BEYOND THE CORE

Expand Your Market Without Abandoning Your Roots

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Preface

The drive for growth has been fundamental to businesses for centuries. If businesses have a primal urge, it is the need for profitable growth. That growth is the source of value creation to shareholders. It is the gravitational pull that attracts and retains the best people. It is the life force of the organization. And it is the fuel to outpace competitors. No business that has failed to grow has ever been able to maintain excellence over time; this has always been true and probably always will be.

Yet, something has changed the game fundamentally, increasing the pressures to find growth more than ever before, raising to new levels the penalties for failure, and moving the goalposts of growth farther down the field. No other period in the history of business has seen as many economic disasters driven, in part, by the reckless pursuit of lofty growth objectives. One study my team conducted identified the twenty-five most costly business disasters from 1997 through 2002 (excluding those caused by the dot-com bubble). In 75 percent of the cases, the root cause, or a major contributing factor, was a failed growth strategy whose unrealized goal was to move profitably into new, adjacent areas surrounding a core business. At the same time, many of the great success stories of value creation or turnaround in the 1990s were cases of bold, new moves that successfully pushed out the business boundaries beyond the core. Some, like IBM, Li & Fung, and STMicroelectronics, are inspired stories of rejuvenation. Others, like Dell, Vodafone, and Nike, are stories of the relentless repeatability of a powerful growth engine.

I realized the potential for a book on the topic of how businesses push out the boundaries of their core businesses during a trip to Rio de Janeiro. It was my sixth talk in two days. I was reporting on some new research that we had conducted at Bain & Company on the sources of profitable growth. It was one of nearly two hundred such presentations in eighteen countries that I was privileged to make after the publication of my first book, *Profit from the Core.* The presentation contained data and analysis that argued that the most successful growth companies used every trick in the book to realize the full potential of their strongest businesses before venturing into potentially greener pastures outside their core. The talk cataloged case after case of companies that had abandoned their cores in search of new sources of profitable growth, only to realize that the greener pastures were not so green after all and that their departure from the core had been far too premature.

While the attendees in country after country liked and generally agreed with these ideas, they asked the same natural follow-up questions that seem so consistent with the heightened pressures businesses are feeling to grow.

"Yes," they would say, "full potential in the core business should be top priority, but what then? What if there really is not enough growth in my core business? What if I am a follower in my core business and want to build on my strengths to grow another way; is that possible? How have companies stuck in a niche taken their best skills and broken out into new territory successfully? What is the best way to balance focusing on my core business while also pushing into new, adjacent territory at the same time? How do I hedge growth bets at the periphery of my business without becoming too diffuse?"

Suddenly, I recognized the theme underlying these questions: What is similar to and different from growth at the boundaries of business, as opposed to growth right in the core? These questions triggered a new wave of research on the growth patterns of companies, focusing especially on the risks and benefits from extending the boundaries of a core business.

The primary original sources of information that I used for this book are these:

- One hundred company profiles and executive interviews, of which twenty-five were companies with some of the best growth records in the world (these companies are listed in the appendix). For these twenty-five, my colleagues and I conducted in-depth CEO interviews, other management interviews, and a complete company profile.

- Original analysis of twelve company pairs that were in similar situations in the early 1990s, but whose different expansion paths and choices led to dramatically different financial performance and strategic position (see appendix). Together, these twenty-four companies made more than five hundred growth moves from their core business; my team examined these different moves.

- A database of 181 major growth initiatives from 1995 to 1997 in the United States and the United Kingdom. For these initiatives, we did our best to assess their outcome and calculate the typical odds of success.

- The database built for *Profit from the Core*. These numbers include fourteen years of financial information for more than eight thousand public companies in seven major countries.

- Three special global surveys of executive perceptions and intentions about growth, conducted jointly by Bain & Company and the Economist Intelligence Unit.

Other sources tapped included my team's analysis of the odds of achieving profitable growth under different starting conditions, a full examination of the secondary data, access to the Bain & Company archives, and my notes from discussions at nearly two hundred business forums and events.

I believe that this is the first book-length study of such strategic adjacency moves and hope that three groups of readers will benefit from its findings: executives charged with making difficult choices about growth; boards of directors providing oversight on major new growth initiatives; and investors trying to understand the risks inherent in companies' strategies. A 2002 survey showed that 86 percent of executives placed finding the next wave of profitable growth in their top three priorities—and 43 percent placed it at number one.[1] Hopefully, the new data and the company experiences in this book will inform better decisions in this key area.

