

# The facts about growth

Essay #1

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## Full Potential Series on Growth and Shareholder Value Creation

By Chris Zook and James Allen

### The challenges of growth

Most growth strategies fail, even when they succeed. What do we mean by this? We mean that only a small minority of companies succeed in creating shareholder value over long periods of time, even when they manage to grow revenues. Many companies enjoy temporary spurts of growth, only to see their gains erode under the onslaught of competitors. And even those who achieve sustained revenue gains are often surprised to find no corresponding gain in shareholder value. Yet a handful of companies *do* succeed in growing revenues, net income, and most importantly, shareholder value for extended periods. Our research has shown that these few companies demonstrate four common characteristics:

- 1| An ability to properly define and remain focused on their business’ “profitable core”;
- 2| A relentless pursuit of business adjacencies that leverage and strengthen the profitable core;
- 3| The ability to anticipate and quickly react to major industry structural changes; and
- 4| Processes that eliminate or circumvent the inherent organizational inhibitors to growth.

*Chris Zook and James Allen together head Bain & Company’s Worldwide Strategy Practice. This material is derived from extensive original empirical analysis, the case archives of Bain & Company, interviews with scores of CEOs, and our direct experience with clients who face the challenges of generating growth and shareholder value on a day-to-day basis.*

These four themes are explored in the Bain & Company, Inc. Full Potential Series of Thought Pieces. This Thought Piece, the first in the series, is intended to provide a factual foundation for the discussions on growth and value creation that follow, and to debunk the many myths and misconceptions about how companies grow and create value.

## The facts about growth

**Fact #1: Only 1 in 7 companies generates sustained, profitable growth and creates long-term shareholder value.**

Quality growth is rare. To prove it, we examined the performance of over 2,000 companies for a ten-year period<sup>1</sup> to see which generated sustained, profitable growth and created value for shareholders. The results, shown in **Figure 1**, are startling. Only 14% of companies in our database equaled or surpassed a reasonable set of growth targets (5.5% real annual revenue and income growth) and created shareholder value over the ten-year period!<sup>2</sup> (For the remainder of the text we will refer to these companies as **Sustained Value Creators**, or SVCs.)

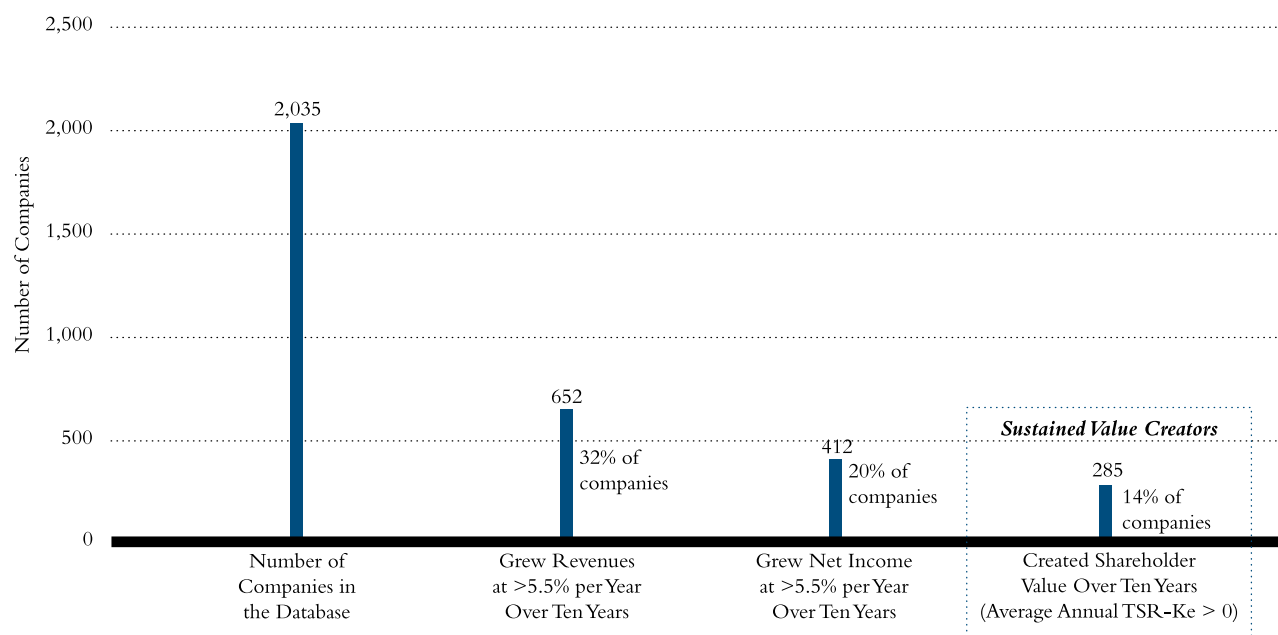
Many firms find these targets—5.5% revenue and net income growth and positive shareholder value creation—achievable for short periods of time, but nearly all stumble sooner or later (and mostly sooner).

