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MEASURING AND MANAGING CORPORATE VITALITY

By Martin Reeves, Gerry Hansell, Fabien Hassan, and Benjamin Chan

To thrive in today's complex and dynamic business environment, preserving past positions and business models is not sufficient. Our previous research showed that large, established companies are increasingly vulnerable because of declining vitality—the capacity to explore new options, renew strategy, and grow sustainably.

Declining vitality is explained partly by the natural life cycle of companies: the growth rates that startups experience cannot be sustained forever. Still, among mature companies, there are significant differences in vitality and hence in their ability to grow. In the long run, the majority of returns for shareholders are necessarily driven by revenue growth. So the companies that maintain their vitality create more long-term value.

The Fortune Future: A Forward-Looking Index

Today, enterprise management is still largely informed by backward-looking financial indicators, with the implicit assumption that past success is predictive of future success. We might call this rearview management.

There *is* predictive power in historical data. But the high rates of change and uncertainty driven by evolving technology, business model innovation, and other factors make this assumption increasingly untenable. We need new metrics and approaches.

The Fortune Future index, the result of a two-year research effort to develop a way of measuring vitality, can help fill this gap. The index, which ranks US-listed companies by their ability to generate long-term revenue growth, is based on two pillars:

1. **Potential.** This is measured as the implicit expectation of future growth from financial markets, through the present value of growth options (PVGO). It represents the proportion of market value that is not attributable to the earnings power of the existing assets and business model.

2. **Capacity to Deliver Potential.** This comprises 14 factors, which were drawn from a larger group of variables tested and calibrated against historical data for their ability to predict long-term growth. These variables are grouped in four clusters: strategy, technology and investments, people, and structure.

The Index Leverages Novel Analytics

The capacity pillar extensively leverages nonfinancial data to create predictive insights that cannot be obtained from financial data alone. For instance, we developed a measure of technology advantage by analyzing investments in startups and comparing them to the activities of the best-performing VC funds.

Artificial intelligence techniques were also used to digest unstructured data and tease out predictive patterns: natural language processing (NLP) algorithms enabled us to assess whether the strategies expressed in annual reports reflect a vital approach with respect to clarity of intent, long-term orientation, and a new dimension, "biological thinking." This last dimension represents management's ability to embrace and leverage the uncertainty and complexity of business environments and address them with flexibility, adaptation, and mutualism.

What Patterns Does the Index Reveal?

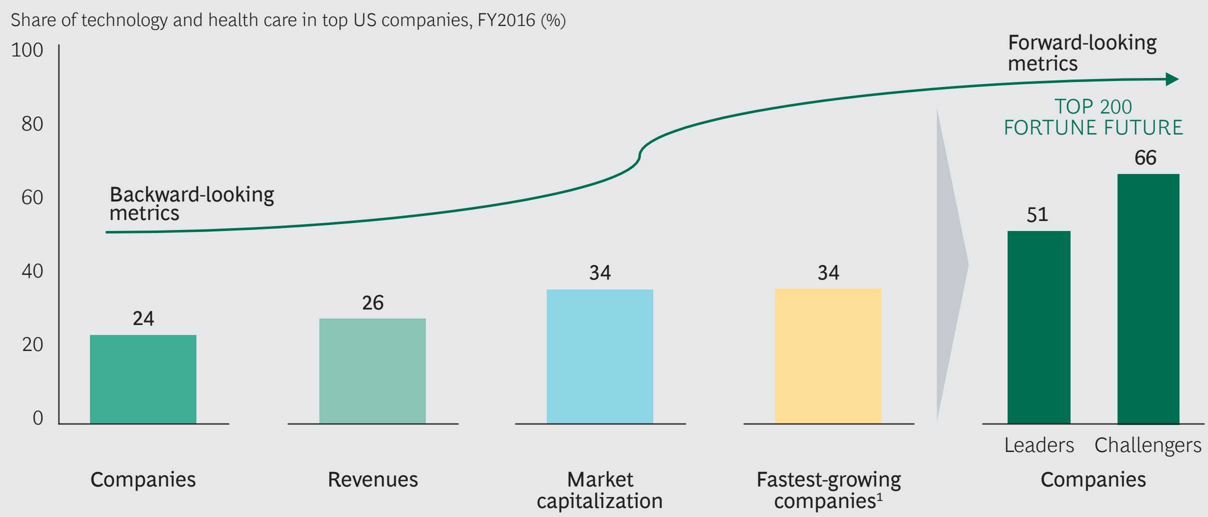
The Fortune Future index is split into two size categories: Leaders (companies with a market capitalization over $20 billion as of fiscal year 2016) and Challengers (companies and startups with a market capitalization below $20 billion).