Profit from the Core was about the power of focus, the choice of focus, and the cost of losing focus in a business. The finding that, during the 1990s, only about 13 percent of companies worldwide achieved even a modest level of sustained and profitable growth surprised executive audiences and other readers. Furthermore, the discovery that nearly all the sustained-growth companies were built around one or two strong or dominant cores proved a powerful counterpoint to some of the hallmark disastrous diversifications and investments of the 1990s. The book was replete with stories of businesses that incorrectly assessed their core strengths and that sought growth in the wrong places. It featured cases from a wide range of businesses that prematurely abandoned their cores in search of hot new growth, only to experience severe erosion in their once-strong business in addition to the direct cost of failed growth initiatives. How managers defined their companies' sources of competitive advantage, the economic boundaries of their core, and where they could or should compete effectively, and then assessed the full potential of that core, was at the heart of many examples.

This book picks up where the first one left off. *Beyond the Core* focuses on the question of how to expand a core business into adjacent areas in a way that is profitable and contributes to the strategic objective of expanding, defending, or redefining the core business. If the first book asked "Who am I?" this book raises the even more challenging follow-on questions of "Where should I go? What should I be? How do I get there?"

The six chapters of this book are organized around six questions that proceed in a logical sequence, beginning with the environment and definition of what I mean by an *adjacency* as a way for businesses to grow. I end with some observations on the long-term potential of these strategies not just to grow, but to transform, a company's core over time:

- What are adjacencies, and how often do they succeed?
- What is the best way to decide which adjacencies to pursue?
- What are the characteristics and sources of the most lasting adjacency strategies?
- When do adjacencies make the most sense, and when are they a last resort?
- What are the most important organizational enablers and inhibitors to the success of new adjacency initiatives?
- How often do these types of strategies not only grow, but also transform, a company's core over time?

These are all substantial questions whose correct answers will vary by the specifics of a company's situation. The intention is certainly not to be encyclopedic or to present a universal solution. That would make no sense. Rather, the intention is to identify the most universal success factors and provide some ideas that management teams might find useful in improving the odds of an inherently risky undertaking.

Acknowledgments

My first debt of gratitude must go to the clients of Bain & Company, who allow my partners and me to participate on a daily basis on the front lines of businesses in virtually every industry around the world. It seems as if the job of a senior executive in business is becoming more complex, more risky, and more pressurized every day. I have immense respect for these men and women who remain in the arena creating the value that propels the world economy.

I also thank all my partners at Bain & Company, most of whom have contributed an idea, a contact, a reference, or encouragement to this effort. After the publication of my first book, *Profit from the Core,* I had the privilege of visiting nearly all the Bain offices and speaking to our teams. At every stop, I learned about new and interesting local companies, such as Olam in Singapore, AmBev in São Paulo, and Centex Homes in Dallas, that have subsequently provided much of the input for this book.

It is impossible for me not to acknowledge certain partners who have supported this book from its inception to the end through their ideas, their encouragement, or their willingness to slog through my manuscripts. On the other hand, it is difficult to draw the line for whom to mention by name and whom to reference as part of the group. John Donahoe, Bain's managing director, and Orit Gadiesh, Bain's chairman, have been supportive of this book and of the Bain Growth Project without fail. Phyllis Yale, head of Bain's Northeast offices, supported the project by allowing me access to analytic resources, to time, and to her great judgment. As he did for the first book, Steve Schaubert read and commented in detail on every draft and has constantly encouraged me. I have collaborated with Darrell Rigby on a number of projects related to growth, including some work on innovation. There is no one more generous with his friendship, his ideas, and his time than Darrell. Jimmy Allen, my coauthor on the first book, has commented in detail on multiple drafts and worked closely with me on a myriad of other endeavors since then.

I also thank Chuck Farkas and Fred Reichheld for commenting on my earliest drafts. Mike Garstka gave me consistently good ideas, data, and advice regarding how the findings of this work applied to Asian companies. Wendy Miller, Cheryl Krauss, and the Bain marketing team were constantly by my side helping me to think through how best to articulate the key messages of the book.

At the core of this book are the insights from an extensive number of interviews, primarily of CEOs. I am deeply grateful to the executives who hosted me at their companies and told me their, and their companies', stories. These companies and the CEOs interviewed are listed in the appendix.

Marci Taylor has worked on the growth projects that have spawned both of my books from the very beginning. Without her competence, flexibility, judgment, and friendship, this book might have taken twice as long to be written and might have been half as accurate. Thank you.

In addition, I have been blessed with a continual stream of excellent Bain consultants on the notorious 3EC team. This group has generated more than a hundred modules of analysis on the topic of how companies grow and has codified at least as many case examples along the way. The Bain managers who have worked on this project, Ajay Agrawal, Emma Gray, David Fleisch, and Patrick O'Hagan, epitomize the best of Bain & Company.

