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## ARTICLE INNOVATION

# Finding Your Company's Second Act

**How to survive the success of a big-bang disruption**

*by Larry Downes and Paul Nunes*



# FINDING YOUR COMPANY'S SECOND ACT

How to survive the success  
of a big-bang disruption

BY LARRY DOWNES AND PAUL NUNES

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# IN JULY 2016 A PANDEMIC BROKE OUT.

## IN BRIEF

### THE QUESTION

Why do so few companies achieve successful second acts? Too often they grow incredibly quickly and then cool off almost as fast. The average life span on the S&P 500 has fallen from 67 years in the 1920s to 15 years today.

### THE ANSWER

New products quickly saturate markets; sales spike early and then plummet. Digital components rapidly make products obsolete. Following management mantras about strategic focus, executives limit their organization's assets to those necessary to complete a single mission—and then struggle to find a second successful revenue source.

### THE SOLUTION

The authors identify common attributes of companies that risk an existential crisis and argue that several tactics can avert one: abandoning hot products before they run out of steam, evolving to build platform or service offerings rather than products, and acquiring disruptive companies before the original business is upended.

Tiny monsters known as Pokémon suddenly appeared all over the world, threatening to use their fantastic powers to do battle in parks, on city blocks, and in homes. Fortunately, a dedicated volunteer force quickly arose to subdue them, using little-known technology embedded in smartphones to capture and domesticate the creatures.

Pokémon Go was the first big success in what will most likely be a potent run of new multiplayer smartphone games that use augmented-reality technology, which overlays digital images on real-world environments. It was also what we have described as a “big-bang disrupter,” a new product that reigns largely uncontested for a period of success that is often shorter than one would expect from traditional market dominators. (See “Big-Bang Disruption,” HBR, March 2013.)

In the case of Pokémon Go, that period was only a few months. In its first week 7.5 million players downloaded the game. At its peak, just one week later, 28.5 million played for an average of 1.25 hours a day. But 10 weeks later the game had largely run its course. Pokémon Go lost 15 million players in just a month.

By the end of the summer the beasts were gone, along with about \$6.7 billion in value for Nintendo, which co-owns the characters that were licensed to Niantic, the developer. Imagining that the \$35 million of revenue from players in the first month would continue, investors added \$23 billion to Nintendo's market capitalization, which fell back to earth by August.

Pokémon Go is hardly the only phenomenon that simply ended. Big-bang disrupters such as Fitbit, GoPro, Zenefits, and TiVo scaled up incredibly quickly and then cooled off almost as fast. That's because they weren't ready with their next innovation. Companies in that situation may be caught not only with nothing to recapture shrinking revenue but also with their resources committed to a now-faded product. Rapid and total collapse is often the result.

This dramatic rise and even more dramatic fall reminds us of F. Scott Fitzgerald, who famously wrote, “There are no second acts in American lives.” Fitzgerald was referring to the stunning brevity of success in the booming movie industry of the early 20th century, but the same observation is even more applicable to many of today's hottest businesses.

The good news is that the early demise of so many young enterprises makes it easier to study the underlying causes of modern business failure and their remedies. Using a database of more than 300 big-bang disrupters across multiple industries, we have uncovered important lessons about how to achieve a successful second act.

Though our focus here is on the moment of crisis for start-ups, failure to raise the curtain on a second act isn't a problem for big-bang disrupters alone. Even the most respected and successful companies in the world today rarely survive their first crisis, whenever it arrives. The average life span of companies on the Standard & Poor's 500 has fallen from 67 years in the 1920s to just 15 years today. According to Richard Foster, an executive in residence at the Yale Entrepreneurial Institute, in 2020 as many as three-quarters of companies in the index will be companies that were unheard of in 2010.

This shortened life cycle is primarily the result of rapidly spreading digital disruption in industries largely untouched by the first wave of internet transformation—including manufacturing (disrupted by 3-D printing and the internet of things), agriculture (drones and sensors), transportation (autonomous vehicles), and professional services (artificial intelligence). Even if second-act crises are most acute among start-ups, incumbents would do well to understand why they occur and how to avoid them.

## WHY THE SECOND-ACT CRISIS EXISTS

Accelerating technological improvements have changed the speed with which new innovations penetrate markets. Graphed over time, the market adoption of innovations now resembles a dramatic shark fin—a dangerously deformed version of Everett Rogers's classic bell-curve model of diffusion. (See the exhibit “The Shark Fin of Adoption.”) Rogers's five distinct market segments have been reduced to two: trial users, who help develop the product, and everybody else. Disruptive products, and often the businesses

created to promote them, rise rapidly, only to stall and fade away almost as fast.

