

Increasing the odds of successful growth: the critical prelude to moving “beyond the core”

Chris Zook

Chris Zook is a Director of Bain & Company based in Boston, MA, and leads its global strategy practice (content@bain.com). His new book *Beyond the Core: Expand Your Market Without Abandoning Your Roots* (Harvard Business School Press) expands on his earlier work, *Profit from the Core* (HBSP, 2001).

From a multi-study Bain & Company search to identify the most reliable principles on which to base a strategy for profitable growth, two key insights emerged. The first is that the most promising growth opportunities tend to lie adjacent to the core business. Indeed, the farther away from the core business companies extend themselves in pursuit of growth, the worse they tend to fare. The second insight, and the one focused on here, is that the competitive strength of the core business itself is a crucial factor in the success of growth initiatives. The principle message of this article is that companies should first re-examine the strength of their core business before they attempt to expand beyond it. Even if the core business is a market leader, it may need to seek even greater competitive advantage before essaying major growth initiatives. If it's well behind the market leaders, its position can be greatly strengthened through consolidation, upwards or downwards. The result will be a sounder, more reliable base for growth. The cases featured here help show the way.

A chief concern of senior executives these days is finding new sources of sustained and profitable growth. Yet choosing between investing in a proven business versus a potential one requires careful analysis and study of both successful and failed attempts. Recent Bain & Company research shows that overreaching for growth in areas adjacent to a firm's core business is often destructive.

To put the successful and failed attempts into historical perspective, consider the starkly contrasting investment choices on expansion into markets adjacent to their core businesses taken by Kmart and Wal-Mart in the 42 years after both chain stores opened their first stores in 1962. Wal-Mart made a series of methodical moves into such adjacencies as Sam's Club, electronics, and overseas stores, one by one. Kmart overreached with adjacency moves ranging from books (Walden) to sporting goods (Sports Authority) and a chain of department stores in Czechoslovakia. Though there are many causes of the two firm's different fortunes,

“According to Bain's recent five-year study of 1,850 companies, the chances for success in growth initiatives were nearly three times higher for companies moving into adjacencies from strong leadership positions in their core business.”

over the decades Wal-Mart became the largest company in the *Fortune* 500, while Kmart descended into bankruptcy.

When Bain examined the top 25 non-Internet business calamities between 1997 and 2002, we concluded that a failed strategy to grow into a new adjacency around a once-successful core business was a critical factor in 80 percent of these cases. In total, these companies experienced an 88 percent loss in value, totaling \$1.1 trillion. On the other hand, successful adjacency moves fueled some of the same period's greatest growth stories, such as IBM's move into services and Nike's remarkable string of product extensions from jogging gear into new sporting venues such as volleyball, tennis, basketball, soccer and finally golf.

In short, adjacency judgments are among the most difficult and critical decisions senior executives face. They can make or break a company. According to Bain's recent five-year study of 1,850 companies, the chances for success in growth initiatives were nearly three times higher for companies moving into adjacencies from strong leadership positions in their core business (see Exhibit 1).

Accurate determination of core strength is challenging. The three critical dimensions are competitive position, market dynamics and financial performance (see Exhibit 2). Competitive position can range all the way from a weak follower to strong market leader, with parity or weak leadership common states in between. Market dynamics range from strong growth to stable low growth to total meltdown. Financial performance can vary from full potential to under-performance. Executives need to take a hard and detailed look at the state of their cores along these three dimensions when considering the challenge of targeting and pursuing promising adjacencies. For leaders and followers alike, the first priority is to define, secure, and if necessary, fix the core business.

Boosting an under-performing core – the case of AmBev

One of the most striking findings from our study is the frequency with which executives underestimate the full potential of their core and prematurely abandon the business (see Exhibit 3).

