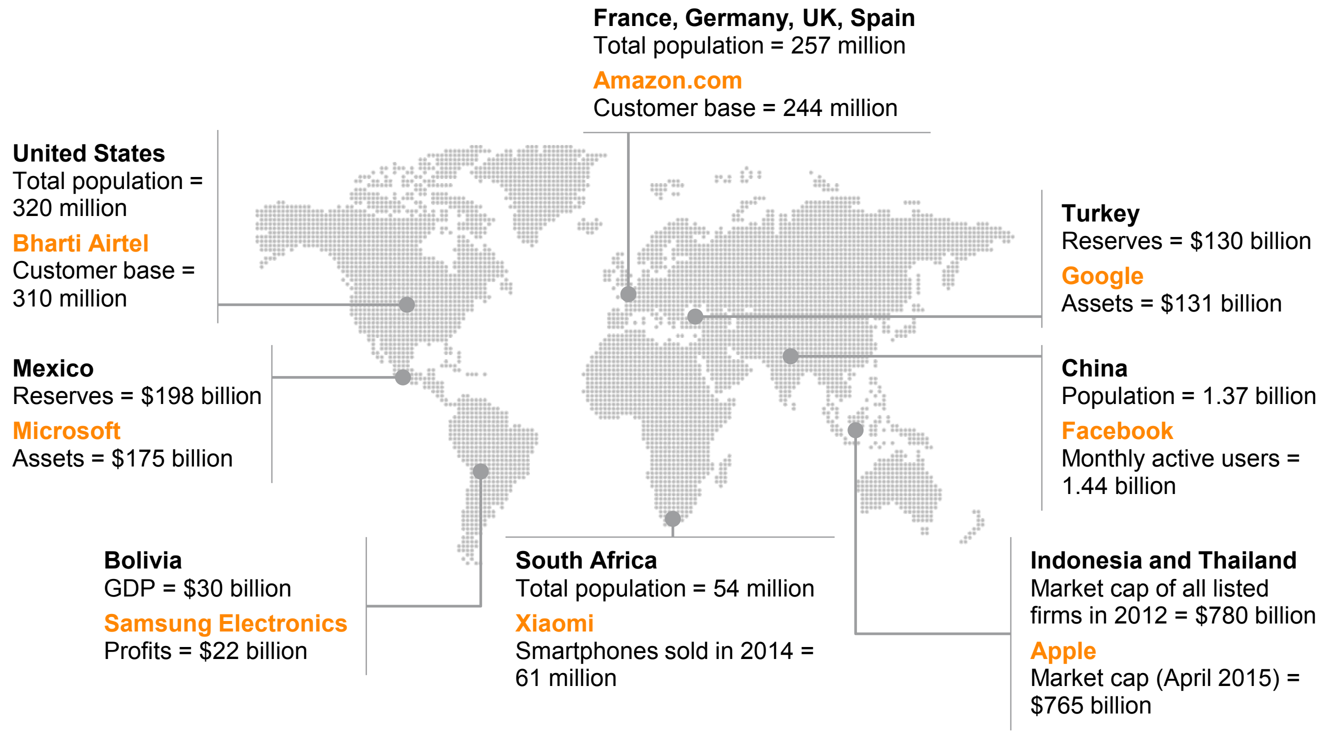
The second challenge for incumbents stems from the hundreds of thousands of smaller enterprises that are empowered by these platforms. The largest e-commerce marketplaces—such as Alibaba, Amazon, eBay, Flipkart, and Rakuten—can host an entire universe of vendors, giving them the kind of payment infrastructure, logistics support, and global visibility once reserved for large firms. Thousands of small and medium-sized

Chinese manufacturers and wholesalers, for example, now sell to overseas customers on B2B marketplaces that have millions of registered buyers.

Exhibit E7

The largest tech firms rival the size of nations

2014 or latest data



SOURCE: Forbes; Fortune 500; World Bank; company websites, annual reports, and press releases; McKinsey Corporate Performance Analysis Tool; McKinsey Global Institute analysis

The pooling of small players on these platforms constitutes a competitive threat in itself. But in some cases, tech-enabled firms go beyond the traditional intermediary role by creating marketplaces that unlock entirely new capacity in the economy, as Uber has done with private vehicles. The US hospitality industry owns $340 billion in fixed assets such as hotels, for example, but platforms such as Airbnb can create digital trade in more than $17 trillion of residential assets currently in the hands of private owners.