Two forces have compressed Rogers's bell curve. The first is near-instant saturation by new products in a growing number of markets—initially in consumer goods and software, but increasingly in digitally enabled durable and industrial goods. The spread of information through social media and other digital channels has dramatically lowered transaction costs for consumers evaluating potential purchases, resulting in what we call “near-perfect market information.” Buyers are thoroughly informed about your product—including what other buyers like and dislike about it—at launch (and sometimes even before). Everyone who wants the product will adopt it immediately. Rogers's other segments never arrive: Any holdouts simply wait for a better, cheaper product to be introduced by you or a new entrant.

In 2016, for example, Tesla presold nearly 400,000 Model 3s in the first two weeks of the car's highly anticipated unveiling, most of them in the first three days. But that didn't mean, as it might once have, that armies of buyers—Rogers's early and late majorities—were waiting in the wings. Most buyers showed up at the product announcement. Consistent with the shark fin, the pace of new orders slowed dramatically by week three. Since then only about 200,000 have been added to the queue. Filling orders will take time (shipments won't begin until late 2017), but that is simply backlog, not new demand.

The second compressing force is the rapid obsolescence of digital components, which are increasingly fundamental in every company's products and services. Continued improvements in the price, performance, size, and power utilization of these components lead to ever-shorter cycling of new versions and innovations. The speed with which consumers and businesses replace pretty much everything is now determined by the dramatic pace of technological transformation rather than the orderly evolution of industry standards.

## THE SEVEN HABITS OF HIGHLY VULNERABLE ENTERPRISES

With each new buying opportunity, consumers can and often do switch to even better alternatives. So why are so many start-ups slow to recognize the shark fin and the danger it poses to their sustainability?

In studying companies that faced second-act crises, we found that the leading cause of premature death was, ironically, that their executives had enthusiastically embraced the latest management ideas. In the name of concepts such as “design thinking,” “lean,” and “agile” development, they focused resources and creativity on making first-generation products as compelling as possible—on delivering a

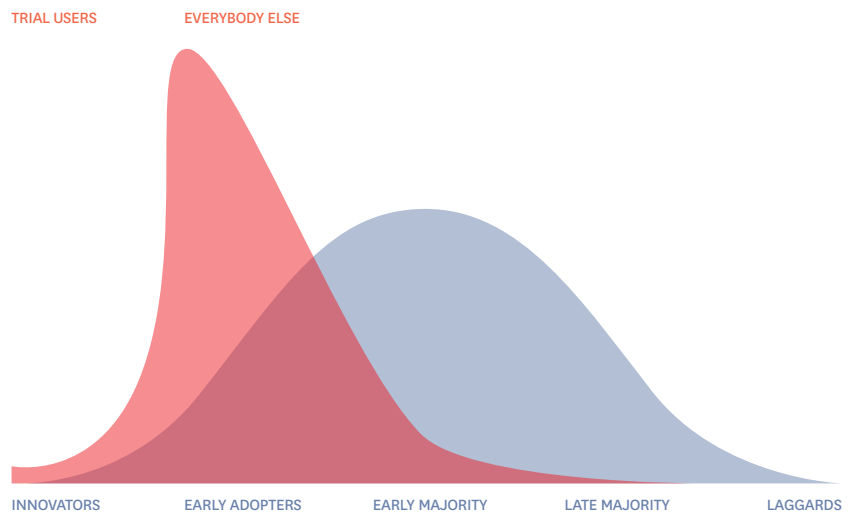
superior if not “delightful” customer experience for each user. But in the process, they ended up limiting the assets of the organization to those necessary to complete a single mission.

To be sure, even in the era of big-bang disruption, managers need to stay focused on business fundamentals, including careful management of fixed costs, capital assets, product inventory, and human resources. But an inflexible obsession with a single product or a single customer segment leads more often than not to a second-act crisis.

Our research has identified seven common errors that explain why even some enormously successful companies have failed to launch more than one big-bang disruption. Comparing those organizations with the relatively small subset of companies that have

## THE SHARK FIN OF ADOPTION

In the past, technology adoption generally happened in predictable stages. Innovators and early adopters were in the vanguard, followed by a much larger group of mainstream customers and then by a smaller group of laggards. Recently this pattern has been compressed into two short stages.