AmBev, the Brazilian-based beer company, is a case that demonstrates how to boost an under-performing core. In 1989, a group of private investors led by Ambev's current CEO, Marcel Telles, purchased what was then called Brahma. At the time, the company was one of the top two competitors in its domestic market. Telles and his colleagues might well have decided that

Exhibit 1 Market leadership drives adjacency success

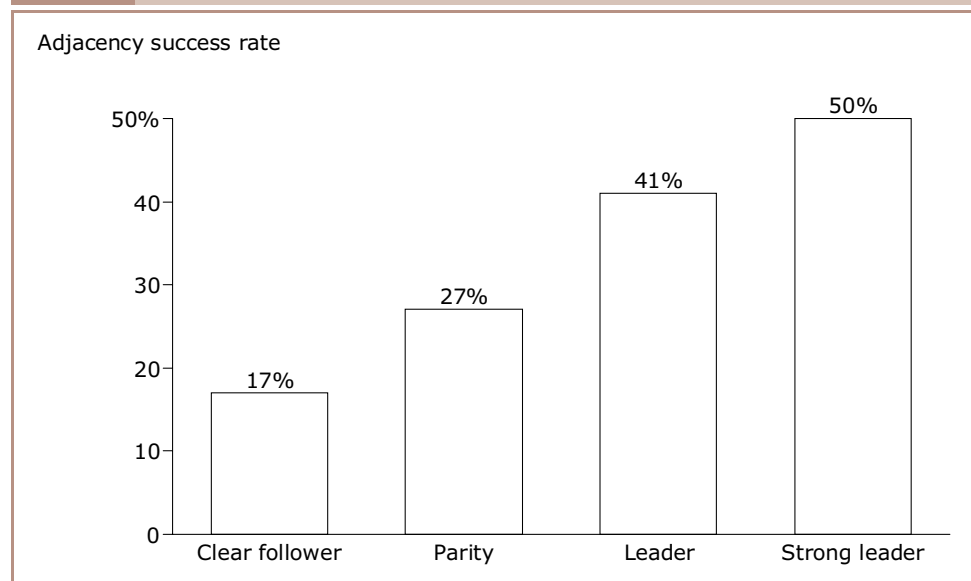


Exhibit 2 Core situations

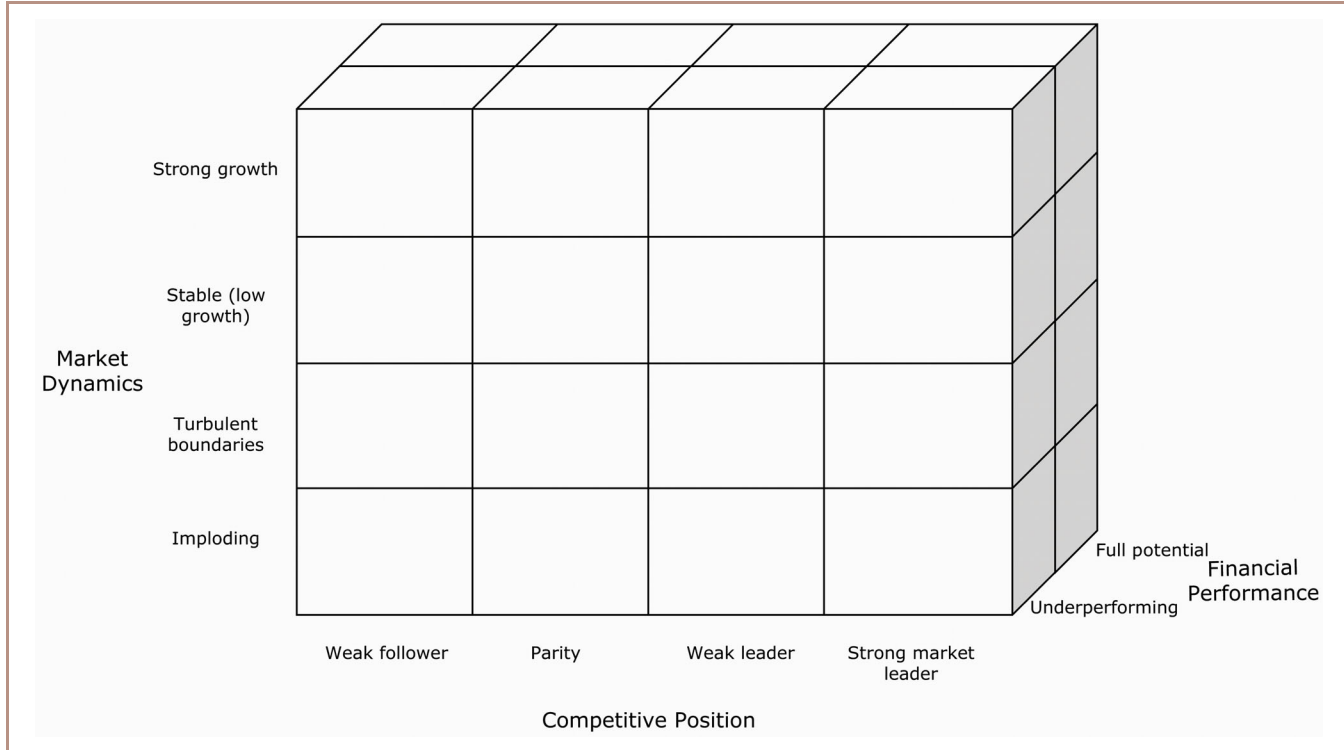


Exhibit 3 Eight signs of value opportunities in the core

1. Poorly defined core, no consensus
2. Declining core customer "share of wallet"
3. Flattening unit cost experience curves
4. Increasing competitor reinvestment rates or market share up
5. Disappointing recent adjacency attempts
6. Increasing product and process complexity
7. Varying and unexplained performance differences across units
8. Neglecting to revise customer segments

the business was maxing out and used its extensive distribution network as the basis for diversification into related or adjacent products or segments. Instead, they decided to concentrate on boosting the performance of the core business. From 1989 to 2001, the company posted an annual growth rate of 20.4 percent in a low-growth market, fueling a year-on-year rise in its stock valuation of 34.4 percent. Today, AmBev is the leading brewer in South America. And with its recent combination with Belgium's Interbrew, it will also take over Canada's number two brand, Labatt, to move into North America.

Telles describes the turnaround this way: "The growth story of AmBev actually begins with ten years of cost cutting and cultural rebuilding in the core business. This takes time. We instilled a culture . . . of being intensely dissatisfied with anything less than full potential and results . . . We discovered that we could constantly turn the screw more and more in the core business to extract much more than ever seemed (possible) at first glance. In 1989, AmBev had productivity of 1,200 hectoliters per employee. Today it has productivity of 8,200 hectoliters per employee . . . It is the power of these core economics that is now allowing us to drive into new adjacencies successfully".

The vocabulary of adjacency expansion

There are six primary ways to push out the boundaries of a business:

- (1) *Product adjacencies*: selling a new product or new services to core customers is one of the most commonly pursued and highest-potential adjacencies. The creation of IBM Global Services for IBM's hardware customers illustrates one of the most successful growth strategies triggered by a product adjacency. Global Services now constitutes 40 percent of the company.
