“The vast majority of CEOs are optimistic about the economy and their own business prospects in the coming three years. They see possibilities for ‘efficient growth’ and the potential to leverage new technologies to enhance customer relationships and streamline operations.”
From the chairman and CEO:

After years of navigating through the most significant financial, political and technological disruptions in more than half a century, CEOs at companies of every size and in every sector continue to confront business challenges of unprecedented complexity. In this environment it’s not enough to have a point of view on only the next fiscal quarter or six month period. Today’s business leaders must look beyond the immediate horizon.

Gathering insights on the longer-term outlook is the unique goal KPMG set out to achieve with our comprehensive CEO study, “Setting the Course for Growth: CEO Perspectives.” We asked 400 U.S. CEOs from companies of all sizes, operating in sectors ranging from retail to manufacturing to utilities, to offer an in-depth look at the most critical business issues they expect to face over the next three years. Where are their greatest opportunities for growing profits – not just in the coming months, but through 2015, 2016 and 2017? Will their organizations outpace the slow-moving recovery, or fall behind competitors with fast-moving product innovations? What are the top concerns shaping strategies that will drive years of growth?

The CEO responses to these questions and more provide valuable insights on the state of business today, and more importantly, on the priorities shaping strategies and decision making for years to come. The vast majority of CEOs are optimistic about the economy and their own business prospects in the coming three years. They see possibilities for “efficient growth” and the potential to leverage new technologies to enhance customer relationships and streamline operations. At the same time, regulation, risk and product relevance are concerns that cannot be ignored.

Alongside the CEO perspectives, this report also features commentary from KPMG partners, who provide frontline insights drawn from their experience helping world-class organizations navigate their business and strategic needs.

KPMG is proud to present “Setting the Course for Growth: CEO Perspectives” as one of the most extensive and forward-looking examinations of business available today, with powerful insights on where U.S. leaders hope to take their companies in the next three years, and beyond.

John Veihmeyer
Global Chairman and U.S. Chairman and CEO of KPMG

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Executive summary

The next three years will continue to bring change, caused by political, economic, social and especially technological forces. It will be happening amid an economic recovery that is in itself not a typical exit from a recession. These times, when a single app can change an entire business model, require new expertise, approaches and processes to harness these disruptive changes for growth.

Compared with last year, CEOs’ confidence in the future growth of the economy, their industries and their companies has increased, according to a KPMG survey of 400 CEOs. Their confidence is based on plans for “efficient growth.” While focusing on growth, especially through organic and geographic expansion, CEOs remain conscious of the need to enhance efficiency. The intensity of their growth strategies is split, with half of the CEOs describing their growth strategies as conservative, and the other half as aggressive.

External factors are making it more difficult to stay ahead of competitors and keep up with customers. The majority of CEOs surveyed are concerned about the relevance of their products three years from now, and about keeping up with their competitors, whether existing or new entrants. To this end, they are set on becoming more consumer-focused and see branding as a top organizational priority.

CEOs fully grasp the need to change. Three-quarters of the company leaders surveyed are in some stage of transforming their operating models. Spurring innovation is a top challenge for CEOs. But are the processes needed to succeed at innovation or transformation up to the task? The KPMG survey reveals that there remains room for improvement.

Efficient growth is the lens through which every aspect of the organization and external forces affecting it should be viewed. This includes the regulatory environment and risk, the two areas that are often seen as burdens rather than opportunities. Regulatory environment is the top issue that can have an impact on a company and the area to which CEOs devote the most time. After years of reputational hits following the financial crisis, and more recently cyber security breaches, the majority of CEOs are personally involved with risk management. But the survey found that many may not have rigorous and integrated risk processes, as well as cultures that will help them choose the best strategy for growth.

Key findings

Confident on economic outlook, hiring

More than half of the CEOs surveyed—55 percent—feel more confident about the economy over the next three years than they did a year ago. Seventy-eight percent intend to increase head count.

Expect To Be Much More Acquisitive

Today, two-thirds of the CEOs say their current growth strategy is built around organic growth, with one-third saying it is combination of organic and inorganic growth through acquisitions. When asked to look at their growth strategy over the next three years, 53 percent expect their priority will be organic growth, with 42 percent indicating that it will be an even split between organic and inorganic growth through acquisitions.

Strong Focus on Growth

Seventy-two percent say that the focus on growth is more important for their companies’ well-being than a focus on operational efficiencies. Yet, the KPMG study found CEOs less than certain about the course and speed to take their growth strategies. Study results show that CEOs are evenly split in categorizing their overall growth strategy as either aggressive or conservative.

Optimistic About Business Prospects

Sixty-two percent are optimistic about the growth prospects for their business in the next three years. And the CEOs expect greater profits ahead. In looking at the next five years, 28 percent tabbed 2016 to be their greatest year for profits and 29 percent said 2017.
Key findings

Surge in Operating Model Transformations
A vast majority of company leaders in the survey (76%) are at some stage of operating model transformation — assessing the need, planning for it, starting or having just implemented it. However, just 16 percent said that they evaluate their operating models quarterly and the majority (54%) do it yearly.

Spurring Innovation a Top Challenge
While spurring innovation is among the top challenges for CEOs, just 17 percent of companies have developed and implemented a formal, companywide process for innovation across all units. Many more (47%) of the largest companies, with revenues over $10 billion, have a formal, companywide innovation process.

Product Relevance a Top Concern
Seventy-two percent of the CEOs said they are concerned about the relevance of products/services three years from now. Furthermore, a vast majority (90%) are concerned about the ability of competitors to take business away from them, and 59 percent are concerned about new entrants disrupting their business model.

Adapting to Government Regulation a High Priority
When asked to identify issues that can have the most impact on their companies, the CEOs identified the regulatory environment first, followed by corporate tax reform. In fact, 34 percent of the CEOs are spending more time with regulators or government officials or are considering doing so.

Growth Strategies Largely U.S. Focused
The KPMG study reveals that growth strategies are largely U.S. focused. In looking at domestic and international operations to drive growth over the next three years, a far greater number of CEOs tabbed domestic expansion as the priority.

Expanding Geographically Ranked as Top Challenge
The CEOs tabbed expanding geographically as their top challenge, just ahead of adapting to government regulation, focusing on operational excellence, strengthening the brand, and spurring innovation.