SOURCE EVERETT ROGERS (BELL CURVE)

avoided these errors, we've also found strategies that help businesses achieve a second act while they still can—which is almost invariably at the very moment of success with a new venture.

**1. The company is too lean.** The American entrepreneur and author Eric Ries advises start-ups to launch a minimum viable product and then iterate rapidly on the basis of intense customer interaction and feedback generated through social media and other low-cost channels. Although the lean start-up approach has found great favor in both new and old enterprises, companies fail when they devote all their resources to a single product—the first act. That's

because market saturation occurs faster all the time, resulting in the rapid downward slope of the shark fin.

Some companies tragically mistake that decline for a failure to satisfy users, triggering what Ries calls a “pivot”—a “structured course correction” in product design. But if the market has simply moved on and is waiting for the next innovation, pivoting isn't going to help. Management must organize a new team to begin the cycle from scratch *before* saturation. Otherwise the company will enter a death spiral, trying to serve the incremental needs of a dwindling number of once-enthusiastic customers and surviving, if at all, by being acquired by a more diversified company, often at a fire-sale price.

Consider the lean methodology acolyte Groupon, which continues to pivot around its core innovation

only to fade quickly over the next few months as the company belatedly scrambled for a replacement.

**2. The company's capital structure is built to fail.** One area where lean can still be good is corporate finance. Private companies and start-ups bootstrapped with funding from the founders or their friends and family have the most flexibility to shift strategy and resources to the next product when the time comes—even if that time is sooner than anyone would like. Angel and venture capital investors, so-called “smart money,” likewise appreciate the dangers of overreliance on a single product and often nudge management toward a second act.

But the trend of sudden market saturation encourages companies to raise substantial outside capital for production and expansion much earlier in the process

# COMPANIES FAIL WHEN THEY DEVOTE ALL THEIR RESOURCES TO A SINGLE PRODUCT—THE FIRST ACT.

of “social shopping,” whereby consumers leverage scale to negotiate discounts from merchants. Despite strong indications that enthusiasm for social shopping was fleeting, Groupon remained singularly focused on proving the concept, methodically tweaking its interface, acquiring its failing competitor LivingSocial, and halfheartedly expanding group buying into travel. Meanwhile, inattention to basics has led to ballooning operating expenses and run-ins with the SEC over embarrassing accounting errors both before and after its 2011 IPO; since then the company has lost nearly 90% of its value.

It isn't just strict adherents of the lean philosophy that risk missing the market forest owing to an obsession with customer trees. Makers of smartphone software apps, which have a rapid life-and-death cycle, frequently become anchored to product development that focuses on solving the wrong problem. Zynga, the wildly successful game developer of FarmVille and other hits, barely survived the shark fin of its social drawing and guessing game Draw Something, which jumped to 16 million players in a matter of weeks,

than was once the case. Start-ups may feel forced to turn to crowdfunders or other investors who offer little value beyond money. Or, worse, they may take on non-equity debt. A deeply leveraged capital structure works only during times of extraordinary growth. If markets contract even modestly, traditional creditors quickly become anxious, encouraging or even forcing retrenchment at the precise moment when investment in innovation is critical to survival and future expansion.

One-act companies also take on other long-term encumbrances before they need to, limiting future flexibility. Although start-ups generally don't have union contracts, pension commitments, or other trappings that may hold back older companies, they frequently do have excessive operating expenses, such as catered lunches, generous leave policies, free day care, and leased office space in high-end properties. These costs are just as dangerous, especially when markets change suddenly.

**3. The company has lost its head.** In the typical Silicon Valley pattern, venture investors give visionary entrepreneurs considerable freedom to



run their organizations, often haphazardly, until product launch. But once the company has garnered real customers, investors quickly push for experienced management—or “adult supervision”—to take over day-to-day operations. (See “When Founders Go Too Far,” by Steve Blank, HBR, November–December 2017.) Yahoo’s Jerry Yang and Twitter’s Evan Williams, for instance, ended up in engineering roles that were too constraining. Without the means or the encouragement to continue innovating, founders soon quit, often to launch other start-ups, taking their most trusted colleagues along with them.

Investors in a start-up frequently fund the founder’s next venture, so for them the departure of the visionary may mean little more than a change of address. But for the company left behind, the second-act problem becomes acute. Experienced managers focus on improving the original product, which is often the target of sudden competition from new entrants with ready access to the same component technologies and no commitment to a business model that may have outlived its usefulness.