Leading companies in both categories share a number of characteristics.

- **The most vital companies are in technology and health care.** Among the top 200 companies in the Fortune Future ranking, 51% of Leaders and 66% of Challengers are in either technology (especially internet, software, and IT services) or health care (especially biotechnology and health care equipment).

  This reflects recent trends in the US economy. For example, the proportion of technology and health care companies among the fastest-growing US-listed companies (by revenue) increased from 29% in 2010–2013 to 34% in 2013–2016.[1] (See Exhibit 1.)

Exhibit 1 | The Fortune Future Index Signals the Continued Vitality of Technology and Health Care



Sources: S&P Capital IQ; BCG Henderson Institute analysis.
[1]Defined as companies with 2013–2016 annualized revenue growth above 10%.

The domination of technology and health care is strongest in the top 25 companies and less pronounced further down the ranking. (See Exhibit 2.) The top 100 Leaders and top 200 Challengers reflect relatively well the total number of companies in each sector, with the exception of real estate and utilities, which are underrepresented in the index.

- **The West Coast leads the way.** The top 50 companies in the Fortune Future ranking (for both Leaders and Challengers) are headquartered in California. Salesforce.com is from San Francisco, while Veeva Systems is based in Pleasanton. This is not just a coincidence: the top 200 Fortune Future companies are also highly concentrated in the Pacific region (31% for Leaders, 39% for Challengers). (See Exhibit 3.)

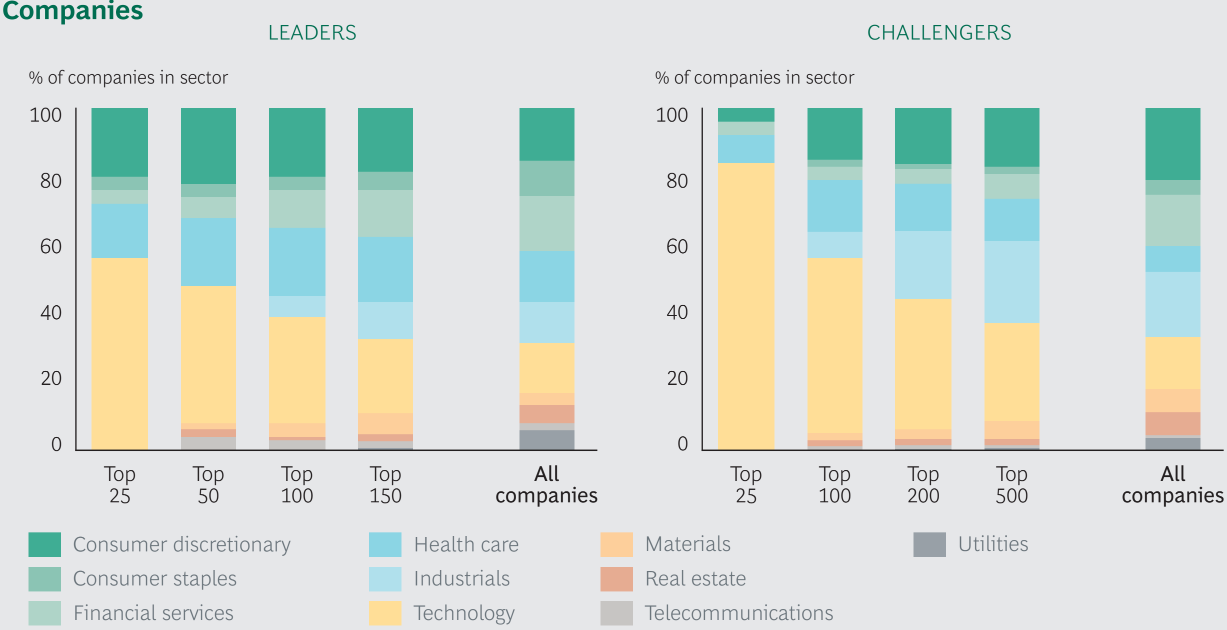
  This is consistent with the strength of the West Coast in the digital economy, a trend that started in the 1990s and remains as robust as ever. The dominance of the Pacific region is particularly striking for Challengers in the top 25, while the top 100 show more geographic diversity. (See Exhibit 4.) Again, this is consistent with current trends: 32% of the fastest-growing public US companies in 2011–2016 were headquartered in that region.