Brenda Davis has prepared the manuscript, provided editorial help, scheduled the interviews, offered constant encouragement, injected needed humor and a sense of balance, and counseled me psychologically through the entire manuscript process. She has also somehow endured eight years as my assistant. I do not underestimate how much I owe to Brenda.

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The members of my family, particularly Donna, my wife of nearly three decades, have been saintlike in their patience and tolerance through the process of my giving birth to another book. My sons, Andrew and Alex, have been a continuous source of positive energy for everything I do.

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The Growth Crisis

Dangerous Moves Beyond the Core

Like an interminable tennis rally on the red clay of nearby Roland Garros, the verbal volleys flew across the table in the warm and crowded boardroom late that Paris afternoon. Back and forth went the heated argument about the new growth opportunity. Yes, the market research did show that the market could be enormous. But some tough competitors had already entered, so was it already too late? Yes, the finance department had documented a large profit gap that needed to be filled to meet investor promises. But was this really the most prudent place to make the big bet? Yes, the enthusiastic team was ready to launch the initiative. But had the members grown too close to it and lost their objectivity? The group ended the day inconclusively, tired and frustrated. They agreed to sleep on it and reconvene at 8 A.M. the next day. As he walked back to his office, the CEO felt enormous tension. The last few movements into adjacent markets in search of new growth had been disappointing. The core business was weakening and losing momentum. Was this risky proposal the answer? Or might it just exacerbate the problems, add complexity, and sap credibility? Was it worth the chance?

The Challenge for Today's CEOs

CEOs facing decisions about major investments in new growth initiatives that push out the boundaries of their core business into new territory ("adjacency moves") are often right to be concerned. While bold adjacency moves have proved for some to be the new well that liberates a gusher of growth, often that is not the case. When my team examined the top twenty-five business calamities (other than Internet companies) of the period 1997 to 2002, we concluded that a failed strategy to grow into a new adjacency around a once-successful core business was a critical factor in 75 percent of these disasters. Just consider the following examples of how a growth strategy can go awry:

- For nearly three decades, Loral and its CEO Bernard Schwartz represented the poster child for growth companies, expanding from a money loser in 1972, when Schwartz was hired, to the most successful defense electronics firm in the United States. To a *Wall Street Journal* reporter, Schwartz declared, "For thirty years of my life I walked on water."[1] Then in 1994, Loral made the first of several investments in Globalstar, a satellite-based mobile telephone system. The risky venture absorbed $1.8 billion of capital and a large share of management time in the ensuing years. When Globalstar collapsed in January 2001, defaulting on $3 billion of debt, Loral's stock price had declined 90 percent from the previous year.

- During the four years before becoming the largest bankruptcy in U.S. history, Enron moved into thirty-four different adjacencies around its core, five times more than in any previous decade. Many, such as investment in broadband futures, consulting, and water treatment, were far from their core. Many observers believe that the financial carnage and ethical issues were magnified by the operating disasters brought on by overzealous adjacency moves.

- Swissair had a seventy-year history of punctuality and attention to detail. Then, in 1995, a new management team decided to attempt a growth strategy that involved investments in ten regional airlines as well as in a series of services, from catering to maintenance. When the regional airlines began having financial difficulties, Swissair found that it had flown to an altitude it could not handle. Soon, Swissair's debt was five times its equity value and the company, having fired its management team and much of its board, was plummeting toward bankruptcy.
- In 2002, Wal-Mart became the largest company in the *Fortune* 500 and the most respected company in the United States, while Kmart drifted into bankruptcy. Both companies opened their first store in 1962. The history of Wal-Mart is one of methodical movement into adjacencies such as Sam's Club, and electronics, and Mexico, one by one. The history of Kmart is strewn with adjacency expansions gone wrong, from books (Walden) to sporting goods (Sports Authority) and even to a chain of department stores in Czechoslovakia. These failed adjacency moves sapped the strength of Kmart at exactly the time it was under a blistering attack to its core from one of the toughest competitors on earth.

These are extreme examples of what can happen when a growth strategy overreaches, pushing a company into spreading its resources too thin, or leaving its core unprotected, or moving into areas it simply doesn't know how to manage, or burdening the company with excessive risk. Yet, how did such smart management teams, all backed by market research, make these decisions while others hit the jackpot? Is it all good fortune, or is there something to be learned from the lessons of history?

Finding or maintaining a source of sustained and profitable growth has become the number one concern of most CEOs. And moves that push out the boundaries of their core business into "adjacencies" are where they are most often looking these days. As

Jack Welch commented regarding where he looked for growth within GE, "Expanding into adjacent businesses is the easiest way to grow. By challenging the organization to continually redefine their markets in a fashion that decreases their share opens their eyes to opportunities in adjacent markets."[2]

Profitable growth is the wellspring of most value creation in business. The prospect of achieving profitable growth provides the air under the wings of most companies' stock prices. The rewards of profitable growth offer a source of oxygen for employees at all levels. When profitable growth dies, these same forces of positive energy can begin to run in reverse, creating a downdraft, a reinforcing cycle, that can build a value-destroying momentum of their own.