In response, the company doubles down on its existing strategy, increasing its chances of being stranded when the market moves on. Google’s investors saw the risk in time and brought the founders back into leadership roles before the company had become reliant on unsustainable growth in search advertising. Apple famously rehired Steve Jobs for a second and even more glorious incarnation of the company after his seasoned replacement failed to launch new products that consumers wanted. Yahoo, meanwhile, stumbled through a succession of CEOs poorly fitted for the task of reinventing the company, leading investors to look for an exit.

**4. The company is overserving investors.** Public investors and the research analysts who advise them can be even more conservative than creditors. Beloved start-ups that cash in on IPOs find themselves stymied by investors who say they want more disruption but pummel the company’s stock price and management when profits don’t show up fast enough. Second acts are postponed as managers respond to investors’ demands.

Management teams at companies including Snap and Blue Apron, for example, are already struggling to balance a dynamic strategy with the demands of the public market after recent and possibly premature IPOs. And although many factors contributed to the difficulties of the business networking disrupter LinkedIn, which went public in 2011, the company’s repeated failure to generate the kind of revenue that Wall Street expected led to a collapse of its stock price five years later. That made LinkedIn an attractive takeover target for Microsoft, which believed it could restore LinkedIn’s lost luster—but at the cost of the company’s independence.

Adjusting strategy to appease shareholders can quickly threaten the very mission of a young business, to everyone’s disappointment. When the handmade goods pioneer Etsy went public, in 2015, CEO Chad Dickerson limited retail investors to a \$2,500 stake, hoping to ensure that the company’s social and political missions would continue to take priority. But after two years of ballooning costs and confusion among Etsy’s artisanal sellers over a tortured decision to allow manufactured goods on the site, activist investors forced Dickerson out, along with 8% of Etsy’s staff. The company may now lose its status as a socially conscious B corporation, and a promised restructuring as a public-benefit corporation is unlikely. Instead of helping Etsy burnish its brand, the company’s public investors may wind up killing its soul.

**5. The company won the lottery.** In an era when new products and services are quickly built from combinations of interchangeable hardware and software parts, a growing number of big-bang disrupters have achieved private and sometimes public valuations in the billions of dollars in record time. These “unicorn” prices seem based not on any investing fundamentals but simply on early-user fervor and the promise of revenues to follow—the result of near-perfect market information generating winner-take-all success.

Some of today’s most admired start-ups simply got lucky—a fact that becomes clear when a company fails utterly to build on its initial popularity. Launching a first product that turns out to be a big-bang disrupter can leave managers feeling invincible. Too often an ex post facto history is written that makes the enterprise’s successful but accidental first act appear to be the result of exceptional management decision making—a dangerous delusion. Success frequently breeds failure.

Twitter, which ended its first day of public trading with a value of \$24 billion, has since struggled to find revenue and maintain explosive growth. New features, including promoted tweets, polls, streaming videos, and long-form posts, annoyed many longtime users, who complained via the company’s own service. Management, meanwhile, has become a revolving door. In addition to losing half its value, the company has lost its way, calling into doubt whether it ever had one.

Founders who confuse a high valuation with business genius may also cripple an elegant product design with all the bells and whistles wisely left out of the initial offering, alienating the devoted early customers who launched them into the spotlight in the first place. Just months after winning Best of the Best at the 2014 Consumer Electronics Show with a virtual-reality headset that was still a prototype, Oculus was acquired by Facebook for \$2 billion. But design excesses delayed the company’s first commercial product until 2016, and the resulting price of \$800 for a fully configured unit depressed consumer enthusiasm. Simpler products developed in the interim by HTC, Sony, and Samsung



vastly outsold the too-much-anticipated Oculus Rift in its first year, leaving Oculus with just 4% of total sales.

#### 6. The company is held captive by regulators.

In response to the rapid uptake of products in the big-bang phase of the shark fin, stunned incumbents increasingly turn to regulators, hoping to buy time by derailing insurgents. In industries as different as aviation (threatened by drones), hospitality (Airbnb), health care (genetic testing), and financial services (bitcoin), incumbents first lobby for an outright ban on the disrupters. When consumers revolt, regulators fall back on hastily crafted and often crippling new rules, designed

#### 7. The company anticipates customers who don't exist.

In a winner-take-all phenomenon, customers for the big-bang disruption show up all at once, sending confusing signals about future sales and the market's appetite for follow-on products. As the Tesla example reveals, consumers use social media and other electronic channels to signal when a new product is a must-have, leading to a sudden rush followed by a trickle. Everett Rogers's gentle bell curve of diffusion disappears, leaving only the shark fin.

Consider the smartwatch, effectively a wearable smartphone. Apple garnered one million preorders

# LAUNCHING A FIRST PRODUCT THAT TURNS OUT TO BE A BIG-BANG DISRUPTER CAN LEAVE MANAGERS FEELING INVINCIBLE.

with little or no understanding of how the start-ups' products or services differ from those of incumbents.

In response, start-ups must now engage legal counsel much sooner than was ever before thought necessary, diverting scarce resources from building the company to dealing with city councils, public utility commissions, and legislative hearings. Around the world, Uber, Airbnb, and other sharing-economy enterprises are engaged in pitched battles for the right to do business at all, much less to do it without taking on the regulatory legacy of incumbent transportation companies and hotels.

For start-ups desperate to stay in business, this trend carries hidden risk: They can quickly develop the same dependency on regulators that stalls incumbents. Having legal advisers makes them newly cautious. They, too, come to believe that they can use the law as a barrier against next-generation innovators. They may win the regulatory battle, but in doing so they lose their momentum and, eventually, the once-potent sympathies of their customers.

from U.S. customers on the first day of availability for the Apple Watch, at a relatively high price point. But smartwatches don't seem to have a second act based on new features, new looks, or new hardware, let alone the rapid replacement cycle of smartphones and tablets. Sales have been essentially flat, leading some analysts to suggest that consumers have rejected smartwatches in favor of fitness-oriented products with similar features.

Anticipating more customers and new market segments, managers conditioned to the bell curve commit costly resources to expanded production and distribution for follow-on sales that never come. Or, worse, they produce vast inventories that quickly become unsellable at any price. The game developer THQ, which experienced great success with a drawing tablet for the Nintendo Wii, exuberantly committed to other game platforms in 2010. But the launch of the Apple iPad soon after suddenly shifted the market to stand-alone drawing applications. THQ continued to manufacture its tablets anyway, warehousing 1.4 million unsold

units. The company was forced into bankruptcy and never recovered. THQ's president later confessed, "I'm not sure how that happened."

### **SURVIVING TO A SECOND ACT**

Just avoiding the pitfalls described above is not enough to separate the standouts from the burnouts. Timing the shift from one shark fin to the next is equally critical. In the era of big-bang disruption, the life-or-death moment for any enterprise comes well before sudden decline—when a fast-growing market abruptly shifts course.

with, redirecting as many of their best assets as they can while still generating revenue to finance the shift.

After dispatching Blockbuster with its original DVD mail-delivery service, for example, Netflix famously launched internet-based movie delivery in 2007, long before broadband speed or penetration was ready for it. The company was accused of cannibalizing its own revenue, but CEO Reed Hastings understood that DVD delivery was only an interim solution—and an inefficient one at that. Today the company has leveraged its streaming dominance into the production of original content. It now has more than twice as many subscribers as the cable giant Comcast.

# **MOST SECOND-ACT SURVIVORS LAUNCH NOT A SINGLE PRODUCT BUT, RATHER, AN ECOSYSTEM.**

The few companies that survive to a second act and become truly sustainable enterprises are those that see the big bang for what it is—a short burst of success, followed by ever-briefer windows of opportunity. Companies that go on to launch a second product, enter a second market, or lead a second technical revolution do so because their founders structured them not as one-offs to solve a specific problem but as engines of innovation that spawn a thousand experiments. Those founders also have the wisdom to see which experiments are promising and which need to be terminated quickly and (relatively) painlessly.

To ensure that your business is a second-act survivor, learn from some of these tactics of perennial disrupters:

**Abandon the successful product before it runs out of steam.** Second-act companies not only see the top of the big-bang tsunami coming but also have the courage to jump from one shark fin to another before they've extracted the last drops of value. While many companies get caught in the eddy of the wave, serving a dwindling number of legacy customers who haven't moved to the better and cheaper alternative, the survivors go in search of new technology to experiment

**Build a platform, not a product.** Most second-act survivors launch not a single product but, rather, an ecosystem, connecting customers, suppliers, and others and deriving revenue from services provided to all of them, including payment processing, curation, dispute resolution, data analysis, and quality assurance. As tastes change, the platform abides.

Internet giants—including Google, Amazon, Facebook, and China's Tencent Holdings—have honed this lesson to razor sharpness. Tencent, for example, leveraged its gaming platform and expertise in smart devices to add the WeChat messaging app, now a daily obsession for more than a billion Chinese. WeChat, which has itself expanded to include social-networking tools and mobile payments, has revenue of close to \$2 billion annually, most of it still related to online gaming.