- (2) *Geographic adjacencies*: moving into a new geographic area is a type of adjacency move that companies consistently underestimate in complexity, hence the lower-than-average success rate. An example is Vodafone's expansion from the UK into Europe, into the USA through the AirTouch merger, into Germany through the purchase of Manesmann, and into Japan through the acquisition of a majority share in Japan Telecom and its J-Phone subsidiary.
- (3) *Value chain adjacencies*: going up or down the value chain into an entirely new set of activities is one of the most difficult forms of adjacency expansion. Merck's acquisition and recent divestiture of Medco, a mail-order drug distributor, illustrates a value chain adjacency. Another example is the entrance of LVMH, the luxury goods company that owns 25 fashion brands, from Fendi to Louis Vuitton, into the retail business by the purchase of Sephora and Duty Free Shoppers in 1996. At the time, LVMH announced that these purchases were complementary to its activities. In 2001, the company changed its point of view and announced that these units would be divested, indicating that this retail segment was found to be "noncore".
- (4) *Channel adjacencies*: if successful, the move into a new channel can produce an enormous source of new value. If not, it can turn into a true Waterloo. For example, Experimental and Applied Science (EAS), the leading sports-supplement company, has had great success in making minor changes in the formulation, packaging, and celebrity sponsorship of its Myoplex sports bars, originally sold in specialty nutrition stores, and quickly becoming a leader in its category selling to Wal-Mart. By contrast, the entry of Dell into the mass retail channel with personal computers caused massive disruption in pricing, factory processes, marketing, and sales and led to the only time in which Dell lost money – 1993, when it lost \$36 million. In June of 1994, Dell made the courageous decision to exit the indirect retail channel even though at the time it was building a large warehouse to serve Wal-Mart. This exit move allowed Dell to resume its trajectory to become the best-performing company in the United States during the 1990s.
- (5) *Customer adjacencies*: modifying a proven product or technology to enter a totally new customer segment is a major adjacency move for many companies. Examples include the creation of Kids "R" Us by Toys "R" Us, the move by Staples from retail into the delivery of office products to small businesses, and Charles Schwab's expansion of advisory services to target high-net-worth individuals.
- (6) *New business adjacencies*: Building a new business around a strong capability, essentially repurposing it, is the rarest form of adjacency move – and the most difficult to pull off. The classic example is when American Airlines created the Sabre reservation system, which grew into a spin-off now worth more than the airline itself. Sabre, in turn, went on to create a new business adjacency of its own in Travelocity.