When Jim Kilts, a veteran of some of the most successful turnarounds in the world of consumer products, took over the helm of Gillette in 2000, he referred to his number one priority of stopping the company's "self-inflicted cycle of death." Gillette had missed seventeen straight quarters of earnings targets, was starting to lose the edge of even its strongest core shaving business, and was seeing employee and investor confidence wane by the day. Kilts has since turned the company around, renewed confidence, and begun reigniting growth. But what caused Gillette and similar companies to fall into this loss of profitable growth in the first place?

A mountain of economic evidence can be amassed (some presented throughout this book) to demonstrate that profitable growth is becoming increasingly elusive and more fleeting for most companies, not just Gillette. This was true during the boom times at the end of the 1990s, when even then, underlying corporate returns on capital were flagging in most industrialized countries. Profitable growth will probably be even more elusive during the first decade of the twenty-first century, a potential period of extended growth crisis worldwide.

There are myriad ways to grow a company—diversifying; investing in venture capital; accelerating the rate of innovation in R&D; grinding out hidden scraps of growth from deep inside the existing core business; jumping into new, hot markets; globalizing;

and stepping up the organization's "metabolism," getting it to work faster and thereby grow faster. Each of these methods has its zealous advocates. And in the right situation, each has some validity.

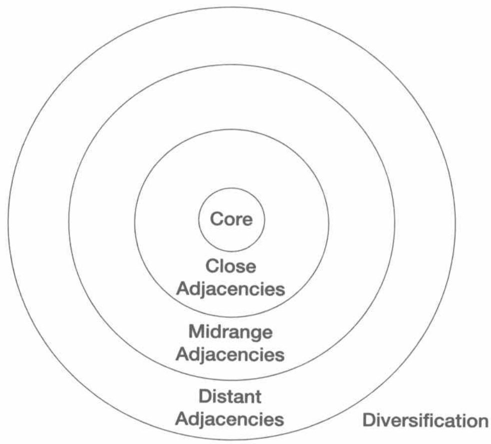
This book focuses on growth through adjacency strategies. These strategies have three distinctive features. First, they are of significant size, or they can lead to a sequence of related adjacency moves that generate substantial growth. Second, they build on, indeed are bolted on, a strong core business. Thus the adjacent area draws from the strengths of the core and at the same time may serve to reinforce or defend that core. Third, adjacency strategies are a journey into the unknown, a true extension of the core, a pushing-out of the boundaries, a step-up in risk from typical forms of organic growth.

Adjacency moves are typically made at the discretion of the CEO or the president of the relevant business unit and, by their nature, are among the most difficult decisions to make. They entail risk, potentially draw resources away from the core, and may shape the course of the future. Adjacency moves can be near the core, perhaps varying only one dimension, such as the decision to sell the same products to a totally new customer segment. These moves might also be much farther from the core. For example, the company might decide to sell a related product through a new channel against a poorly understood competitor. A recurring theme in this book is the importance of understanding the distance of a growth move from the core, one indicator of risk and movement into the unknown. We find that companies continually underestimate the amount that they do not understand, taking on risks and future obligations that are greater than they may have realized. Visually, you can think of this relationship as a set of concentric circles around the core, like the rings of a tree, radiating outward (figure 1-1).

The importance of understanding the true strength of the core to support new growth is a second theme that runs through this book. Again, we find that companies sometimes overestimate the ability of their core business to support new growth, or they see major adjacency moves as a way to leap to a new core, a new "lily

FIGURE 1-1

Growth Opportunities Should Be Examined Relative to a Core Business



pad." The risks and benefits of such thinking are examined from a number of angles in later chapters.

An important theme of this book is what I refer to as "the new math of profitable growth." The most powerful long-term growth trajectories are composed of repeated sequences of smaller adjacency moves that lead to higher odds of success, the ability to handle many more initiatives at the same time, greater ability to anticipate and control the cost of failure, and the incentive to create a focused organization to implement these adjacencies that captures the learning and experience curve benefits of performing a similar task over and over. The arithmetic that accompanies such a "virtuous cycle" of growth becomes increasingly powerful over time. In contrast, the arithmetic that accompanies the occasional "big move" in search of growth embodies the opposite of all the positive factors listed above and seldom leads to sustained value creation.

What are successful adjacency moves, and why are they so important? An adjacency move could take many forms: