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Strategies for growth

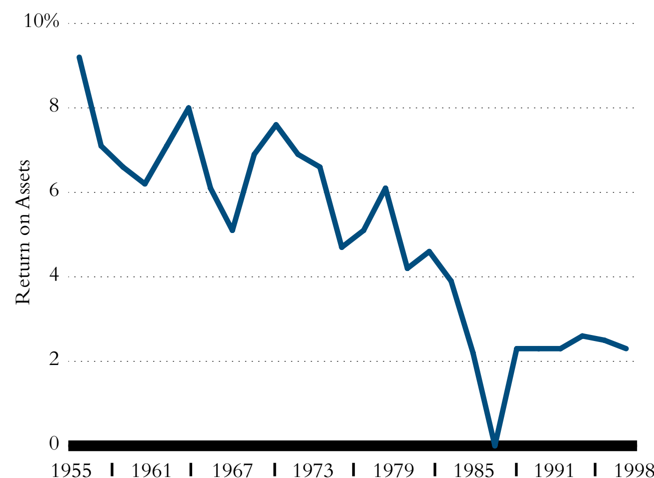
The hidden perils of corporate growth

By Chris Zook and James Allen

Growth is back at the top of the CEO's strategic agenda. Creating sustained growth is the primary task of the CEO—a task in which, the research shows, 86 out of 100 fail. In fact, most CEOs who try to increase their rates of growth fail with consequences that leave many of them wishing they had never made the investment. According to Bain & Company research, most companies' growth batting average could be increased by applying some proven approaches and by adhering to a set of "growth laws of gravity."

During the last 20 years, the growth of the US economy has slowed appreciably compared growth in the preceding decades. Despite a recent uptick, the average return earned by large companies has trended downward for 50 years, reflecting the increased difficulty of sustained, profitable growth ***(Figure 1).***

Figure 1: **US company returns (1955–1998)**



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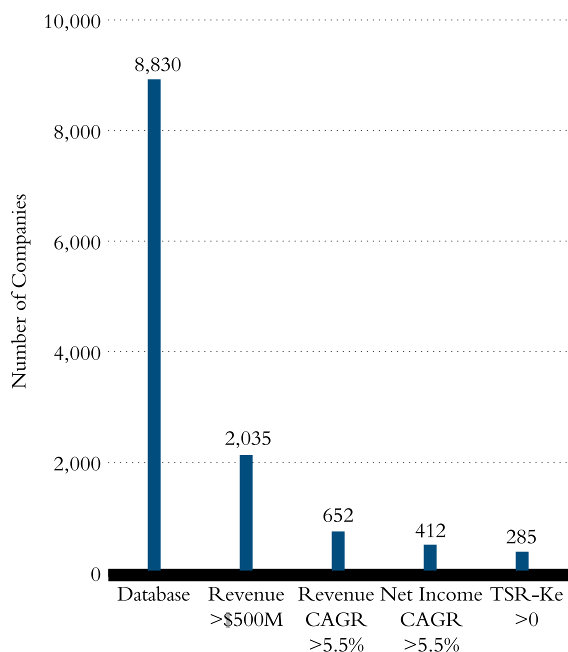
Companies that achieve profitable growth have a difficult time maintaining this momentum. In any two years, up to 40% of large companies may grow revenues and profits at rates almost twice the GNP, while also creating shareholder value. But throughout a ten-year period, only 14% of large companies posted that kind of growth. ***(Figure 2)***

Much of the corporate growth that does take place appears not to create significant shareholder value. Of thousands of companies that increased their revenues at an annual rate of 8% (on average 5.5% on the real basis) over ten years, only half created shareholder value by earning more than their cost of equity. The rest experienced growth that is not sufficiently profitable to justify the investment—earning less than the cost of capital and destroying shareholder value. ***(Figure 3)***

Figure 2: **The growth minority**



Fewer than 1 in 10 companies achieve sustainable, profitable growth. In fact, more than half of "growth" companies destroyed value for their shareholders.

