Disruption
The Way Forward for Middle-Market Companies

By Michael C. Slocum

Michael C. Slocum discusses the results of Capital One Commercial Bank’s recent survey of more than 300 senior middle-market executives. How is this group preparing to identify and respond to disruption?
There is nothing new about technology and globalization driving changes in business, dooming long-established companies and spawning new ones. Fifty years ago, a company on the S&P 500 stayed for 33 years, on average. Today, approximately half the companies currently on the list are expected to be replaced over the next ten years.

Without question, the pace of change is accelerating, driven in part by startups that disrupt entire industries. However, despite popular wisdom, startups are not the only disruptors. Apple was a mature, 30-year-old company when it introduced the iPhone. These enterprises share a willingness to envision a future that is different from the present, rewrite their business plans accordingly, and dedicate capital to support their disruptive strategy.

In this volatile environment, middle-market companies—those with annual revenues between $100 million and $3 billion—can feel besieged from all sides, threatened by nimble startups and industry giants alike. Although these pressures are indeed real, middle-market companies can turn disruption to their advantage. While resource constraints can make them an object of disruption, their size can provide the agility they need to adapt and even become agents of disruption themselves.

The middle-market response to disruption will have a significant impact on the economy. The nearly 20,000 U.S.-based middle-market companies employ more than 30 million people and produce approximately $1 trillion of the $30 trillion in annual gross receipts generated nationwide.

Capital One’s Commercial Bank surveyed more than 300 senior middle-market executives to determine how they have prepared to identify and respond to disruption, as well as any plans to engage in disruptive strategies themselves.

We found a broad range of attitudes and strategies to cope with disruption. For example, companies that are focused on introducing disruptive strategies themselves often give defensive measures short shrift. Many have also failed to arrange for the financial resources needed to withstand a disruptive attack. With 75 percent of respondents reporting that they will require additional capital to remain competitive in the event of an industry disruption, it has become especially critical for middle-market companies to have a financial partner capable of offering a broad spectrum of services.

**Middle-Market Companies Appear Unfazed by Disruption, Leaving Them Vulnerable**

As a group, these executives are acutely aware that their business may be disrupted. Fifteen percent have already faced a disruptive event that had a material impact on their finances, while an additional 23 percent expect to experience a disruption of this magnitude within the next three years.

Different industries anticipate different sources of disruption. For instance, companies in transportation, logistics, and distribution see the internet of Things—the wireless network of sensors embedded in everyday objects allowing them to send and receive information—as their greatest concern. Not surprisingly, those in apparel and retail worry about the influence of social media on consumer choice, while manufacturers are concerned about robotics. A few sources of disruption, such as big-data analytics, transcend specific industry segments.

We also found that many middle-market executives hold seemingly contradictory views on disruption. Forty-three percent believe their industry is quite or extremely vulnerable to disruption. However, they are far less worried about its effects on their own companies, just 18 percent reported that their company is quite vulnerable to disruption. These executives see the coming storm, but expect it to hit their competitors only.

While some executives assume they will not be impacted by the coming changes, we expect that most fall into a second group—executives who are optimistic because they see disruption as primarily an opportunity for their company, not a threat. Indeed, 60 percent said their companies are actively pursuing a disruptive strategy. In fact, the more vulnerable they feel, the more likely they are to be pursuing a disruptive strategy of their own. 85 percent of those who feel quite or extremely vulnerable have launched disruptive strategies.

For most middle-market companies, the old adage applies: the best defense is a good offense. However, we found that many companies adopt this approach without also mounting an adequate defense. Fifty-five percent of those who see disruption as an opportunity consider themselves only slightly prepared for potential disruption, and 11 percent of respondents declared they hadn’t done anything at all.