Risk Management Not Regularly Discussed
The majority of CEOs either lead the discussions on risk planning or have a strong voice in them (89%). Yet, even though risk management is the second-highest concern about the company for CEOs (following financial performance), risk planning is proactively discussed on a regular basis at just 27 percent of organizations.
CEOs surveyed feel confident about the economy, their industries and their companies over the next three years. “My economic models suggest that we will still be in the growth phase for the next three years, however, we will probably be nearing the end of the recovery. It all comes down to what happens with the labor market and wages. If much of the low participation is cyclical then wages won’t rise too much and inflation will not be an issue. If the low participation is structural then we have a smaller supply of labor and wage price pressures will drive inflation and rates higher which will impact the length of the growth cycle,” says Constance Hunter, KPMG’s chief economist in its Alternative Investments Practice.

Michael R. Odell, President and CEO of automotive aftermarket service and retail chain Pep Boys, sounds even more measured: “We assume that the economy is going to stay at status quo. We’re not expecting anything to get worse, we’re not expecting things to get a lot better, which means it’s a fight for market share.” Making managing through this recovery even more complex for CEOs is a varied landscape, with the economy rebounding unevenly across the United States. As a result, many CEOs operate across up and down areas. Such sentiments may be behind CEOs’ citing a few years out as the time when they expect to record the greatest profits.

Overall, the KPMG study reveals that CEOs are in growth mode, as growth decisively trumps efficiency as more important to companies’ well-being, with 78 percent of CEOs expecting to increase headcount over the next three years.

The KPMG CEO study reveals that even as CEOs prioritize growth, they continue to focus on efficiency. Many of the growth strategies and programs that CEOs are undertaking are executed while keeping an eye on savings. For example, the transformation of operating models, which are being undertaken in some form by 76 percent of companies, according to their CEOs, is influenced mostly by financial and efficiency-based factors. The success of operating model transformation is measured by financial metrics as well. Reducing cost structure is among the top five strategic priorities. That approach changes in the case of companies with revenues over $10 billion, which tend to rely more on non-financial metrics for designing and measuring growth strategies.

Healthcare giant WellPoint is prioritizing growth based on the belief that national scale and local market density will continue to be central to achieving higher membership for...
PG&E: Driving Operational Efficiencies

PG&E is aggressive about both growth and efficiency. The company is investing about $6 billion a year in infrastructure, its highest rate of investment ever. In a regulated industry, growth is driven by capital investment. The risk to that growth is that capital investments lead to higher rates charged to the customers. In a low-growth economy like today’s, operational efficiencies have to be driven in order to counterbalance the increase in costs associated with the capital investment. “We’re aggressive on growth, but we’re also aggressive on operational efficiencies to counterbalance that, so we can maintain a strong focus on affordable bills for our customers,” says PG&E’s CEO, Anthony F. Earley Jr.

To achieve higher efficiencies PG&E has a very aggressive continuous improvement program. Each business unit starts with extensive benchmarking of processes in relation to the best in the industry. PG&E used to be in the fourth quartile, but is now, on average, in the high third quartile, moving across into the second. The target is to get to the first, which Earley translates into $500 million to $1 billion of savings opportunities.
GROWTH VS. EFFICIENCY
Q&A With Stephen Lis, Leader, Management Consulting Practice, KPMG LLP

When we asked CEOs what was more important, growth or efficiency, three-fourths said growth. Is it possible to have both? Growth and efficiency are not contradictory. It’s hard to get both at the same time, but it is definitely not impossible. While CEOs are increasingly looking at growth strategies to drive value creation, they are still investing in infrastructure, the operating environment, and the back office and support functions. That investment is focused on positioning the operating environment and infrastructure to support growth as well as drive efficiency.

CEOs use measurements related to efficiency and cost-cutting. Are these measurements growth-related? Traditional measurement systems are historical, looking at past performance and typically focused on efficiency, cost, capital utilization, etc. Very little in the measurement system today is forward-looking. Simply put, the measurement systems have not caught up to the agenda of growth. They tend to lack key indicators and predictive insights on where growth opportunities may exist. However, technologies are beginning to emerge that provide greater insights into customer sentiment, behavior and opportunities for growth.

What are some examples of such predictive, growth-generating measurements? A lot of attention is being paid to analytics predicting customer behavior. Another area of interest is analyzing customer engagement and satisfaction, and how to enhance both. Such measurements can help decide which areas have the greatest growth potential and how to position the organization (both marketing and sales as well as delivery and service) to maximize growth. These new uses of technology for predictive measurement have gained favor as we’ve also begun to see the emergence of the chief marketing officer function. Surveys indicate that marketing organizations are starting to get more technology investment than IT organizations themselves.

health plans and higher profitability. “We will maintain a lean mindset, but we will not do so at the expense of investing in the business for the long term,” says CEO Joseph R. Swedish. (See sidebar, PG&E: Driving Operational Efficiencies, page 5.)

Tamara L. Lundgren, president and CEO of Schnitzer Steel, spends considerable time on improving efficiency by reviewing the company’s operating model with her executive management team. “The results include our decisions to streamline our shared-services division, combine administrative functions within operations and adjust our operating model to ensure that we are positioned to extract synergies across our entire business platform, which extends from the sourcing and processing of scrap metal to the manufacturing of finished steel,” she says.

Across the board growth strategies are split, with half of CEOs classifying their growth strategies as conservative and the other half as aggressive. In line with this balance, a majority of CEOs surveyed (84%) are pursuing moderate growth strategies, divided roughly in half between moderately aggressive and moderately conservative.

Beth Mooney, CEO of KeyBank, is pursuing a moderate growth strategy relative to the industry. “We are pursuing a growth strategy that is better than peer average but doesn’t put us in a position for the next downturn of having taken risks that we will pay the price for,” says Mooney. “Our industry has to remember that when and if there is another recession or bubble, you have to prove that you built a business model that can survive it without causing investors volatility.”

The KPMG study reveals that growth strategies are largely U.S.-focused. In fact, almost a quarter of CEOs surveyed (23%) believe that their international operations will require less time or energy, with the biggest group (37%) saying that international operations will get the same time and attention as other priorities. Just 10 percent say that international operations will require more time and energy.
Whirlpool: Balance Built on Experience

Major home appliance giant Whirlpool Corporation has a balanced, multipronged approach to covering all the bases of growth, built upon the company’s 100 years of experience. “Our growth plans include organic growth through innovation, growth beyond our core products and geographic expansion,” says CEO Jeff M. Fettig. Whirlpool is also on track to become the majority shareholder of Hefei Sanyo, a Chinese home appliance maker, to accelerate its growth in the emerging Chinese market.