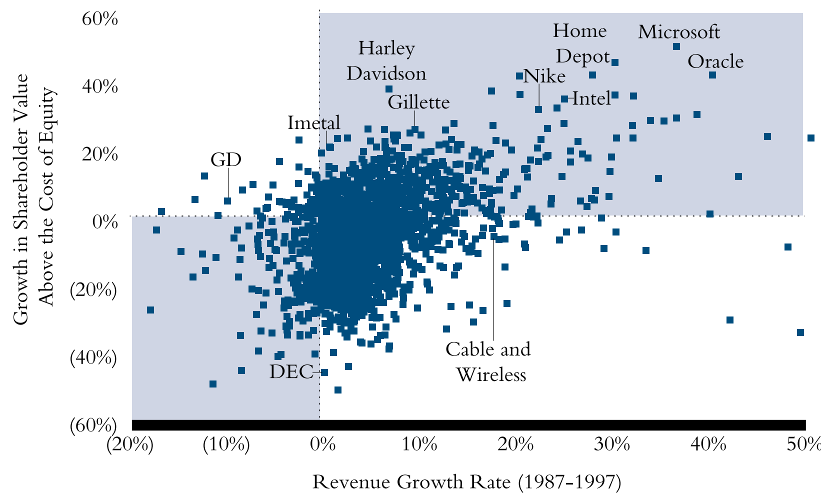
The difficulty of achieving profitable growth is being internalized, we find, by an increasing proportion of senior executives and general managers. For example, about two-thirds of CEOs are dissatisfied with either the growth programs being generated by their organization or by their organizations' inabilities to implement these new growth initiatives. Yet, almost all believe that growth will be a higher priority in the next five years.

Mining growth from a strong core business

Contrary to conventional wisdom, most profitable corporate growth doesn't come from participating in a "hot" industry and riding the trends upwards. In fact, a large number of companies with sustained profitable growth are in industries that may appear to be mature, such as Mattel in toys, Cooper in tires, Pep Boys in auto repair, Nike in shoes, and Servicemaster in basic services. Relatively few—no more than 10% to 15%—are in what anyone would call high tech.

So what does drive growth, if not the overall industry trend? In 80% of the cases we studied, a company's relative performance versus others in the business was the true engine of growth. A strong position in an average industry is almost always a better platform for profitable, sustained growth than a weak position in a high-growth industry or segment.

Figure 3: **Value creation vs. revenue growth: Australia, France, Germany, Italy, Japan, UK, US (1987-1997)**

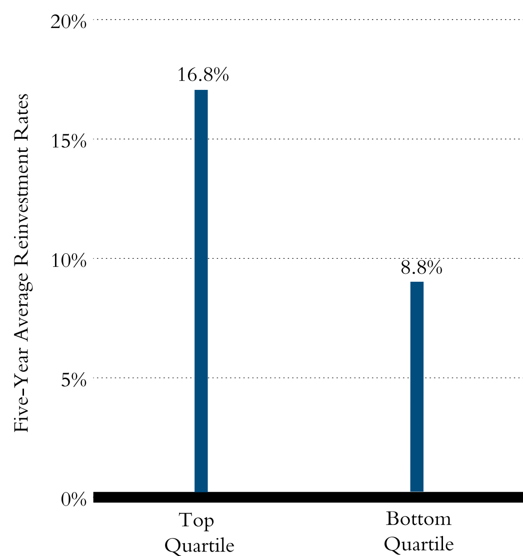


A further probe into the most successful growth strategies reveals two key elements: the first is a strong, or even dominant, competitive position in a core business or segment that has been managed aggressively to gain consistent market share, year in, year out, against key competitors. The second is an investment program that reinvests in the core at a rate that sustains competitive advantage. To put it another way, winning companies often control the industry profit pool—even their competitors' profitability levels—and use that leverage to ensure that they invest at a higher rate than their competitors. Frequently, the result is even greater levels of market control and greater levels of competitive superiority—allowing even more investment to build positions in the "periphery" of the core business.