The new strength in its core allowed the then-Brahma to overtake and wear down its long-standing domestic competitor, leading to a merger ten years after the Brahma buyout. The new combination, renamed AmBev, now controls close to 70 percent of the Brazilian market. More than a decade of sustained productivity improvement and market consolidation has helped AmBev to drive up its pretax profit margin from 8.7 percent to 30.5 percent, giving it a very strong position in a core market that is set for further growth (one study estimates that 42 percent of new growth in the world profit pool for beer will come from Brazil).

The company was wise to delay diversification until it had boosted its under-performing core. By waiting until it had trimmed its cost structure, Ambev has been able to move into market after market beyond Brazil. At each step, it used its low-cost operations to build share through lower prices and to gain competitive advantage through higher margins and greater levels of re-investment. Through its superior operating economics, AmBev has taken leadership market positions in Uruguay, Paraguay, Bolivia, and Argentina, along with establishing a strong beachhead in Venezuela and Chile. It is now the largest brewer in South America, and the most profitable in the world. It is well positioned there for expansion into further adjacencies –

including the market for beverages like “guarana”, which is a major non-cola soft-drink flavor category in the South American market. Moreover, Ambev’s latest deal with Interbrew will make it part of the world’s largest brewer.

Strengthening a weak core

Companies with relatively weak core positions face an uphill struggle when pursuing profitable growth. However, the situation is not without hope. Consider the strategies of companies like US Foodservice (USF) and MBNA (credit cards). The most reliable route is through consolidation – upward, like USF, to improve its leadership position in the market as a whole – or downward, like MBNA, in pursuit of a stronger position within a more narrowly defined market boundary.

Consolidating upward – USF

According to Bain data, more than 45 percent of companies that succeeded in improving the strength of their core businesses did so by moving up their industry rankings through merger or acquisition, consolidating upward.

A good example is US Foodservice (USF). In 1989, Sara Lee spun off USF in a leveraged buyout. At the time, the business was number six in the US market as a whole, and number three in its principal regional markets in the Midwest and Northeast. USF’s strategy of consolidation began by building up stronger regional market shares, followed by a series of equity offerings that enabled it to make 17 acquisitions in its core business area over a six-year period.

The focus was threefold: the improvement of operations; the introduction of proprietary, higher-margin, private-label and signature brands; and the rapid integration of back-office activities into the core. Over the next 11 years, from the time of the buyout to its eventual takeover by Royal Ahold in 2000, USF revenues grew from \$0.89 billion to \$6.9 billion, while operating profits rose from \$26 million to \$250 million. Though we estimate the odds of executing a consolidation roll-up strategy are less than 40 percent, it can be a very effective way to secure a leadership position and the economic benefits that flow from it. To be successful, such a strategy requires four critical elements:

- a stable platform on which to bolt on acquisitions;
- a method to achieve real economies of scale;
- realistic acquisition costs; and
- superb execution of the integration process.

Consolidating downward – the case of MBNA

Our data also shows that 20 percent of companies improve the position of their core businesses by consolidating downward into market leadership within a narrower and more finely drawn market boundary. This creates a smaller, but more promising platform for robust expansion later down the line, and might be termed a “shrink to grow” strategy.

The credit card issuer MBNA is a good example of this type of strategy. The business was founded in 1982 as the credit card subsidiary of a US regional savings bank, Maryland National. The bank, however, did not survive the real estate loan crisis of the late 1980s. The distressed parent was acquired by what is now Bank of America, and the MBNA division was spun off.