The company recently announced a $40 million expansion of its small-appliance manufacturing operation in Greenville, Ohio, that would add 400 jobs over the next four years, and it is also launching a new marketing campaign for the Maytag brand. The company is investing heavily in innovation, including smart appliances. The plan is to grow revenue by 5 percent to 7 percent. True to the balance of achieving both growth and efficiency, Whirlpool aims to increase its operating margin by 8 percent.
Ahead: confidence built on plans for efficient growth (cont.)

In addition, in looking at domestic and international operations to drive growth over the next three years, a far greater number of CEOs surveyed tab domestic expansion as the priority. That’s not surprising when you consider the reinvestment in manufacturing in the U.S. and the general steadiness of the U.S. economy when compared with other economies.

A look at where CEOs intend to invest capital reveals that investing within the U.S. takes priority over international investing, according to the survey. Technology sector CEOs put a much greater emphasis on expanding both in the U.S. as well as in emerging markets, followed by CEOs in automotive.

Of course, the scope and direction of growth strategies varies by company and its state of development. The growth strategy of Whirlpool, a century-old appliance maker, includes a major international component in China. (See sidebar, Whirlpool: Balance Built on Experience, page 7) Avon, a 128-year-old direct-selling beauty company, derives 85 percent of its business outside the U.S., and 75 percent of its revenues come from emerging markets.

Currently, the majority of CEOs surveyed (67%) are pursuing organic growth, and a third are evenly split between organic growth and acquisitions. The biggest companies stand out, with a 50/50 split between purely organic growth and strategies based evenly on organic growth and acquisitions.

As one example, Schnitzer Steel has a growth strategy based on organic growth and acquisitions. Organic growth anticipates both top-line growth and continuing margin expansion. Since 2008, the company has made 11 acquisitions in its metals recycling business and 16 acquisitions or greenfield developments in its auto parts business. “Acquisitions and greenfield developments will remain key drivers of our growth, as they have been in the past,” says Lundgren.
M&A activity should be picking up in the near future, according to the survey results. Looking ahead to three years from today, more CEOs surveyed (42%) plan to be pursuing strategies based on both organic and M&A-based growth.

“Organizations are holding on to massive amounts of cash, interest rates have remained at historic lows, and consumer confidence is rising. These positive economic indicators point to a general feeling of optimism in the corporate arena,” says Dan Tiemann, KPMG’s transactions and restructuring lead for the Americas. “When a target that complements an organization’s growth strategy becomes available, pursuing M&A presents an attractive opportunity for corporate players to create long-term equity value for their stakeholders.”

Of course, pursuing M&As is, first and foremost, a question of fit. Celgene, a biopharmaceutical company focused on developing products for the treatment of cancer and immune-inflammatory diseases, has completed multiple strategic partnerships. CEO Robert Hugin makes no future predictions and stresses the importance of synergies when deciding about acquisitions or partnerships. “We don’t have a target for what we plan to do going forward this year or in future years [in terms of deals],” he says. “Having a strong internal research capability gives us insights into programs that would produce synergies to produce disruptive technologies and life-enhancing therapies in the interest of patients, healthcare systems and economies worldwide.”

“Executives are turning their attention to deals that bring revenue and cost synergies to their organizations,” adds Tiemann, “and they are willing to pay a premium for those targets. Otherwise, buyers are willing to wait on the sidelines for the right target to become available that will effectively and efficiently integrate with their organization.”

“Ideally, this three-year time horizon for increased M&A activity would align to a period in which there is greater certainty around business tax reform—an item that survey respondents identified as having relatively high possible impact on their companies. We’re seeing that the current uncertain outlook for reform is particularly challenging for companies undertaking M&A transactions today. It casts a shadow over the tax outlook for the target company’s operations as well as the opportunities for tax-efficient integration of the combining businesses, both of which make pricing deals today more difficult.”

– Lisa Madden
National Practice Leader, KPMG Mergers & Acquisitions Tax.
Staying relevant among disruptions

The concern about staying relevant is running high among CEOs. The majority worry about the relevance of their products three years from now, are concerned about current competitors taking business away and are wary of new entrants. When asked whether she is more concerned about existing competitors or new entrants, Sheri McCoy, CEO of Avon, said simply: “Both.”

Staying abreast of competitors and consumers over the next three years will require new approaches and often different tools than it did in the past. Competition has become industry-agnostic in the sense that a company from any industry can influence overall consumer behaviors and expectations. It thus benefits CEOs to observe all new entrants. This approach can be illustrated by the example of WellPoint’s Swedish. Despite operating in healthcare, which is among the most disrupted and idiosyncratic industries, he carefully studies new entrants in other industries looking for new consumer trends they are introducing. (See sidebar at right, WellPoint: Putting the Consumer at the Center.) KeyBank’s Mooney is also very alert to the waves that technology companies can make in her industry. (See sidebar, KeyBank: Banking on Safety, page 13.)

FIGURE 6
How concerned are you about the following?

- **90%** concerned about competitors taking business away
- **72%** relevance of products/services three years from now
- **59%** new entrants disrupting business model

One important way to stay relevant is to listen to consumers. Indeed, the KPMG study shows that more interaction with customers and clients is a top organizational priority for CEOs. In the era of the digitally savvy customer, the idea of being customer-centric has taken on new meaning.
Wellpoint: Putting the Consumer at the Center

Health insurance giant WellPoint’s CEO, Joseph R. Swedish, stands out in how he thinks about the competition by looking beyond his own industry. He believes that companies like Amazon.com and Uber, a car-ordering service, have changed the way customers think about services. Translating these new entrants’ strategies into his field, he notes that “the ACA has shifted healthcare’s center of gravity toward the customer—and so must we.