**Figure 2** shows the percentage of companies that were able to meet these targets on average for multiple years<sup>3</sup>. Fewer than 40% were able to sustain this performance on average for two years, fewer than 20% did it for four years, and only 14% succeeded for more than five years.

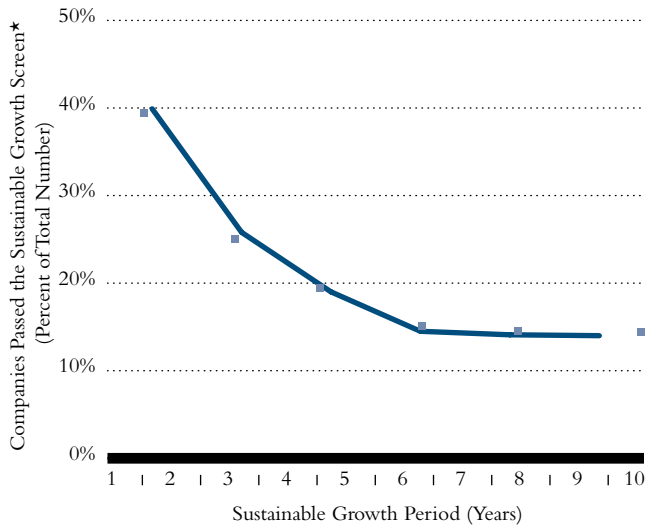
**Fact #2: Growth doesn't create shareholder value. Profitable growth does.**

All growth is not created equal. Our analysis shows that revenue growth alone has little or no impact on shareholder value (Figure 3). In fact, companies that grew revenues were more likely to destroy value than create it! Instead, sustained revenue *and* net income growth is the only reliable way to create shareholder value. As **Figure 4** demonstrates, companies that grew revenues and profits together grew shareholder value on average three times faster than companies that grew only revenue or profits.