The disruption unleashed by tech and tech-enabled firms often plays out in the consumer's favor. Using their cost structure advantages, tech firms are upending established business models. In many cases, they go after a market-leading position by creating consumer surplus, providing free or low-cost products or services where other businesses charge fees. Skype, for example, saved consumers around the world $150 billion in international phone charges from 2005 to 2013, and about $37 billion in 2013 alone. In some consumer-facing industries, traditional intermediaries have come under pressure or have been completely put out of business by digital platforms offering lower prices, more variety, or more convenience. Consider the bookstores shuttered by Amazon, the video stores wiped out by Netflix, and the travel agents rendered obsolete by Expedia.

Tech firms tend to be brutal competitors. Many are privately held by founders or by venture capital investors who often prioritize market share and scale at the expense of profits. Sometimes this mindset—and the control of founders—persists even after companies go public. Among NASDAQ-listed software and Internet companies, founder-controlled firms have 60 percent faster revenue growth and 35 to 40 percent lower profit margins and returns on invested capital than widely held firms. Amazon, Twitter, Spotify, Pinterest, Yelp, and other major players all have focused on growing revenue or large user networks even while losing money over extended periods of time.

THE OPERATING ENVIRONMENT IS TURNING TOUGHER

As today's industry leaders scramble to respond to these fast-moving competitors, another challenge looms: falling costs may have bottomed out. The combined effect of intensifying competition and new headwinds could bring the age of record profits to an end.

1/3
of the workforce in advanced economies could retire within a decade

The global war for talent is heating up

Human capital is a critical source of competitive advantage. But 38 percent of the 41,000 global employers surveyed by Manpower in 2015 reported that they could not find the talent they needed. The aging trend will only exacerbate these shortages. In advanced economies, one-third of today's workforce could retire in the next two decades, taking valuable skills and experience with them. In Germany, Japan, and South Korea, nearly half of today's workforce will be over the age of 55 ten years from now. As these workers retire, replacing them with younger workers will not be easy. Corporations are still learning how to manage a new and more mobile generation of millennial workers and draw the best out of them.

With the spread of online platforms such as LinkedIn and Glassdoor, workers have more information about potential employers, job openings, and the wages they could command. Talented workers have many more options and greater mobility—and competitors have new digital tools for poaching top performers (or even entire teams).

This war for talent is playing out globally. The most coveted jobs in emerging economies were once positions with Western multinationals, but that is changing rapidly. As emerging-market companies become global firms themselves, they are closing the gap with foreign multinationals in remuneration and career opportunities. Increasingly, the most sought-after talent in these countries prefers to work for large companies with local roots.

Even in industries that do not rely on highly skilled workers, labor costs could be on the rise. Opportunities for global labor arbitrage will become more limited as the Chinese workforce ages and offshoring activities come under renewed scrutiny. Income inequality has become a heated topic of debate, spurring new movements to raise the minimum wage.

Other tailwinds that propelled profit growth may be reaching their limits

Some of the forces that boosted corporate growth are reaching their limits. With benchmark rates set practically at zero in major advanced economies, interest rates cannot fall any further. Balance sheets will become more difficult to manage when "easy money" policies eventually come to an end. Corporate tax policies, too, are subject to change as governments face growing fiscal concerns. Governments, the social sector, and even consumers are paying greater attention to the wider societal impact that companies create. The trend toward deregulation is being rolled back in some industries.

While consumption will continue to climb in emerging economies over the next decade, demographics could dampen revenue growth over the longer term. Over the next 50 years, an aging population will significantly reduce labor force growth, creating a major drag on the global economy. If productivity growth merely stays constant and does not accelerate enough to compensate, global GDP growth could slow by 40 percent to just 2.1 percent annually.[12]

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[12] *Global growth: Can productivity save the day in an aging world?* McKinsey Global Institute, January 2015.