It has been said, wisely, that the first imperative of business strategy is to discourage your competitor from investing in those segments or products that are central to your own business—just as focusing on enemy supply lines is a key principle in successful military campaigns.

Sustainable growth is a result of management decisions, not the industry in which the company competes. In fact, a surprising number of growth companies were in low-growth, seemingly sedate industries.

Figure 4: **Comparative reinvestment rates—industry leaders and laggards**



Industries: Aerospace, specialty retailing, shoes, tires, air transport, entertainment, heavy electricals, semi-conductors, discout retailing, tobacco, and food

You can see this dynamic at work in ***Figure 4***, which illustrates the comparative reinvestment rates of top- and bottom-quartile companies in each of eleven industries that we studied. In many instances, the leader's reinvestment rates were more than double those of its competitor, fueling both a higher and more profitable rate of growth for the leader.

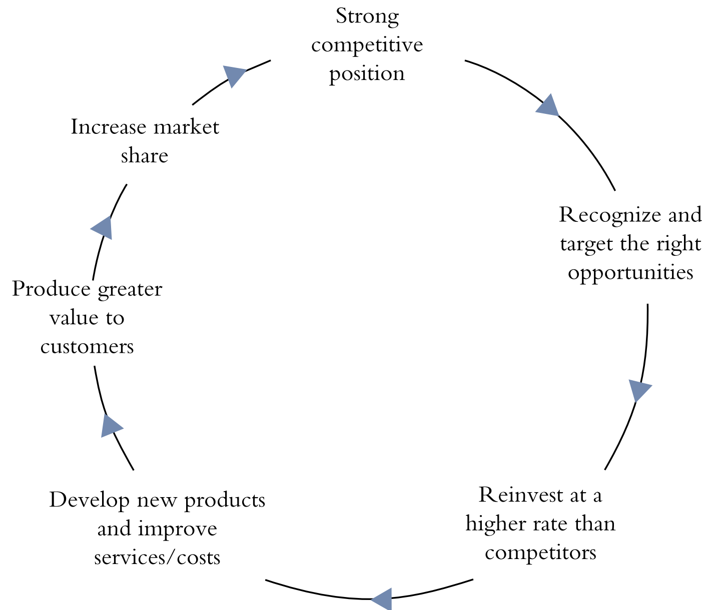
Boeing, for example, maintained a reinvestment rate for more than a decade that was twice that of McDonnell Douglas. This has resulted in a steady widening of Boeing's leadership in commercial aircraft, as demonstrated recently by McDonnell Douglas's decision to stop investing in the development of the next generation of commercial aircraft, by American Airlines' recent decision to commit to Boeing for all fleet purchases until well into the next century, and by the Boeing-McDonnell merger announcement in 1997.

As a corollary to this principle, we find that a company most commonly falls short of the growth it might achieve by underestimating the potential of its core business, prematurely declaring it infertile ground. An example: in 1988 Enterprise RAC and Agency RAC each had approximately half of the market for insurance-replacement car rentals. In this basic, seemingly sedate industry, Agency attained a place on a short list compiled by *Business Week* of the "most competitive companies in America." But in the ensuing years, its management concluded that the company's basic rental business lacked the potential for growth and, accordingly, moved Agency into other lines of business. Enterprise, which started from the same position as Agency, is today the largest car rental company in the US—even bigger than Hertz. The company has been growing at 12% per year with 10% margins. Agency, by comparison, is about a tenth the size of Enterprise and was recently sold to new owners.

Sherwin Williams offers a similar example in house paint. In the mid-1980s the company was only marginally profitable, with 200 company-owned stores at a point when competitors were withdrawing from this segment of the market. Today, Sherwin Williams has over 2,000 stores, has been growing at 8% to 10% per year, and has a shot at doing in paint what Anheuser-Busch has done in beer. All this with a core business that others judged fallow.