- **Recent performance supports the findings.** The Fortune Future 50 ranking was based on data from fiscal year 2016 and earlier. Ten months is a long time in today's dynamic economy. Still, as of early October 2017, Fortune Future 50 Leaders had outperformed the S&P 500 by 12 percentage points in total shareholder return (TSR) since the beginning of 2017.[2] Challengers outperformed the S&P SmallCap 600 by 29 points.[3]

  Despite those positive signals about the promise of the index, it is important to stress that the Fortune Future ranking is not a crystal ball. Effective strategy does not always follow precedents or aggregate patterns, circumstances change, and performance can always be derailed by individual decisions and circumstances.

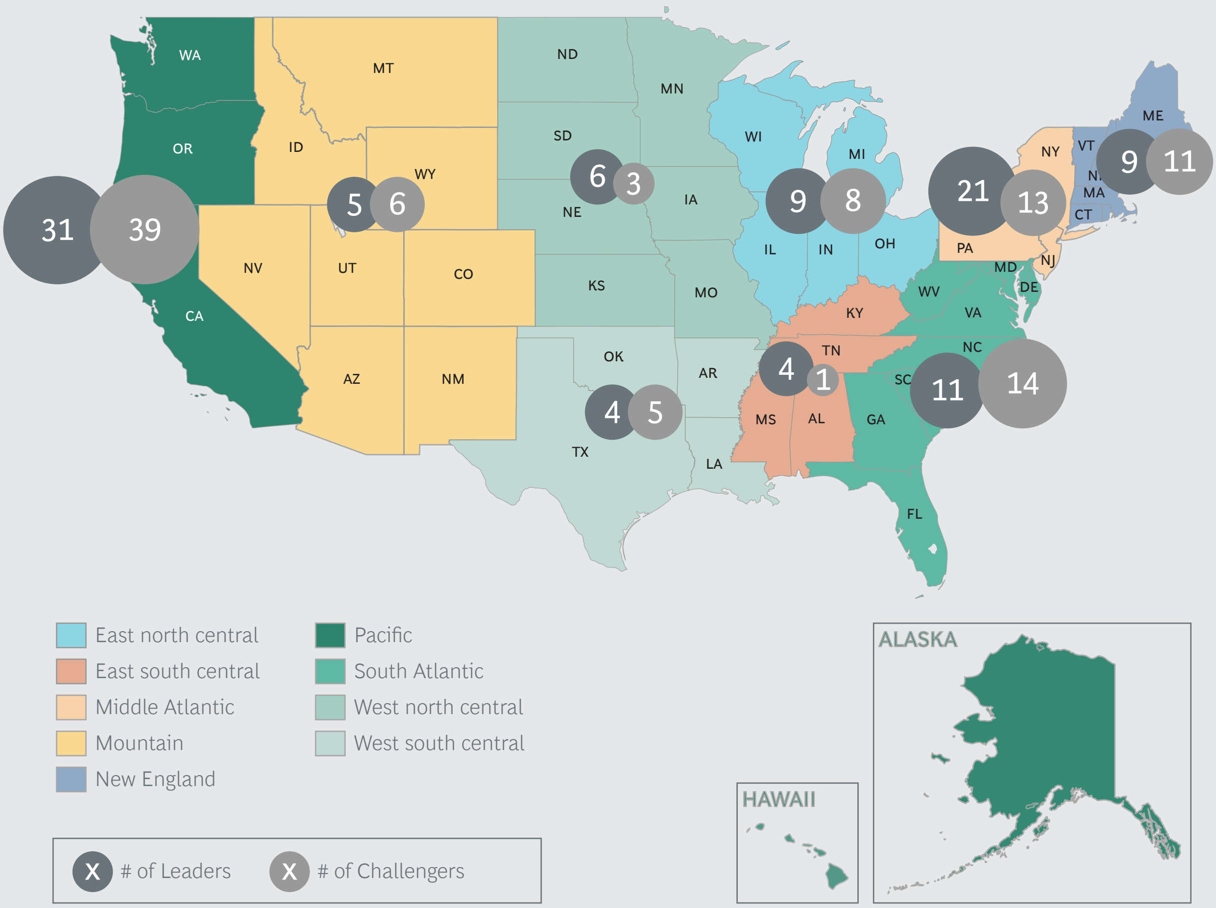
Beyond the ranking itself, our methodology for assessing vitality provides a novel, for-