“ More than 45 percent of companies that succeeded in improving the strength of their core businesses did so by moving up their industry rankings through merger or acquisition, consolidating upward. ”

Lou Gerstner on renewal of the base business

“In my 35-year business career I have seen many companies, when the going gets tough in their base business, decide to try their luck in new industries . . . Too many executives don’t want to fight the tough battles of resurrecting, resuscitating, and strengthening their base businesses – or they simply give up on their base business too soon . . . History shows that truly great and successful companies go through constant and sometimes difficult self-renewal of the base business. They don’t jump into new pools where they have no sense of the depth or temperature of the water”.

Who Says Elephants Can’t Dance by Louis V. Gerstner (HarperBusiness, 2002).

At the time of its acquisition, Maryland National was a weak follower. However, time revealed it actually contained a smaller, specialized, alternative core business with much greater growth potential. MBNA built its latent core strength by focusing on the credit card customer base segmented by profession and affinity group, and by concentrating on customers with the best economics and the greatest potential for loyalty. It found that the best way to reach this market-within-a-market was through zeroing in on affinity groups like universities and the National Education Association. The practice went back to the company’s first core customer in 1982, the Alumni Association of Georgetown. Though other credit card companies competed for this business, MBNA established a lead in know-how regarding customer segmentation and in servicing the needs of specific groups to ensure their retention. Over the following 20 years, MBNA grew to become the third-largest credit card issuer. It entered the new millennium with \$7.9 billion in revenue and \$1.3 billion in profit. All that was built on an obscure initiative within a weak follower that led to a smaller, stronger, more specialized core business platform for significant future growth.

Escaping from a declining core – the case of Imation

The least promising basis for future growth is a core market in inexorable decline. Fortunately, this condition is a rarity, represented by no more than 2 to 3 percent of the examples in our study, and severe market decline is most often a process of erosion, rather than one of sudden collapse.

Our research revealed that only 12 percent of the 1,000 distant followers that we analyzed actually achieved significant improvements in financial performance or market positioning. Virtually none of these improved through entering adjacencies. But a few found ways to fix their core business.

Some companies have found ways to rehabilitate their core business and expand into adjacent businesses even though their market is in precipitous decline. One of the most interesting examples involved transferring skills to a new core, a strategy used effectively by Imation.

When the company’s core floppy-disk business began to disappear and be replaced by optical storage media, the company decided to use its value chain reputation, expertise and infrastructure to build a new core business from the ashes of the old. Created in 1996, as one of six businesses spun off by 3M, Imation has since become, by necessity, a master at creating new growth opportunities through strategic partnership. According to CEO Bill Monahan, the “ability to set up joint venture partnerships that work is a core skill in our company, has taken a long time to develop, and is now the primary engine for our expansion into new products and adjacencies”.

At the time of the spin off, Imation had built a leading position as a manufacturer of floppy disks. But even though the floppy disk has rapidly declined as the medium of choice for data storage, Imation continues to possess a strong industry position, thanks to its successful partnership with a world-class manufacturer of optical storage media. The relationship gives Imation access to a quality product line at low cost, while its partner gains access to worldwide markets, through Imation’s branding, customer relationships and distribution infrastructure. As Monahan now describes it, this new concentration on marketing and distribution “will ultimately become a total replacement of a major piece of our core and possibly our largest core business”.

It is not easy to build a new core business from the ashes of an old one, and odds against it being successful are quite high. Nevertheless, Imation's recovery suggests that for companies in such a difficult situation, it's well worth emulating.

Synthesizing the lessons from our research, we've discovered that there are four reasons why executives frequently misjudge their companies' ability to support an adjacency:

- (1) believing a major adjacency move will transform a follower situation, or create parity – unfortunately, the odds are minuscule;
- (2) abandoning the core business before reaching its full potential – businesses nearly always underestimate their true capacity; this is particularly true for leaders;
- (3) misjudging the adjacency gap – the difference between an adjacency and a leap into the unknown can be measured in the number of steps outward from the core; and
- (4) misunderstanding their company's strength – the best adjacency moves grow out of a minute understanding of the core business.