The key, again, is reinvestment. As ***Figure 5*** illustrates, by reinvesting in a strong competitive position, a company can create a self-perpetuating cycle of ever-widening out-performance of competitors, a cycle that sees the level of the company's game increase on each dimension critical to the business system—market share, product quality, capacity to attract the best customers, and the ability to keep the best employees.

Figure 5: **Self-perpetuating cycle of growth**



Working with clients we have developed a variety of ways to achieve profitable growth from a strong core business. Strategies include:

1. Identifying and quantifying customer defections, then determining their true root causes. In industries like insurance and stock brokerage, the defection rates experienced by different competitors turn out to be the best predictors of their profitability relative to one another. In most industries, the average company loses half of its customers every five years, yet typically executives don't know the rate at which this is happening in their own businesses. If you can improve retention of your best customers by as little as 5%, you can increase your growth rate by several percentage points.

2. Re-segmenting your customer base periodically on actual buying and usage behaviors rather than on standard industry demographic data. Companies such as Calloway golf clubs, Dell Computer, and Oakley sunglasses have used a strategy focused on emerging market segments to outflank larger competitors.

3. Tracking investment by segment and by channel to make sure that you are not being out-invested in your target segment by a key competitor.

4. Understanding better than your competitors the cost and service gaps perceived by your, as well as their, core customers and using this in account targeting and product investment.

Two implications follow: If your company's relative competitive position in a particular business is weak, you would be well advised to strengthen it, before launching into a new growth initiative or diversification. This sounds simple and obvious, but is violated all the time. If you do have a strong position, though, even in what might seem like an unpromising industry, you can grow profitably, providing you pursue and implement the right strategy.

Expanding into business adjacencies

In our work, Bain has identified at least six dominant patterns of sustained corporate growth:

- Organic growth, into a range of surrounding "adjacent" businesses
- Market share gain through product/service differentiation or focusing on meeting the best needs of a particular customer segment
- Development and implementation of a new, superior business model (usually superior economics)
- Industry consolidation followed by leveraging the new, higher market share
- International expansion
- Positioning and control of new, fast growing distribution channels

By far the most successful growth strategy is rapid organic growth to adjacent businesses from a position of economic strength, akin to the growth recorded in the rings of a tree's trunk. Over 50% of companies that grow in a sustained, profitable manner do it in this way, rather than by acquisition. They may, for example, expand by increasing their coverage of the market, going after customers they never reached before. Or, they may increase their market penetration, seeking 100% of the business of existing customers. Champion growth companies are also expert at identifying and moving into businesses adjacent to their own. They are prepared to enlarge their business definition, but only one "ring" out at a time. Great examples of this inexorable organic progression of a company are Coca-Cola, Fidelity, Motorola, and Disney.

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From our work with clients, we think there are three steps that businesses can take to expand into adjacencies:

1. Clearly identify the "strategic assets" that can be built upon to move into new business areas. These can be brands—Nike's move into clothing or Dunhill's move into premium merchandising—or capabilities—Gillette's capabilities in managing "checkout counters" that led to the acquisition of Duracell batteries, as examples.
2. Rigorously map out all the business adjacencies surrounding your core business, just as a general maps out the full battlefield terrain for his army to exploit. Companies that do such mapping, gauging the size of these adjacencies and estimating their true profit potential, invariably find more directions for growth than they initially think possible. Witness the experiences of companies like Servicemaster, 3M, USAA, or Microsoft. Each has achieved sustained growth by proceeding from adjacency to adjacency—while continuing to invest to protect the original core of their business.
3. Explore second or third generation adjacency moves as part of the initial business opportunity. Companies that think more than one move ahead in planning adjacency moves make more effective investments. For example, Disney's move into retail opened up far more merchandising oppor-tunities and is now having a profound effect on how its characters are developed and marketed.

As mentioned above, the survey of CEOs conducted by Bain & Company found that over two-thirds of the chief executives thought part of their growth problem was due to an in-adequate flow of credible growth ideas being put forward by their organizations. Would idea flow be the problem if these companies mapped out a full set of adjacencies for each business? We don't think so.