We also found that the response to disruption correlates highly with company size. Companies with revenues between $2 billion and $3 billion are much more likely to see a disruptive event as an opportunity, whereas smaller middle-market companies are not. Those larger companies are more likely to have prepared for a disruptive event by creating contingency plans and purchasing interruption insurance. In addition, half the companies in this group have increased their R&D budgets by 11 to 25 percent in the past year alone. These companies are likely to be pursuing a disruptive strategy of their own that could lead to a competitive advantage.

The contrast with smaller companies—those with revenues between $100 million and $499 million—is striking. They are more likely to view disruption as a threat, primarily because they have difficulty mustering the financial resources needed for mounting a defense. For instance, they often lack essential banking relationships. If confronted by a disruption, these smaller companies would be in jeopardy.

**Disruptors and Delayers**

Our research identified two clear groups with diametrically opposed approaches to disruption—we dubbed them
disruptors and delayers. Success in the face of disruption requires both preparation and proactivity. Disruptors are those who are quite or extremely prepared for disruption and are pursuing a disruptive strategy. They constituted 16 percent of the respondents. Financial services and insurance companies are archetypal disruptors.

By contrast, 30 percent of respondents are delayers—that is, they are unprepared for a disruptive event and are not pursuing a disruptive strategy. Energy, resources, and chemicals companies tend to be classic delayers.

Here again, company size jumps out as a differentiator. Just three percent of small middle-market companies are disruptors, while 44 percent are delayers. By contrast, 27 percent of large middle-market companies are disruptors, while only 13 percent are delayers.

**Strategies to Help Middle-Market Firms Navigate a Disruptive Environment**

How can delayers and smaller middle-market companies better position themselves for success in a disruptive environment? The first and perhaps the most obvious step is to deploy a set of defensive measures. Delayers are particularly lax in creating a contingency plan, purchasing interruption insurance and implementing regular firewall testing.

Companies at risk of disruption also need to marshal their financial resources. Although middle-market companies overwhelmingly recognize the need for financial support, a significant portion of our respondents—32 percent—said they lack a banking relationship capable of supporting their companies in case of disruption.

Disruptors are more forward-looking in their preference for financial partners. For them, financial institutions remain the preferred source of funding. They look to them for access to private equity as well as asset-based lending and asset securitization. The delayers and the smaller companies, on the other hand, are more likely to consider alternatives such as peer-to-peer lending and crowdfunding. We believe that to increase their readiness to confront disruption, middle-market companies should look for stable, established financial partners that offer a broad and evolving selection of services and have a deep understanding of their specific industries.

Investment in R&D should also be on a middle-market company’s checklist, to create opportunities to launch offensive measures while strengthening defensive capacity. The survey found a positive correlation between access to capital and a company’s R&D strategy; those with strong banking relationships are most likely to have increased their R&D budgets by between 11 and 25 percent.

Finally, a good offense—while not an adequate substitute for defensive measures—is an excellent complement to them. Middle-market companies need not develop disruptive technologies themselves; they can simply incorporate disruptive digital tools or partner with companies that have introduced them. Disruptors embrace this strategy. Nearly three-fifths of disruptors welcome digital tools, compared to two percent of delayers. Disruptors are much more inclined, for instance, to have adopted a disruptive financial service, and they also embraced online and mobile payments. We recommend that small firms and delayers would do well to follow the lead of disruptors in strengthening their companies by adopting disruptive technologies.

**Strong Financial Partnerships Can Ensure Survival**

It’s a view widely shared across the modern business landscape: disruption is a fact of life. Globalization and the advent of new technologies have made new and unorthodox business models possible, lowering costs and creating efficiencies that are transforming once-staid industries. Middle-market companies are often targets of disruptors, but their size can provide the nimbleness needed to be disruptors themselves—but only if they make sure their defenses are in place.

Companies that deploy contingency plans and other defenses, increase their R&D spending, and adopt disruptive strategies can create and exploit a competitive advantage. A key element of this strategy is access to capital. Finding the right financial partner—one that is capable of offering a broad spectrum of services—is a critical step for middle-market companies as they prepare for the inevitable disruptions that are reshaping the business landscape.

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