“We need to put the end-consumer at the center of everything, and these end-consumers calibrate their expectations of us against the likes of Amazon and Uber,” he adds. Exponential advances in digital health technology will significantly change how customers access and consume healthcare. This means employing new technologies and new business models in the healthcare industry. “We need to innovate to remain relevant and to defend our business against untraditional new entrants that may disrupt our industry,” says Swedish.
This new approach is based on utilizing data pertaining to customer information, says Linda Imonti, Principal, National Business Intelligence Leader/West Advisory leader in Advisory Services at KPMG. (See sidebar, The Power of Information.) “Organizations understand that if they analyze the customer, gaining further understanding in how to attract, acquire, manage and retain customers in a meaningful way, the company creates a more satisfied customer and thus an impact on the top line,” says Imonti. Pep Boys is one example of a smart use of Customer Data Segmentation (See sidebar, Pep Boys: Know Your Customer, page 14.)

KPMG’s Hunter points out that many of these new customers are members of the millennial generation, and the shifts in attitudes they bring with them are much more significant than in the previous generations of baby boomers or Gen X’ers. “It’s going to require better understanding of how the customers are different and what their needs might be,” says Hunter.

THE POWER OF INFORMATION
Q&A with Linda Imonti, National Business Intelligence Leader/West Advisory leader in Advisory Services at KPMG

What is the best defense against competitors, either existing competitors or new market entrants? One of a company’s greatest defenses against competitors, and how they’ll stay in a position of competitive advantage, is being an information-driven organization. Information will drive a level of potential innovation, speed to market and customer interaction in a way that we haven’t had the ability to do in the past. The key is to create information that allows you to not only see historically but to provide predictive information. When you utilize predictive information, you enable future competitive positioning.

Are CEOs aware of the importance of data analytics? There’s been a fundamental shift in understanding of the value of data. In previous years, data was really viewed as a technology asset. Today, companies recognize that it’s not simply the data that’s an asset, it’s the information they glean from that data. The right information is the asset.

Does the data live in various pockets of the organizations or is it utilized enterprise-wide? The power comes from data when the dots are connected. Going forward, organizations do understand the benefits of being an information-centric and intelligent enterprise. The CEO has a very large role in making this happen. When it’s an enterprise-wide culture to utilize information to make business decisions, that’s where the power comes in. That’s where you get and maintain the competitive edge.

Over the past few years, manufacturers have seen an explosion of new technologies and innovative developments in materials science, advanced manufacturing and synergistic operating models. With this sea change, manufacturers the world over are now starting to take stock of the more complex world that they are operating in and use that insight to redefine ‘the art of the possible,’ fundamentally transforming the way manufacturers compete and succeed.

— Jeff Dobbs
Global Chair, Industrial Manufacturing and Partner with KPMG in the U.S.
“I see more competitive disruptors on the landscape than I’ve ever seen,” says KeyBank’s CEO, Beth Mooney. While KeyBank has a group of banks it competes with, Mooney is very aware that technology can result in new entrants into banking. “Does Google figure out how to own the wallet? Does Wal-Mart figure out how to really bank everybody?” wonders Mooney. Companies are attempting to use some new technologies to bypass what has been the traditional payment system.

The crux will be whether a non-banking institution can figure out how to move money safely. “Banks have to play to their strengths,” says Mooney. Regional banks have the size and scale to meet competitive demands, be nimble and comply with regulatory requirements at the same time. “We keep your money and your information safe and secure,” says Mooney.
Staying relevant among disruptions (cont.)

On the flip side, companies need to stay relevant not just to their millennial customers but to their millennial workforces as well. CEOs understand the importance of human capital. Only a third of respondents (34%) agree that they have an adequate workforce and see no disruptions in the next three years. The approach to human capital may not be keeping up with the times, though. Just 30 percent of the CEOs report that their companies are exploring non-traditional ways of attracting employees.

Pep Boys, the automotive aftermarket service and retail chain, is a good example of a company using analytics to drive future growth. The company is betting on organic growth based on service, which is a bigger market segment than the Do It Yourself. Although the DIY market has benefited over recent years due to the weak economy, service is expected to grow slightly faster than DIY in the future.

But DIY customers are a very different segment than service customers. The former shop on price, the latter are more interested in the availability and quality of service. To understand how to tailor its offerings to different customer segments, Pep Boys analyzed its loyalty database of 24 million customers. The analysis yielded five different customer types, from the “Economical Ed” who shops based on price with the zeitgeist. “Millennials don’t think of themselves as working for someone. They don’t feel tied to their employer,” says Hunter. “Yet that doesn’t mean they cannot be a great asset, especially in terms of innovation.” Engaging millennials, whether by investing in their ideas or their ideals, is one way to keep them within a company, instead of letting them leave to join—or become—its competitors.

Pep Boys: Know Your Customers

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FIGURE 7
How are you fostering a more customer-centric organization?*

19% I am spending significantly more face time personally with our clients and customers

44% I have charged senior leadership to invest more time personally with our clients and customers

55% We are training our junior staff at an earlier age so they can interact with clients and customers

23% We have not changed our customer strategy at this point but are planning to.

* Multiple responses allowed.
Predictive change

How do companies stay relevant in a fast-changing world? Considering the overwhelming number of shifts in technology and customer behavior, to name just a few areas, the portfolio of ideas to choose from is vast. “One of the biggest problems organizations face is taking on too much too fast and not focusing enough. As a result, they do a lot of things marginally,” says Steven Hill, Vice Chairman, Strategic Investments, KPMG.

Hill says the key to a successful transformation is not going about it in an ad hoc and hurried manner but to be instead focused “on prioritization and then rigorous and thoughtful implementation.” “It is about limiting the number of wrong moves and correcting mistakes fast,” says Hill.

We are living in interesting times, with multiple transformation triggers all present at the same time, all equally intense. Among major forces that can lead companies to transform their business and operating models are significant shifts in technology, the emergence of a digitally savvy customer and regulatory overhauls. CEOs definitely realize that they need to innovate and transform. A vast majority of company leaders in the survey (76%) are at some stage of operating model transformation—assessing the need, planning for it, starting or having just implemented it.

Change is ongoing. However, the frequency with which companies take the measure of their operating models varies. The majority of respondents (54%) assess their operating models yearly. Financial services firms are the most vigilant, with the highest number of CEOs surveyed saying that their companies (43%) evaluate their operating models quarterly.