Creating the growth-oriented organization

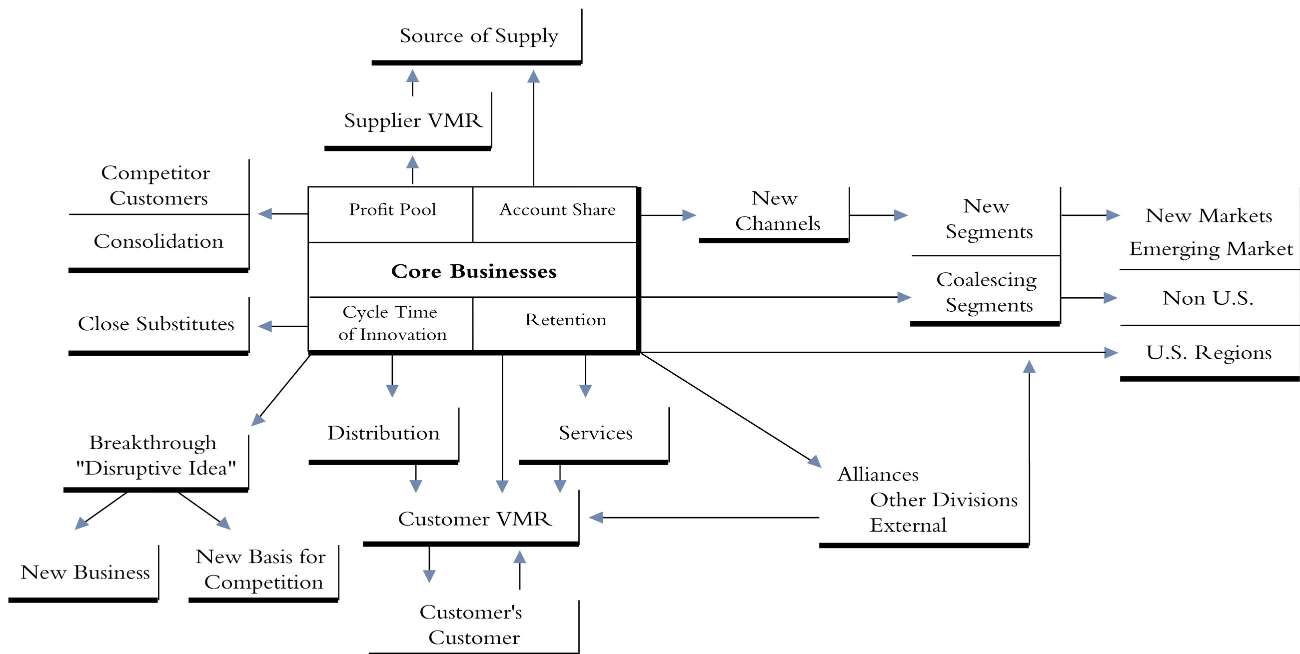
Ultimately, growth management must not only change what companies do (focus on core, expand into adjacencies) but also who they are. Growth can only come from a management team focused on and motivated by growing the top line of their companies. It is much harder to form a growth-oriented team than it is to develop a growth-oriented strategy. Changing who you are, though harder, will have far greater rewards. It is no accident that some of the best cases of sustainable growth emerge from venture capital firms. They know the power of creating a motivated management team with plenty to gain from growth and plenty more to lose if they fail to grow.

Back to the basics

Partly in response to the heightened interest in growth, the number of fads and "silver bullet" approaches has proliferated—idea generation exercises, elaborate scenario planning, the search for new industry models, and the use of the Internet, to name a few. These may have their roles, but our review of hundreds of business situations leads us to conclude that these superficial approaches are not the drivers of most sustained, profitable growth.

The most effective way to increase your company's rate of growth begins with refreshing your understanding of the business dynamics and microeconomics of your best core businesses. Hard data show that this is the first step in creating a growth strategy that works.

Figure 6: **Key success factors: Value chain adjacencies**



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