**Figure 1: Sustained Value Creators (1987-1997)**

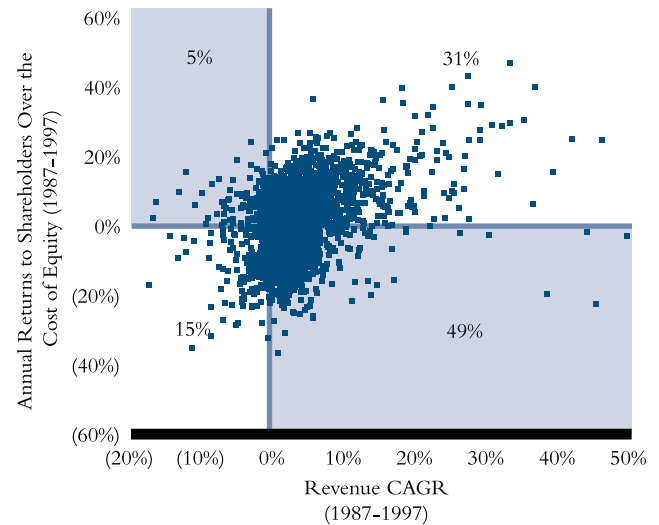


**Figure 2: Decay analysis for sustainable growth companies**



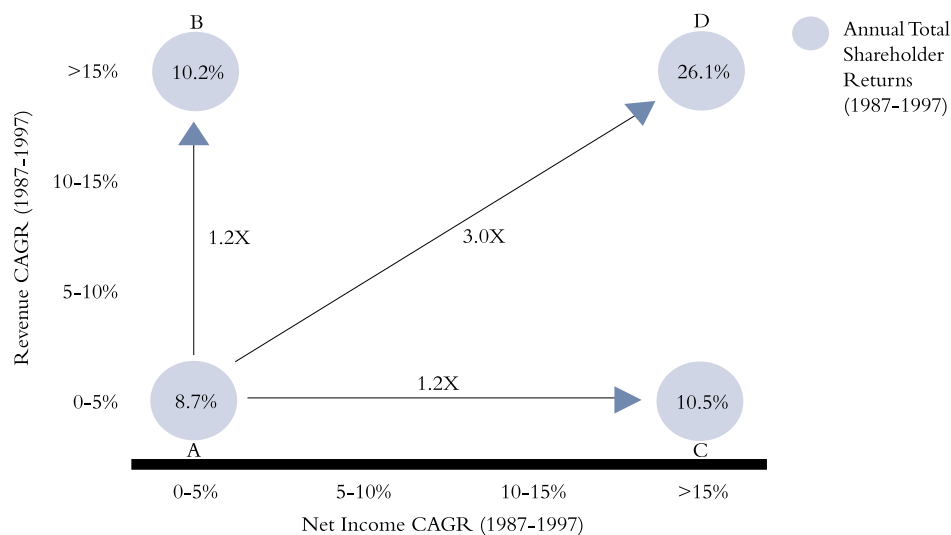
\*Sustainable Growth Companies satisfy criteria of real revenue and real net income annual growth (5.5%) and  $TSR - K_e > 0$  over given period  
 Note: Total number of companies in the database=2,035  
 Source: Worldscope Database; Bain Analysis

**Figure 3: Value creation vs. revenue growth (1987-1997)**



Note: Total number of companies in the database=2,035  
 Source: Worldscope Database; Bain Analysis

**Figure 4: Value creation: Revenue and net income growth**



Note: All growth rates are nominal. Number of companies=984 (companies from 2,035-company database with Net Income CAGR>0 and Revenue CAGR>0). Annual TSR calculated as the Compound Annual TSR over 10-year period 1987-1997.  
 Source: Worldscope Database; Bain Analysis

**Fact #3: Company size is not a key determinant of growth.**

Size has little bearing on a company’s ability to generate sustainable, profitable growth and shareholder value. Our Sustained Value Creators, or SVCs, varied greatly in size, from companies with \$500MM in revenues to those over \$10B. As **Figure 5** shows, these highly successful companies were distributed more or less proportionally to the composition of our original database. Only the largest companies, those over \$20B in revenues, exhibited a retarding effect of size.<sup>4</sup>