Avon’s chief executive officer, Sheri McCoy, says “We are always evaluating and pressure-testing our operating model and are not afraid to make adjustments where needed.” McCoy understands that in developed markets such as the U.S., it is key to be on the cutting edge of digital, so Avon has been investing in digital technologies as well as mobile and e-commerce. In Europe, the company is looking at innovative ways to deliver products to its Representatives, and it has introduced drop boxes in parts of Europe. Avon has also begun selectively leveraging its channels to bring in new brands. It is experimenting with multichannel through Liz Earle, a naturally active skincare brand that Avon acquired in 2010.

McCoy does not forget to stay personally engaged in her pursuit to improve the operating model. “Whenever I travel for business, I always meet with small groups of associates and Representatives to get their feedback, and the insight they provide me is incredibly valuable,” she says.

There are different ways of thinking about the business and operating models and defining transformation. PG&E CEO Anthony F. Earley Jr. says he comes at it from two very different perspectives—continual and the big picture.
The continual approach is reflected in having a detailed long-range integrated planning process, with monthly business plan reviews and special attention on a more frequent basis if necessary.

The big-picture thinking involves getting ready for the future based on major forces affecting the energy sector. These are interesting and challenging times for the energy sector. “Today’s energy company has never operated in such a dynamic, challenging and uncertain environment,” says Regina Mayor, advisory industry leader, energy & natural resources, KPMG. “The long-term growth outlook is promising but filled with uncertainties. There are a number of significant transformational forces at work changing the industry in profound yet unpredictable ways.”

Among these forces are the emergence of distributed generation technologies, such as rooftop solar, or the potential of fuel cell technology. PG&E considers possible scenarios of how the energy sector can develop and looks at commonalities in each scenario to determine what changes need to be implemented.

For innovation, it is crucial to have company-wide processes in place. “To grow, companies must first accurately assess how equipped they are to drive innovation and surface good ideas throughout their entire organization,” says Pat Dolan, national leader, consumer markets, KPMG.

Such processes may include enterprise-wide platforms for sharing ideas, rewarding employees for creativity, a process for approving ideas and funding projects, and often also a process for creating new units to develop new ideas and take them to market faster. Today, just 17 percent of company leaders surveyed say that they have implemented an innovation process across all units. It should be noted that many more (47%) of the biggest companies, with revenues over $10 billion, have a formal, company-wide innovation process.

Understanding the difference between the “development” engine (encompassing innovation and transformation) and the “operational” engine is also crucial to the success of innovation, according to KPMG’s Hill. The disciplines required for development and operations are important, but different.

Says Hill, “Most organizations have incredibly strong operating cultures that have been honed over time. However, the culture and processes relating to innovation are often not equally well developed or even recognized as distinct.”

Compounding the issue, innovation or transformation can also have operational efficiencies as their goal. In fact, the top factors influencing business model transformation are purely operational and financial. (See Fig. 11) Furthermore,

### Figure 10

**Do you have a formal, company-wide process for innovation?**

- Developed and implemented across all units: 17%
- Developed and started implementation: 25%
- Developing, not yet implementing: 11%
- Plans to develop: 20%
- No process or plans to develop: 27%

### TRANSFORMATION CHALLENGES

**Q&A With Stephen G. Hasty, U.S. Innovation Leader for Advisory, KPMG**

**Which part of business transformation is more difficult: strategic vision or its execution?**

Most companies get the vision right. The harder part is to execute on the transformation. A large number of companies don’t achieve the desired business result. Some of the challenges to execution of business transformation are the people dimension. It is important to understand the culture of the company, along with its capacity to absorb change. Defining metrics, which can measure transformation outcomes, will improve the ability to achieve the desired business results.

**Are certain corporate cultures favorable for achieving successful transformation?**

The design of the transformation program has to fit the culture. Organizations that have an enterprise-wide agenda and formal processes do better at transformation. Overly decentralized organizations may have trouble with change, because in many cases what is optimal for an individual function might not be optimal for the enterprise as a whole. With such organizations it is essential to ensure the buy-in of all the necessary parties at the start of the transformation.

**The regulatory environment is a significant driver of business transformations, especially in the financial and healthcare sectors. Are there any lessons specific to regulatory-based transformations?**

The key to a successful regulatory-based transformation is being able to understand current regulations and their possible future interpretations. It is crucial for the regulatory requirements to be designed upfront to avoid rework. It is also necessary to design the systems with enough flexibility to be adaptable to future regulatory change and to allow for different interpretations of regulations.
Predictive change (cont.)

respondents indicated that the success of the operating model transformation is measured mostly by financial metrics, such as increased profitability (53%), growth in revenue (41%) and overall cost reductions (40%).

Examples of such tie-ins of innovation and efficiency abound. PG&E’s Earley is especially interested in the ability to analyze Big Data about customers’ usage of electricity—which is being gathered by smart meters—to understand how better to operate energy delivery systems. WellPoint’s Swedish tries to square the costs of innovation with the value-based model of healthcare delivery. He believes that some innovations’ astronomical price tags do not correlate with value. “Is a $1,000 pill ever justifiable for what can’t be considered an orphan drug by any stretch of the imagination? We need innovation, but there needs to be some restraint,” he says.

Since operational and innovative programs often intersect in business model transformation, conflicts can arise if incentives and goals are not explicitly addressed. KPMG’s Hill notes that incentives for innovation and development are often different from operations. “This dichotomy can create an issue in management when company leadership expects operators to execute against innovation without reengineering incentives,” he says.
However, CEOs need to be less involved in scale innovations, defined as accelerations of current capabilities that don’t compel the organization to undergo major changes. This seemingly hands-off attitude on the part of CEOs revealed by the KPMG study may stem from a big-picture perspective on innovation. While CEOs are not involved in all of it directly, they are thinking about how innovation fits into or affects their business and operating models, and how it can change their industries.

PG&E’s Earley is involved in innovation on many different levels, starting with human capital. A lot of the CEO leadership in innovation means creating the right innovation teams by hiring leaders. One such innovative hire was PG&E’s chief information officer, who comes from a retail company. That hire was not a typical choice for an energy company, but Earley said he wanted to have a data person from the retail industry, known for its edge in data analytics over other industries. It has already benefited PG&E in terms of know-how and faster timelines.

Innovation should be part of an ecosystem, rather than just within an organization’s four walls. Innovating with customers, suppliers, distributors, and other partners can bring rich insights about changing market dynamics. “If you don’t have an ability to see what’s happening across your value chain, that’s a major blind spot,” says Hill.