Companies will face slower profit growth and many more competitors in the decade ahead

The outlook for corporations is not all doom and gloom. Overall, the global revenue pool could rise by more than 40 percent in real terms over the next ten years. While this reflects slightly slower growth than in the past decade—consistent with various projections for the slowing Chinese economy, for instance—it is still a remarkable opening for corporations.

40%
projected rise in global revenue pool in real terms by 2025

But as global revenue continues to rise, the outlook for profit growth is less promising. Companies will face a pitched battle to claim their slice of the pie. More than half of the revenue growth expected over the next decade will come from emerging markets, and nearly two-thirds of that will be fueled by capital-intensive sectors. Traded industries within this group (such as cars and machinery) are already under enormous competitive pressure. Large emerging-market firms in industries such as extraction, telecom, and transportation have been relatively protected so far, but that is changing rapidly. These firms currently hold large shares of global profits—primarily by virtue of their size—but their margins are declining, due in part to deregulation and technology disruption.

Much has been written about Uber, Lyft, and similar providers shaking up the transportation sector, and this is unlikely to be an isolated case. In the past few years, digital platforms have shown an ability to bring down the price of everything from hotel rooms to hip replacements. No sector is safe, but companies that rely on large physical investments to provide services, or those that act as intermediaries in a services value chain, are particularly at risk.

Several forces could compress corporate profits in the years ahead. First, emerging-market competitors—and Chinese firms especially—will account for a greater proportion of the corporate universe in infrastructure industries such as utilities, telecom, transportation, construction, and extraction. Based on current trends in profitability, their increased presence could lower the overall ratio of profitability, shrinking future corporate profits by $800 billion to $900 billion below the trend growth line over the next decade. Second, the impact of technology disruption and resulting consumer surplus could reduce profits by an additional $600 billion to $700 billion in sectors such as retail, health care, and utilities. Third, the end of declining labor costs could reduce profits by a further $800 billion. This includes rising productivity-adjusted labor costs in emerging economies. Finally, interest rates and tax rates are also subject to potential increases.

$8.6T
projected after-tax profit pool in 2025

After weighing various scenarios affecting future profitability, we project that while global revenue could reach $185 trillion by 2025, the after-tax profit pool could amount to $8.6 trillion.[13] Corporate profits, currently almost 10 percent of world GDP, could shrink to less than 8 percent (Exhibit E8)—undoing in a single decade nearly all the corporate gains achieved relative to world GDP over the past three decades. Real growth in corporate net income could fall from 5 percent to 1 percent per year. Profit growth could decelerate even more sharply if China experiences a more pronounced slowdown that reverberates through capital-intensive sectors.

Consumers around the world, as well as workers in emerging markets, could be the big winners from these shifts. Meanwhile, companies from advanced economies may have to settle for a smaller piece of the global profit pool; their share could decline from 68 percent today to roughly 62 percent in 2025. The swing in profits to emerging economies could even accelerate if Chinese, Indian, and other emerging-market firms make inroads in idea-intensive industries, either through M&A activity to acquire foreign intellectual property and brands or through their own innovation efforts.

[13] Note that all figures in this projection are in real 2013 US dollars.

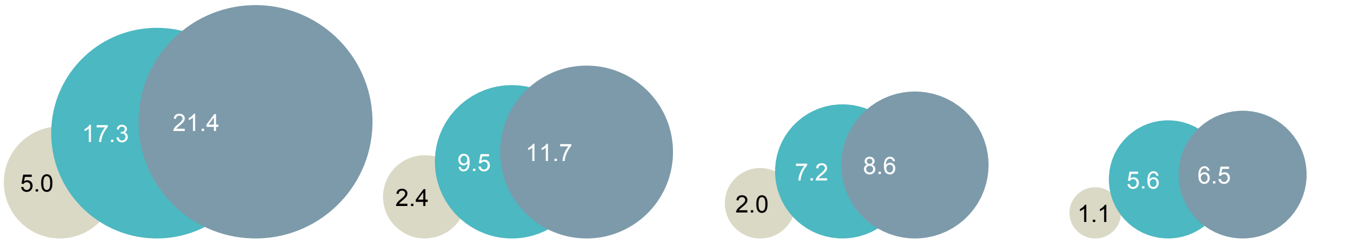
Exhibit E8

The global corporate profit pool will continue to grow, but by 2025, they could lose the relative gains of the past three decades

1980 | 2013 | 2025

Gross pre-tax	Net pre-tax	Net post-tax	Net income
Earnings before interest, taxes, depreciation, and amortization (EBITDA)	Earnings before interest and taxes (EBIT)	Net operating profit less adjusted taxes (NOPLAT)	

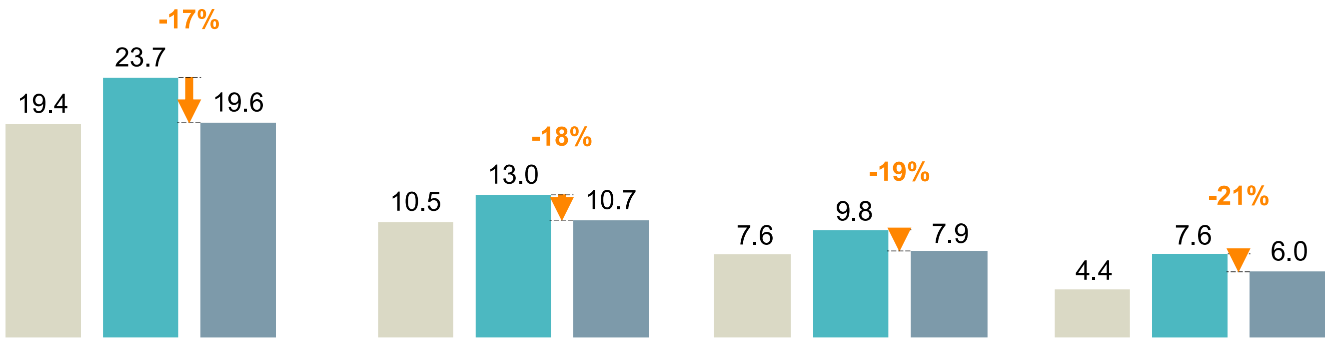
Total size of profit pool
$ trillion, 2013 dollars



Compound annual growth rate (%)

1980–2013	2013–25	1980–2013	2013–25	1980–2013	2013–25	1980–2013	2013–25
3.8	1.8	4.3	1.8	4.0	1.5	5.1	1.2

Corporate profit pool
% of world GDP



SOURCE: World Bank; OECD; Bureau van Dijk; European Commission AMECO database; US Bureau of Economic Analysis; IHS; Oxford Economics; McKinsey Corporate Performance Analysis Tool; McKinsey Global Institute analysis

PREPARING FOR THE NEXT PHASE OF CORPORATE COMPETITION

In the decade ahead, technology and globalization will reshape additional industries, and change will continue at a fast and furious pace. But even in an era of leaner profits, there will be no shortage of opportunities for growth. Successful firms—in every industry—are already demonstrating how to flourish in this new environment.

Three characteristics of winning firms

An analysis of nearly 20,000 companies across a range of sectors finds that the most profitable firms stand apart from their competitors in one of three ways.[14] These strategies determine which companies come out on top, regardless of the sector in which they operate.

First, the most profitable firms are active in fast-growing markets. As revenue growth has shifted to emerging markets, profits are following—slowly at first, but accelerating in the past

[14] We analyzed the top decile in each subsector, as measured by after-tax profits.

decade. Among the most profitable infrastructure companies in the Fortune Global 2000, for instance, are China's Anhui Conch Cement and China State Construction Engineering Corporation, Nigeria's Dangote Cement, and India's Larsen & Toubro and Grasim Industries. Success is not limited to local firms; the foreign profits of US firms have grown twice as fast as their domestic profits since 1980 and today make up one-third of their total profits.

Second, profitable firms, regardless of their sector, build intellectual assets. Over the past decade, the payoff from investing in research and development has grown. The most profitable firms in industries such as pharmaceuticals, semiconductors, and application software tend to significantly outperform their competitors; they tend to spend more on R&D and have higher margins. In other areas, companies enjoy pricing power because of a strong brand (such as those created by Apple and Disney) or intellectual property regulation (such as that enjoyed by Western pharmaceutical firms). Even within capital-intensive industries, highly profitable product segments such as advanced industrial machinery and premium automobiles are more idea-intensive.