The platform strategy is now being imitated by sharing-economy enterprises such as Uber, Airbnb, and TaskRabbit (recently acquired by IKEA). These network-based companies have no physical assets of their own; they simply connect buyers and sellers while relentlessly driving down the transaction costs that make their markets inefficient. That leaves

the companies with considerable flexibility to add services, change interfaces, and redesign back-end relationships with the actual suppliers as market needs rapidly evolve, greatly reducing second-act risk.

**Turn your initial product into a service.** The real value in a disruption may be the infrastructure that was built to make, deliver, and support it. Unless the company's product is a cobbled-together throwaway, as is true for many software start-ups, a second act may lie in leasing core tools and processes to others, perhaps in very different businesses and industries.

Since 2015, for example, the fitness technology leader Under Armour has invested heavily in the nascent internet of things, launching its own line of fitness trackers developed in partnership with HTC. But Under Armour has generated stronger reviews for its Connected Fitness platform, which allows customers to import tracking data from a wide range of sources and third-party products, including those of Under Armour's competitors, into a single dashboard and a series of apps. A partnership with Johns Hopkins Medicine adds research-based health guidance for the 200 million members of Under Armour's Connected Fitness community.

Or consider Amazon, which started off as an online retailer selling first books and then pretty much everything. From there it was a relatively short leap to hosting other retailers. Now the company offers cloud computing to any organization or individual through Amazon Web Services—the fastest-growing IT business in history. AWS hosts operational software, data, and processing for millions of other enterprises, making it the dominant provider. In 2016 it generated more than \$3 billion in operating income—almost triple that of the company's retail divisions.

The need to develop services from a one-shot product is a lesson being learned the hard way by the sports-camera superstar GoPro, which has suffered slowing revenue and a catastrophic drop in its stock price (a decline of 90% in just a few years). The company prematurely reached saturation in its hardware business amid the rapid improvement of high-end cameras embedded in smartphones. Despite painful staff cuts, the company has spent heavily both internally and on acquisitions to build new software for state-of-the-art video-editing tools that can be used regardless of the original source of a recording. The company's new strategy, CEO Nick Woodman said recently, is to become a trusted neutral video host: "the Switzerland of content creation."

**Invest in or acquire nascent disrupters.** Companies with a successful first act may find themselves flush with cash and relatively cheap financing from venture investors. That money, if spent early, can fuel a second act. Even as the company continues serving customers of a popular product, it can invest in or acquire outright the next generation of disrupters.

Evolving through acquisition has been a preferred strategy in Silicon Valley all along, notably for companies such as Cisco, Oracle, and Qualcomm. But even relatively young companies have taken a page from their playbook and expanded on it. Although the multibillion-dollar price tags for recent early-stage acquisitions—including Facebook's \$19 billion purchase of the messaging service WhatsApp and Google's \$3 billion buy of the internet-of-things pioneer Nest—may leave many scratching their heads, for second-act companies these are just a hedge against an uncertain future, well worth the price.

## LIVING TO FIGHT ANOTHER DAY

The sooner a successful start-up accepts the reality that its big-bang disruption may have resulted more from great timing than from uncanny foresight, the better its chances of resisting the bad habits that sank so many of the companies in our study.


But that's only the first step toward a sustainable new enterprise. Even as consumers enthusiastically engage with a first-act product, managers must prepare for its inevitable collapse, shifting their focus to the creation of a solid platform built on business fundamentals. Second-act leaders are those who resist the temptation to take on unnecessary capital and operational obligations and instead invest in a product architecture that can be reshaped however and whenever the market dictates.

The rewards for such virtuous behavior are profound. Companies that survive an early second-act crisis become innovation incubators, focused not on a single product or even a single market but on a corporate culture that attracts the best engineering and marketing talent, along with stakeholders who encourage long-term investments in repeatable disruption. In short, they develop brands worthy of their stratospheric valuations.

Today such enterprises are few and far between. Most are found in the pressure cooker of the internet ecosystem, where survival instincts are of necessity the most valuable entrepreneurial trait. But for every successful second-act enterprise, a hundred once-promising disrupters simply disappear.

And as we've said, it's not just start-ups that quickly face an existential crisis. As the shark fin becomes a reality in every industry, incumbent businesses likewise may find themselves suddenly in need of a second-act strategy—especially those whose most recent hit has already enjoyed an extended run. ☹

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