**Fact #4: Choice of industry doesn’t matter.**

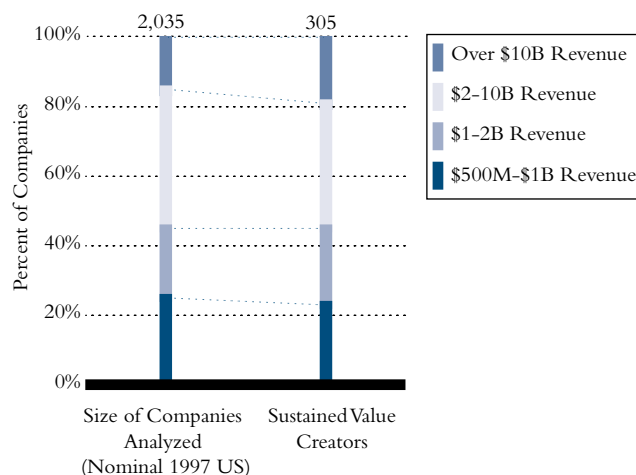
**Relative competitive position does.**

A common misconception is that rapid, sustainable growth can only occur in “hot” markets—markets that are growing rapidly—and that being in a hot market is the best way to generate high profit levels. Our data refutes that. A variance analysis of our database demonstrated that relative competitive position within an industry is *more than four times as significant* than the choice of industry in determining the economic returns of companies. In other words, it’s how you play the game that matters, not which game you play.

Highlighting this is the extreme concentration of profits in most industries. Of all the profits generated by the 2,000 companies in our database over 10 years, over 90% were captured by just 20% of the companies. When we examined the distribution of profits within each industry, the same pattern held—one or two companies in each industry captured nearly all the profits. In other words, it is relative competitive performance within your industry that matters, not which industry you are in. Industries in which “a rising tide lifts all boats” are transitory phenomena.

This point is best made by examining the performance of Sustained Value Creators relative to their respective industries (**Figure 6**). In each industry a major company—frequently the leader—grew at multiples of its industry growth rate. For instance, Nike’s 27% growth far outpaced the 6% growth of the shoe market, its core business, over the period 1987-1997. Many of the other Sustained Value Creators, such as Coca-Cola, Mattell, and Harley-Davidson, grew in markets that were mature, even stagnant. Only 15% of our Sustained Value Creators were in high growth industries such as semiconductors, software, or IT services.

**Figure 5: Sustained value creators by company size**



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## The Profitable Core

The profitable core is the unique, and by definition, highly profitable combination of business assets, skills, products, and relationships that distinguishes a company from its competitors and allows it to provide a unique value proposition to a segment of customers. The profitable core may be a distinct business, a subset of a business, or it may be composed of elements of several businesses. Over the long term, the profitable core is a company's primary engine of growth and value creation.

For Guinness PLC, the profitable core has always been the brewing business in Ireland. Even after the acquisition in the 1960s and 1970s of more than 250 diverse businesses, the brewing business still accounted for over two-thirds of Guinness PLC's cash flow. At Disney, the profitable core is the ability to create and market endearing cartoon characters to a highly loyal group of customers. All of Disney's most successful expansion initiatives can be traced in some way to this original core.

The core can be an extremely durable engine for profitable growth and value creation, driving a corporation for many decades. Baxter Healthcare was founded in 1931 to sell the first commercially manufactured intravenous (or IV) solutions to hospitals. Over the next twenty years, these basic IV products provided the platform for the development of "sterile fluid bags," or plastic containers for storing human blood and other fluids. The sterile fluids business (with its follow-on products such as dialysis, drugs, pumps, etc.) have accounted for the vast majority of profits and value creation for Baxter since its inception in 1931, despite a long series of expansions, diversifications, and acquisitions.

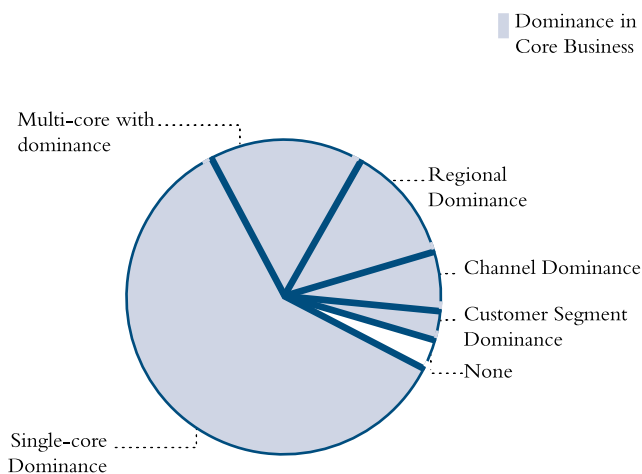
In many companies, however, the profitable core is buried beneath layers of underperforming businesses. Frequently the profitable core generates only a small portion of company revenues, yet provides the bulk of a company's profits. The most successful companies have one or two clearly defined profitable cores and out-invest their competitors in that core, leveraging it for highly profitable growth.