Finally, the most profitable firms have notably more efficient operations than the median firm in their industry, with lower production costs for every dollar of sales. This is particularly evident in capital-intensive traded industries such as specialty chemicals, heavy electrical equipment, and tires and rubber, which are heavily exposed to competition. Efficiency is critical, since many innovations are quickly competed away as consumer surplus. Car prices, for example, have remained flat in real terms since 1985, even as their performance, safety, and reliability have improved dramatically. In 2000, the typical base model of a mid-size passenger car had a retail price of $25,000 (in today's dollars). The 2015 version of the same car has $3,000 worth of additional components, yet its retail price is only $23,000.

Business leaders need to be externally focused, agile, and optimistic

Merely playing defense will not insulate companies from the pressures of global competition. It will take optimism, vision, and agility to spot new opportunities and outmaneuver an increasingly crowded field. Successful firms have shown that it is possible to preserve profit margins while pursuing an aggressive growth strategy—and they do this by precisely targeting the fastest-growing market segments where they have the capabilities and assets to compete.[15]

- **Understand and monitor the new landscape.** Large firms cannot afford to be so absorbed in their internal operations and current customers that they are blindsided by new competitive threats. Beyond merely identifying emerging-market challengers, business leaders need to understand the nuances of their home environments to gain insight into how these firms operate, invest, and innovate. This requires more than just an "emerging-markets perspective" or even a "China view." It requires a better focus on the up-and-coming (but often little-known) cities of the emerging world that will be home to future consumers and competitors. Cultivating intelligence is crucial, because the new competitors spend considerable time studying industry leaders for weaknesses they can exploit.

- **Prepare for tech disruption.** It can be hard to place bets on a specific technology before the dust has settled, but waiting increases the risk of falling behind. Some large firms attempt to stay on the cutting edge by holding competitions and "hackathons," or by partnering with venture capital firms to be their eyes and ears. Others have established their own accelerators and VC funds to carve out a role in the entrepreneurial ecosystem, although this is a challenging proposition to get right. Companies need

[15] Sven Smit, Caroline M. Thompson, and S. Patrick Viguerie, "The do-or-die struggle for growth," *McKinsey Quarterly*, August 2005. Also see Mehrdad Baghai, Sven Smit, and S. Patrick Viguerie, "The granularity of growth," *McKinsey Quarterly*, May 2007.

to be willing to disrupt themselves before tech and tech-enabled firms do it to them. Appointing a chief digital officer can help to institutionalize a high-tech mindset.

- **Seek out patient capital.** Widely held public companies are often hamstrung by the demands of shareholders who want to maximize the current quarter's earnings. But many of the new competitors have the flexibility to play the long game. Eighty-six percent of executives who responded to a McKinsey survey believe that making business decisions in the context of a longer-term strategy would improve corporate performance and innovation.[16] CEOs and boards could begin to move in this direction by seeking out institutional investors that have longer investment horizons. They can also design compensation packages that reward executives for delivering longer-term value rather than boosting the company's stock price in the short term.

- **Stay agile in the face of volatility.** To be resilient, firms have to game out multiple worst-case scenarios; these planning exercises can often reveal ways to make day-to-day operations more efficient. Some companies have created multidisciplinary risk teams, diversified their supply chains, and implemented more flexible procurement contracts and manufacturing systems. Lean footprints and rapid innovation capabilities will be increasingly vital. Yet many companies struggle with legacy assets and productivity gaps; some have a 40 percent gap between their most and least productive sites. Firms cannot afford to be bogged down by strategic inertia or complacency. A McKinsey study tracked the capital allocation of more than 1,600 firms over a 15-year period and found more than 90 percent correlation between capital allocation across business units from year to year. But the companies that reallocated capital more fluidly in response to changing conditions achieved substantially higher growth rates and returns.[17]

- **Build new intellectual assets.** Companies need new clarity about all the assets at their disposal, such as customer relationships and data. Putting unstructured data to use can sharpen existing processes and shape strategies—or yield entirely new products and services. Some firms have found success by creating external communities of users, suppliers, and innovators, from Apple's universe of app developers to AstraZeneca's Open Innovation platform. Acquisitions can be a key part of an innovation strategy, but winning with M&A requires being selective and purposeful. Even without making an acquisition, companies can form smart alliances with firms in other sectors for quick access to new capabilities and markets.