While the innovation ecosystem is crucial across all industries, Gary Silberg, national automotive leader for KPMG in the U.S., stresses its importance for the automotive sector: “Cars continue to evolve into highly complex computers, and the auto industry will need to aggressively invest in R&D and develop new partnerships with non-traditional auto suppliers to foster technology innovation.

Data analytics is beginning to fill some of the information chasms that exist between operations and innovation engines. However, making sure that these two engines work in tandem requires not just the information systems but also people. And the human systems that connect the automated systems in a corporation are not yet well inventoried.

Thus, it is crucial to have visible CEO engagement in transformation efforts. Just 5 percent of CEOs are personally involved in innovation, according to the KPMG study. CEOs cannot just be “involved” in disruptive innovation initiatives; they must visibly lead transformative initiatives that require business or operating model change or significant change in behaviors or mindset. “Ideas are plentiful, but the hardest part of innovation is effective execution. Without the direct involvement from the top of the house, such initiatives are at a much higher risk for failure,” says Hill.

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We’ve seen several OEMs successfully collaborate with tech companies, while others have struggled. Getting this right in the future will be critical, given the enormous technological innovation occurring in the vehicle.”

Innovation needs to be responsive to external factors and also come from a place of confidence within an organization. “The companies with the most successful innovation will be those that can overcome innovation uncertainty, whether sparked by shifting customer dynamics, limited budgets, conflicting visions or a lack of confidence in their ability to pick winning technologies,” says Gary Matuszak, global chairman, technology, media and telecommunications at KPMG.

That uncertainty can be reduced or eliminated by having a disciplined and rigorous approach and via thoughtful engagement of the CEO.
Regulatory environment: more impact than the economy

We have entered a new regulatory environment, one that is intended to change how business is done. No wonder then that the regulatory environment is the top issue that can have the most impact on a company according to U.S. CEOs surveyed. (See Fig. 13) In financial services and consumer markets, corporate tax reform takes precedence. In healthcare, the healthcare reform is most important, while in technology CEOs surveyed point to cyber security as the highest-impact issue.

CEOs surveyed also say that adapting to government regulation is their second most critical challenge, trumping challenges relating to financials or operational efficiency. As a result, 34 percent of CEOs are spending more time with regulators or government officials, or considering doing so.

The two sectors currently most affected by the regulatory environment in the U.S. are healthcare and financial services. The Affordable Care Act and other regulations are causing an overhaul toward a patient-centric model that changes how healthcare is delivered, how it’s paid for and what constitutes value in health delivery. Ed Giniat, leader of the healthcare and life sciences sector at KPMG, states: “The top three risks in healthcare are compliance, compliance and compliance.”

George S. Barrett, chairman and CEO of healthcare services company Cardinal Health, Inc., underscores the dynamic part of the regulatory environment when he says: “Anyone in healthcare who feels totally satisfied or relaxed is not paying attention. Between the regulatory and legislative changes and the simple realities of our national health, both economic and physical, it is clear that healthcare will change.”

In the financial sector, there are a number of regulatory mandates oriented toward transparency and reducing overall market risk. The sheer quantity of regulations coming at financial services companies can be hard to grasp. They include Dodd-Frank, the Volcker rule, Basel 3, the routine rulemaking of up to eight different federal regulators, as well as state regulators, Office of the Comptroller of the Currency, SEC, and FDIC. The effort to comply will be staggering. The first 224 rules of Dodd-Frank that have been written by regulators take up 7,365 pages; the private sector will devote an enormous amount of time and resources complying with them.

1 Securities & Exchange Commission; Commodity Futures Trading Commission; Federal Reserve System; Federal Deposit Insurance Corporation; Financial Industry Regulatory Authority; Office of the Comptroller of the Currency; National Credit Union Administration; Consumer Financial Protection Bureau.
2 U.S. Congress; The Committee on Financial Services; Dodd-Frank Burden Tracker.
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The regulatory environment is changing the financial services industry, in terms of both how it does business and how it manages itself. “The entire business model of the financial services industry is being challenged right now,” says Pamela Martin, Managing Director, Americas’ Regulatory Center of Excellence, KPMG.

New regulations are expensive in terms of compliance, as companies need to transform data tracking and gathering systems, reporting functions and, in some cases, their organizational structures. At the same time, these regulations can limit revenue growth and profitability by, for example, increasing capital ratio requirements, and limiting certain products or activities (e.g., proprietary trading).

“To grow, financial firms have to combine and balance three distinct and competing elements that must be made to fit together,” says Scott Marcello, national leader for financial services and board member, KPMG LLP. “They have to comply with a complex and growing set of regulations, they have to optimize their business models and processes to save costs, and they have to get closer to their customers, all at the same time.”

Prosperity Bank’s chairman and CEO, David Zalman, puts the current regulatory environment in perspective: “I’ve been in banking since 1978, and today, probably over half of my time is spent with regulatory requirements. The regulatory burden is a threat to traditional community banking.

“Expanding geographically”

“Adapting to government regulation”

“Strengthening our brand*”

“Focusing on operational excellence*”

“Spurring innovation”

*same value

REGULATORY TRANSFORMATION
Q&A With Tim Zuber, Regulatory Center Leader at KPMG

How would you assess the current regulatory environment? The ever increasing pace of globalization as well as political and financial volatility has resulted in the proliferation of regulations. The global pace of regulatory change is accelerating. First and foremost are industry-specific regulations, for example, in the financial services industry and healthcare. There are also “industry agnostic” regulations that cross multiple industries, such as anti-money laundering rules.

Are these regulations a burden or do they also present an opportunity? Complying with regulations generally creates a drag on businesses. For example, regulatory compliance can add costs, slow down processes, and restrict expansion. However, that being said, companies are beginning to realize that not only can they comply well, but they can begin to derive a competitive advantage by complying cost effectively. The best companies are now beginning to derive new value out of regulatory compliance processes. One way we help them to do so is to take data and insights that in the past have been used almost exclusively for compliance purposes and use them to drive additional value. For example, sales data required solely for indirect tax compliance purposes may be analyzed to provide new or better insight on product and customer profitability that otherwise was not known or knowable. With these insights, better decision making outside of the tax function may be possible.

The regulatory environment is so impactful that in highly regulated industries companies are changing their business models due to regulations. How well they do that may dictate their marketplace position for the foreseeable future.