**Figure 6: Company vs. industry growth (1987-1997)**

Company	Company Growth	Industry	Industry Growth
Coca-Cola	9%	Beverages	4%
Sysco	15%	Food Service	4%
Harley-Davidson	10%	Motorcycles	3%
Nike	27%	Shoes	6%
Cooper Tire & Rubber	11%	Tires	3%
Mattel	17%	Toys	4%
GAP	20%	Clothing	4%
Rexel	15%	Electrical Supplies	5%
GEHE	26%	Pharmaceuticals	8%
Carrefour	12%	Retailing/Supermarkets	4%
Aiwa	17%	Electronics/Components	6%

Source: *Worldscope Database; Bain Analysis; Analyst Reports*

**Figure 7: Sustained value creators: Core dominance**

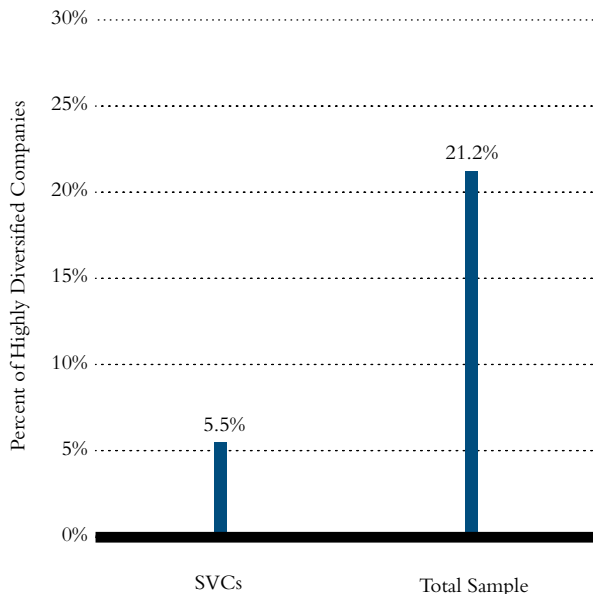


Note: N=66; Core defined as the business that generated the majority of the company's revenues; Dominance defined as relative market share >1.2X  
 Source: Worldscope; OneSource; Industry Reports; Annual Reports; Bain Analysis

**Fact #5: Sustainable, profitable growth requires focus and leadership in the core business.**

If industry choice, company size, and revenue growth don't drive shareholder value, what does? Our research on Sustained Value Creators shows over and over the power of the purest form of business model—the single dominant and differentiated core business. The best stories of sustained and profitable growth almost always come from a company focusing on and growing its “profitable core” and then driving its greatest competitive advantage into adjacent areas around the core. Conversely, we find that diversification almost always destroys economic value. (Please refer to the accompanying inset for a further explanation of the profitable core.)

**Figure 8: Diversification: All companies vs. sustained value creators**



Source: Worldscope Database; Bain Analysis

The power of a single, dominant core business cannot be overstated. **Figure 7** shows a breakdown of a sample of SVCs<sup>5</sup>. Over 80% of these companies had one or two distinctly and clearly defined profitable cores, and more remarkably, over 90% enjoyed dominance in their core business. In addition, as **Figure 8** shows, only about 1 in 20 of our SVCs are what we would consider to be “conglomerates,” with multiple diverse businesses, whereas non-SVCs were almost four times as likely to be conglomerates.