- **Go to war for talent.** Finding and nurturing creative talent is already hard, and will get harder. Offering bold new incentives and maintaining a reputation as a good employer can help companies hire and retain the right talent, especially in emerging markets. Most firms agree on the need for their executives to develop global leadership capabilities, but few do so effectively. HR operations at many firms have traditionally been viewed in terms of compliance and support. But as talent shortages grow, especially in idea-intensive sectors, the management of human capital must become a higher strategic priority. In the global war for talent, the growing sophistication and prevalence of digital platforms gives companies a new set of tools to acquire, retain, and develop human capital. Companies that move quickly to integrate such technologies can increase revenue and productivity by up to 9 percent, while lowering HR costs by up to 7 percent.[18]

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[16] Dominic Barton and Mark Wiseman, "Focusing capital on the long term," *Harvard Business Review*, January–February 2014.

[17] Stephen Hall, Dan Lovallo, and Reinier Musters, "How to put your money where your strategy is," *McKinsey Quarterly*, March 2012.

[18] *A labor market that works: Connecting talent and opportunity in the digital age,* McKinsey Global Institute, June 2015.

Policy makers must acknowledge the realities of a new competitive world

This period of disruption and churn will allow countries and regions to carve out new market niches and new roles in global value chains.

- **Prepare for more pressure on employment and wages.** As the fortunes of idea-intensive and capital-intensive sectors diverge, the labor market has become polarized. Companies in capital-intensive industries have responded to margin pressures by cutting costs—often at the expense of workers. Idea-intensive industries have produced strong wage growth, but they have relatively small workforces. Labor imbalances will lead to a shortage of nearly 80 million high- and medium-skilled workers and a surplus of about 95 million low-skilled ones by 2020. Employment and wages have become a political flashpoint, particularly as technology eliminates some roles and changes others. Companies cannot fend off these trends, and neither can countries. Instead, policy makers should focus on ways to ease the dislocations associated with a period of disruption and adjustment. Not only do more young people need to complete both secondary and postsecondary education, but education and training systems have to become more responsive to changing trends in the demand for skills.

- **Support the disruptions that create consumer surplus and public good.** Competition makes a wider variety of better and more affordable products and services available to consumers. In addition, tech firms and their digital platforms are increasingly empowering individuals to monetize their own assets—everything from their homes and cars to their skills and creativity. Competition can also be channeled toward social goals such as health and safety, environmental sustainability, and higher living standards. Policy makers can exploit the competitive environment by mandating desired outcomes and letting companies compete to meet the mandate. But regulators will have to adapt continuously to keep up with new tech-enabled innovations.

- **Support diversification in the corporate sector.** Rather than protecting one outsized national champion, a safer approach would be ensuring that a country's corporate sector is diversified, with competitive firms in several industries and of all sizes. Young, fast-growing companies are net job creators; small and medium-sized firms employ the most people; and large firms tend to be better at promoting R&D and productivity growth. It takes corporate diversity to capture all of these benefits, and that hinges on creating a competitive environment. Innovation thrives where there is competition, so helping incumbents might not always be the right strategy. Sometimes society may derive more benefit from the entry and growth of new players, even if they come at the expense of the status quo.

•••

Companies all over the world will find ample opportunities for growth over the next decade as new consumers with high aspirations and money to spend give the global economy a jolt of momentum. Yet there should be no illusions: the coming era is shaping up to be much tougher—and less profitable—than the past three decades. Never before has there been corporate competition on today's scale, emanating from every corner of the globe and from any industry and sector. Profits will shift to emerging markets, to intellectual assets, and to the most productive companies. The rules of the game are changing, and incumbents need a radically updated playbook to remain on top.

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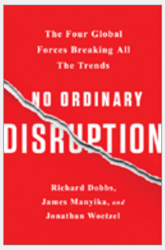

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