What is the best approach to derive competitive advantage from the regulatory environment? A best practice is to take a holistic approach to regulatory-based business transformation. Issues for CEOs to consider are what regulatory transformation means in terms of their people, process, technology, data and their clients. Regulation is not going to go away, and as economies become more connected, regulations are only going to proliferate and become more complicated. It’s important to have a micro view about specific regulations, and also have a macro view about what the regulatory environment and specific regulatory themes mean for the whole enterprise.
It is troubling that we don’t always know what the regulators are going to want."

Other industries are also affected by a strong regulatory component. In the heavily regulated communications industry, companies have to meet Federal Communications Commission requirements. In the energy sector the same holds true for the rules set by the Environmental Protection Agency, state regulatory agencies, or the Nuclear Regulatory Commission.

“In the energy sector, federal and state regulatory agendas are being heavily influenced by customers’ desire for greener energy options, the promise of emerging smart technologies, energy sustainability and the need for safe operations,” says John Kunasek, U.S. sector leader for energy, natural resources and chemicals at KPMG. “Thus, federal and state regulatory policies and actions continue to orient towards additional customer choice, incentives for investment in innovation, safe operations, and greener energy standards.”

PG&E’s Earley can personally identify with the focus on the regulatory issues. “A constructive regulatory environment can either help or hurt us. I absolutely spend time with state and federal regulators. As CEO, most of my time is spent on regulatory issues.”

In the energy sector, federal and state regulatory agendas are being heavily influenced by customers’ desire for additional choice of energy sources, the promise of emerging technologies, global sustainability and need of safe operations.”

– John Kunasek
U.S. Sector Leader, Energy, Natural Resources and Chemicals, KPMG
Risk management: harnessed for efficient growth

Amid disruptive technological changes, an enhanced regulatory environment and the new digitally savvy consumer, growth comes with ever multiplying layers of risk. CEOs are fully aware of these risks and are extremely concerned about managing them. Risk registers as the second most important concern, after financial performance.

The fallout after the most recent financial crisis and the hits to reputations taken by many companies have had their effect. Today, 91 percent of CEOs responding to the survey are personally involved in the risk management of their companies. (See Fig. 16) More than half (63%) of CEOs of companies with revenues over $10 billion describe themselves as extremely involved in risk planning, compared with 33 percent of all CEOs surveyed. For the risk management strategy to be effective, it needs to be comprehensive in terms of content (sources of risk) and follow a rigorous process. That process needs to be embedded throughout the whole organization and needs to fit its culture.

The basis of a productive risk management strategy is harnessing it for growth, looking at the organization through a risk lens equivalent to a growth lens when charting a growth strategy, says Michael Nolan, U.S. and global partner in charge for KPMG’s Risk Consulting Services. A successful growth strategy is contingent on understanding and accepting the risks associated with the assumptions the strategy is built upon. Strategic risk cannot be overestimated. The majority of substantial market capitalization drops that companies incur are due to some failure in dealing with strategic risk.

The push and pull between risk management and growth is especially pronounced in the financial services sector. The regulatory environment has limited some possibilities in revenue and profitability growth. In the aftermath of the financial crisis and global recession, companies are under a great deal of pressure to find new ways to grow, to serve customers in a way that is reflective of the tremendous technological changes that have occurred, to achieve profitable growth in an era of extraordinarily low interest rates, and yet to manage risk effectively and comply with the intense regulatory environment.

“A renewed emphasis on investing in and professionalizing the risk management functions will be critical in achieving the right balance between risk and reward,” says Brian B. Stephens, partner, national sector leader for banking and capital markets, KPMG. It should not come as a surprise then that more financial services CEOs than those in other industries, 40 percent, are extremely involved in risk management, according to the survey.

Understanding the risk content means knowing the sources of risk, their probability and intensity. Regulatory pressure is seen as the issue posing the greatest threat, according to a report from KPMG, Expectations of Risk Management Outpacing Capabilities—It’s Time for Action.

Avoiding Shocks: Risk Management And Electricity

Liberty Power’s risk management strategy, which affects its growth plans, consists of three elements: people, processes and metrics. CEO David Hernandez believes that the biggest risk for any company is not having the right team to execute its strategy – a risk he believes Liberty Power has successfully managed by building a team of hungry, humble and smart people. Second, he believes that his company has the right processes and organizational structure in place to mitigate its risk exposure and to be nimble in response to changing market forces. Third, Liberty tracks the right metrics. “That’s the only way we can tell if our processes are performing well,” he says.

FIGURE 15
Top concerns about my company (ranked in descending order)

1. Financial performance
2. Risk management concerns
3. Workforce issues
4. Operational issues
5. Ability to innovate
How can risk be harnessed to drive efficient growth? Companies have to understand how much risk they are willing to take to achieve a certain growth level. CEOs have an inherent understanding of what their risk appetite is. The challenge with that is that there may be an inconsistency between the CEO, senior management and the board. Having a more formalized risk appetite statement prevents that. It also helps to answer growth questions: Are we taking too much risk? Are we taking enough risk?

Do companies have their risk appetite statements? While nearly all C-suite executives recognize risk management as an important ingredient in their organization’s overall business success, only one in five have fully developed and implemented a risk appetite statement. Nearly a quarter have them in development. While some progress has been made, companies need to do more in this space.

What’s the importance of having a well-articulated and communicated risk profile? In today’s world of enhanced risks, the board and the shareholders are asking more questions around risk. Not having a well-articulated and communicated risk profile in itself means taking on an unnecessary risk.
Risk management: harnessed for efficient growth (cont.)

“New financial regulation is in the forefront of this trend, but the financial services industry is not the only sector feeling the heat. Healthcare, manufacturing, technology, energy and other industries face many new government rules,” according to the report. Regulatory pressure was rated the top risk in financial services, energy and natural resources. “Government pressure to contain spending,” a regulatory issue, was the top risk in healthcare, according to the report.

Each industry presents its individual roster of sources of risk. In the energy industry, for instance, electricity is inherently one of the riskiest commodities, because it can’t easily be stored and prices change by the minute.

While CEOs surveyed have increased the intensity of their focus on risk, the processes and the capabilities of risk management haven’t caught up with the expectations of regulators, shareholders, boards and even the CEOs themselves, says KPMG’s Nolan. He points to the three lines of defense against risk.