**Our research on Sustained Value Creators shows over and over the power of the purest form of business model—the single dominant and differentiated core business.**

Nearly all of the Sustained Value Creators we examined became SVCs by driving their core business to a leadership position, rather than diversifying into new and unfamiliar terrain. Most growth strategies, by contrast, distract management from the profitable core by directing resources to far-flung diversifications or businesses that don't leverage or strengthen the profitable core. These strategies almost invariably result in sub-par performance, and help account for the 6 in 7 companies who don't create sustainable growth or shareholder value.

**Fact #6: Success or failure depends on management decisions, not external factors.**

When we asked a sample of CEOs why they failed to grow, the overwhelming majority—70% of them—cited a lack of management focus. And by a ratio of three to one they cited controllable decisions over external factors as the reasons for large swings in their companies' financial performances. These managers laid the blame not on factors such as technological flux, competitor invasion, or lack of opportunity, but on their failure to focus on the core business, on bad decision-making, and on the inability of management to effectively develop and implement growth strategies.

**Against the odds: Achieving full potential**

Our findings raise a call to arms for any company serious about creating significant shareholder value. Consider what the facts demonstrate: First, profitable growth is the single most effective way to consistently create shareholder value, yet only 1 in 7 companies achieves reasonable revenue and income growth rates for extended periods of time. Second, neither a company's industry nor its size has any significant bearing on the success or failure of its growth strategy. Third, the most successful companies are almost always those that start by maximizing their existing advantages first—in other words, focusing on the profitable core and driving it to leadership.

And finally, the reasons companies fail to grow profitably are almost entirely internally driven; CEOs admit it, and the data supports it. In short, the success and failure of your company's growth strategy is in your hands. We hope that having these facts will increase your odds of success in developing and implementing your growth strategy.

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<sup>1</sup>Our analysis derives from a database of 2,035 companies, built up from The Worldscope Database and Datastream International, and includes financial data on all public companies in seven countries (USA, UK, Japan, Australia, Germany, Italy, and France) with 1996 revenues greater than US\$500MM for whom data was available over the ten-year period 1987-1997.

<sup>2</sup>5.5% revenue and income growth targets were compiled by averaging the growth targets in a random sample of corporate strategic plans. Actual growth rates by individual companies were adjusted for their country's inflation rate. Companies whose average annual Total Shareholder Return (or TSR) exceeded their cost of equity (Ke) over the ten year period were deemed to have created shareholder value. TSR is defined as returns to shareholders from stock price appreciation plus dividends. Average annual TSR is calculated assuming dividend reinvestment in the stock. Companies who exhibited average real revenue and earnings growth of 5.5% per year and positive shareholder value creation over the ten year period were considered to have met the targets. Exceeding targets in consecutive years was not a necessary condition. Allowances were made for one-time events.

<sup>3</sup>Percentages shown are of companies who met these targets on average for multiple years. Exceeding the targets for consecutive years was not required.

<sup>4</sup>The Conference Board, with Hewlett Packard, documented this phenomenon extensively in their excellent 1998 study on Stall Points in growth.

<sup>5</sup>N=66 companies. All were firms ranked in the top 15% of 2,035 companies in terms of total net return to shareholders (TSR - Ke) over the period 1987-1997. The core business was defined as that which generated a majority of company revenues. "Dominance" was defined as Relative Market Share (or RMS) >1.2X.

## **Bain & Company: strategy for sustainable results**

Bain is one of the world's leading global strategy consulting firms. Its 2,200 professionals serve major multinationals and other organizations through an integrated network of 25 offices in 18 countries. Its fact-based, "outside-in" approach is unique, and its immense experience base, developed over 25 years, covers a complete range of critical business in every economic sector. Bain's entire approach is based on two guiding principles: 1) working in true collaboration with clients to craft and implement practical, customized strategies that yield significant, measurable, and sustainable results, and 2) developing processes that strengthen a client's organization and create lasting competitive advantage. The firm gauges its success solely by its clients' achievements.

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