Exhibit 2 | Technology and Health Care Are Prominent Among the Top Fortune Future Companies



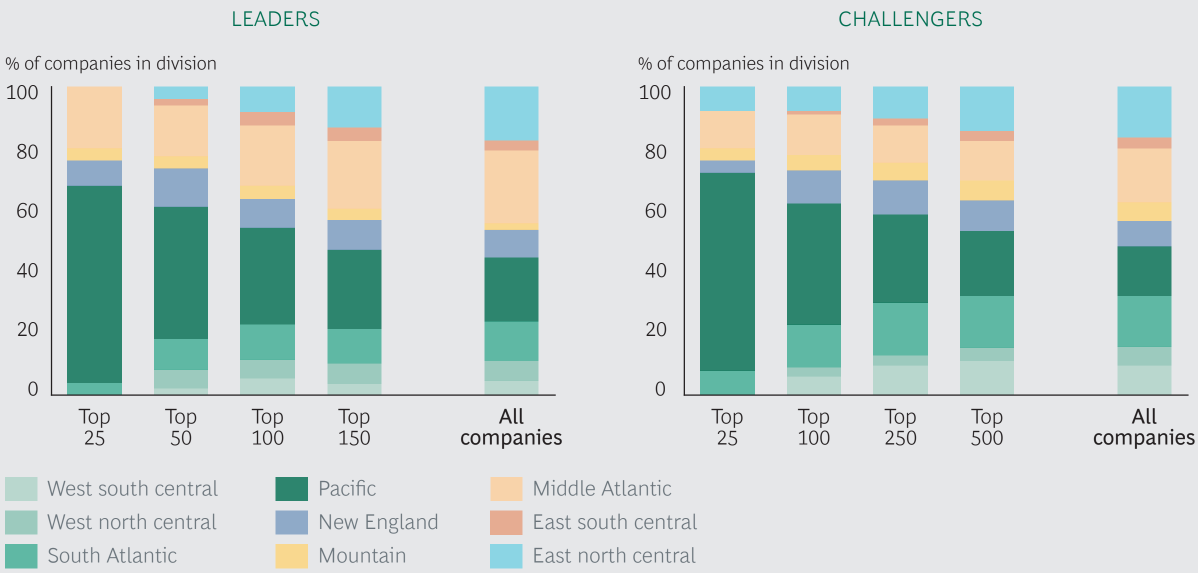
Sources: S&P Capital IQ; BCG Henderson Institute analysis.
Note: "All companies" includes the top 2,000 US-listed companies by revenue.

EXHIBIT 3 | Where Are the Fortune Future 200?



Source: BCG Henderson Institute analysis.

EXHIBIT 4 | The West Coast Is Overrepresented in the Fortune Future Index



Sources: S&P Capital IQ; BCG Henderson Institute analysis.
Note: “All companies” includes the top 2,000 US-listed companies by revenue.

ward-looking view of performance. The concept of vitality can help companies escape the trap of driving on a bumpy road using only the rearview mirror. In subsequent articles, we will explore how companies retain or restore vitality even as they grow and mature.

Notes

1. Fastest-growing is defined as annualized revenue growth above 10% in the relevant period.
2. 27% market cap–weighted average TSR for Fortune Future Leaders versus 15% for S&P 500.
3. 39% market cap–weighted average TSR for Fortune Future Challengers versus 10% for S&P SmallCap 600.

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