Operations is the first line. The second line is compliance and risk management, which sets the policies and procedures and monitors operations. The third line is internal audit, which provides assurance that risk management is working. These three layers need to be aligned for risk management to function. From Nolan’s experience, for many companies the most problematic is the first and second lines of defense, due to the lack of risk management competencies.

Successful risk management is fully integrated within the company. “Silos are no longer acceptable in risk management,” says Deon Minnaar, U.S. lead partner for governance, risk and compliance. Organizations are moving toward an integrated approach to risk management, where everybody has a single view of risk within the organization and shares risk information across traditional silos. While leading risk management from the top is critically important, so is leading from the middle, stresses Nolan. Only such a thoughtful, rigorous and integrated approach to risk management will give companies an understanding of the full impact of potential risks on their global organization.

FIGURE 16
How involved are you in risk planning?

- I lead the discussions 33%
- I have a strong voice in the discussions 56%
- I take part in the discussions 2%
- We do not have a risk planning process in place 9%

FIGURE 17
How is crisis risk planning handled within your organization?

- Proactively discussed on a regular basis 27%
- Discussed proactively, but not on a regular basis 32%
- Discussed on an as-needed basis 31%
- Not a regular topic of discussion 10%
PRIVATE SECTOR AS A GROWTH ENGINE
Q&A With Brian Hughes, National Private Markets Group Leader at KPMG

The majority of CEOs from private companies are confident about their growth prospects. However, fewer private CEOs than CEOs of public companies describe their growth strategy as aggressive, and more of them are focused on operational efficiency versus growth. What is behind these differences? The survey results show much optimism in the private sector. Private companies have more agility than public companies, which are constrained by the demands of quarterly reporting. The focus on efficiency and cost reduction strategies results from the fact that private companies are not accessing the public markets for their capital needs. They need to make extra sure that they’re growing revenues profitably.

You mentioned that private companies have to face more pressures but also have advantages. Let’s first focus on the extra pressures. What are they, and what’s the best way to handle them? It’s largely a matter of resources and infrastructure. The study shows that the regulatory environment is top of mind for both private and public companies. Compared with public companies, private companies may not have the size, complexity and infrastructure to address regulatory change as quickly as the public companies.

In terms of staying competitive, the study shows that private companies are more concerned about new market entrants. Private company owners or managers are focused on the bottom line. Staying on top of the newest technologies and latest innovations can be a challenge. It’s incumbent on private companies to work with the appropriate parties to make sure that they’re getting relevant and timely information regarding what’s going on in the external environment. Indeed, the study confirms that private companies rely on outside parties more than public ones do. (See Fig. 18)

What are the advantages of being a private company? Private companies tend to have a more relaxed governance structure than public companies, which allows the CEOs and the other C-level executives to spend more time with their customers and with their people in the company. Indeed, the study shows that private CEOs intend to spend even more time with their customers.

A renewed emphasis on investing in and professionalizing the risk management functions will be critical in achieving the right balance between risk and reward.

– Brian B. Stephens
Partner, National Sector Leader for Banking and Capital Markets, KPMG

FIGURE 18

In light of the recent economic uncertainty, how has your decision-making strategy as a CEO changed?
Conclusion

Looking out on the next three years, CEOs see opportunities in the steadily improving economy – but they remain focused on efficient growth, and are wary of new challenges in a significantly different, post-recovery marketplace. Amid an unprecedented wave of transformative changes, setting the course for growth will require new strategies, new tools and new thinking.

It’s transform or wither. The currents and cross-currents of change keep swirling, with multiple transformation triggers present simultaneously. Among major forces that can lead companies to transform their operating business models are significant shifts in technology, the emergence of a digitally savvy customer, and rapid regulatory shifts. CEOs recognize the need to innovate and transform over the next three years. More than three-quarters of companies are in some stage of transforming their operating models. The change happens through ongoing processes, as well as testing big-picture, futuristic scenarios. While innovation is a key differentiator, few organizations currently operate with company-wide processes in place that ensure that creativity bubbles up.

Staying relevant means navigating a new competitive landscape, including awareness of industry-agnostic trends and disruptions. A company from any sector can influence overall consumer behaviors and expectations about convenience, service and cost. CEOs see more competitive disruptors on the landscape than ever, many from companies that they traditionally have not competed against. These new industry entrants create new customer expectations, including among the newest customers, the millennial generation. The shifts in attitudes they bring with them are much more significant than in the previous generations of baby boomers or Gen X’ers. Millennials are also a group to watch as they enter the workforce and bring new expectations as employees.

Becoming an information-driven organization is a key strategy for navigating new challenges and defending against competitors, either existing rivals or new market entrants. Smartly utilizing data analytics allows organizations to stay in a position of competitive advantage. At this stage much of the data analytics is aimed at gathering customer information. By analyzing customers, organizations deepen their understanding of how to attract them, acquire them, and retain them. Perhaps the most exciting aspect of data analytics is that it can be predictive and be used for forward-looking growth, unlike traditional metrics. The possible applications of big data go far beyond customer segmentation. Data analytics is beginning to fill some of the information chasms between different functions, which, for example, should lead to breaking down silos. However, making sure that data does its job requires not just information systems but also people networks. The next frontier is building teams of talented individuals to put new information to use.

Efficient growth is the lens through which every aspect of the organization and external forces affecting it should be viewed. This includes areas that are traditionally perceived more as burdens than as opportunities to grow, such as the enhanced regulatory environment or risk management. We have entered a new regulatory environment, one that is changing how business is done in multiple sectors. To grow, firms need not only to get the regulations right – they also must implement them in a way that affords competitive advantage. Amid disruptive technological changes, an enhanced regulatory environment and the new digitally savvy consumer, growth comes with ever multiplying layers of risk. A successful growth strategy is contingent on understanding and accepting the risks associated with the assumptions the strategy is built upon.
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Methodology

The survey data published in this report is based on a survey of 400 U.S.-based chief executives. Many key industries are represented, including financial services, automotive, manufacturing, technology, consumer markets, healthcare and energy. One hundred thirty-four CEOs came from companies with revenues between $500 million and $999 million, 234 from companies with revenues from $1 billion to $9.9 billion, and 32 from companies with revenues of $10 billion or more. One hundred seventy-four CEOs came from public companies and 226 from private companies.

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For further information about this survey, and how KPMG can help your business, please contact me:

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