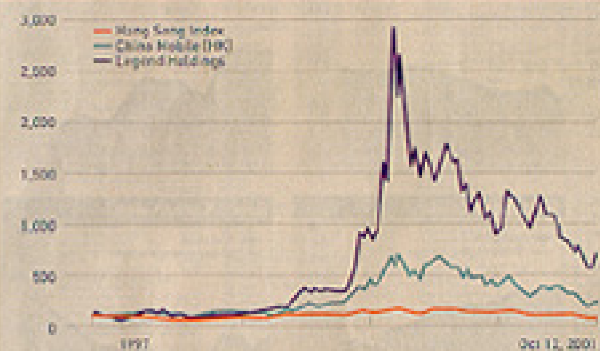
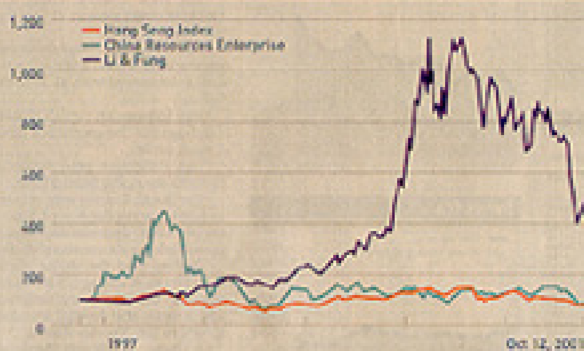
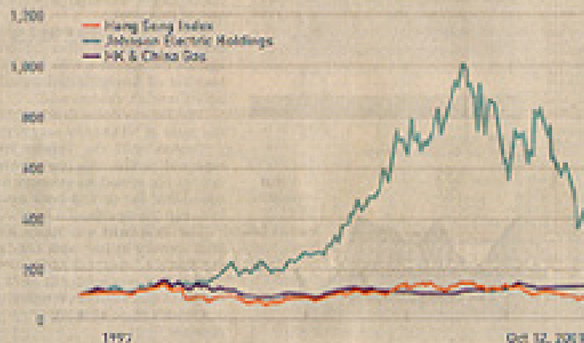
Indexed returns







Source: Thomson Financial Datastream SCMP Graphic

Guard that home base

The more a company strays from its core business the less likely it is to sustain profitable growth, according to studies overseas and closer to home

Chris Zook and
Jim Hildebrandt

SHAREHOLDERS SHOULD be worried. Many per cent of public companies worldwide fail to achieve sustained, profitable growth despite the fact that most managing directors list profitable growth as their top goal.

Our global study of growth over the last decade, across more than 1,800 companies, demonstrated that many companies hit trouble straying too far from their core business.

The cost of diversification is at least twofold. First, it leaves the core business undefended. Second, diversification saps management time and resources and, in some cases, destroys the company's value by confusing investors and damaging share price performance. Conversely, 86 per cent of companies that achieved profitable growth through the 1990s did so by focusing on their core business.

We analysed 33 Hang Seng Index constituents along the same criteria – revenue and earnings growth over 5.5 per cent, and return on equity (ROE) over 9 per cent from 1995-6 to 2000-1.

Eight companies, or almost a quarter, achieved the growth targets. That is double the rate of companies worldwide. These eight companies are China Mobile, China Resources, HongKong & China Gas, HSBC, Hutchison Whampoa, Johnson Electric, Legend Holdings and Li & Fung. This is not surprising.

These companies are focused on their core businesses and have benefited by growth in China and globalisation. If you invested in these eight, you would have earned 4.3 times the performance of the Hang Seng Index.

Hutchison shareholders have benefited from their expansion in ports and telecoms, two businesses where Hutchison has extensive Hong Kong experience. Group managing director Canning Fok Kin-ning started with the benefit of a significant home port, developing superior container management skills. These skills have been used to expand into other attractive port locations in China and worldwide. In telecoms, Hutchison had local wireless experience that proved valuable in Asia and Europe. The market is currently questioning Hutchison's ability to deliver the same performance with third-generation (3G) mobile services, but its track record to date is extraordinary.

Hutchison is unique as one of a few successful global growth companies that have pursued multiple cores. Johnson Electric is a more typical successful growth company, focused on a single core business of electronic motors. Chief executive Patrick Wang Shui-chung took advantage of an increased outsourcing trend, as micromotors replaced pneumatic and mechanical solutions. It had a vertically integrated production chain, strong design capability, joint application development, low-cost production and strong customer relationships. Its global growth path included both acquisition and organic expansion.

Similarly, Legend chairman Liu Chuanzhi also focused on a single core business – personal computers. The China market environment was favourable, with underlying growth in demand and some restrictions on foreign participation in the market. Legend built a strong distribution network in China, with 2,500 sales points, six distribution and 500 maintenance centres. It developed a local brand, selling directly through speciality shops pricing at a premium to local brands but at a discount to foreign players. Legend has a strong base of small and medium enterprise customers. Its growth path will now be tested with more open competition through the WTO and a much more competitive environment for technology companies.

Li & Fung is a Hong Kong success story, focused on supply-chain management. Chairman Victor Fung Kwok-king began by increasing vertical participation across the textile supply chain, leading to product-line extensions and geographic expansion. Strategic acquisitions allowed Li & Fung to reinforce its core business, developing the strongest brand among retailers and suppliers and the lowest-cost sourcing network. It has also used its expertise to build a leading business-to-business portal. This is a very challenging business, but highly related to its core.

> They are difficult decisions ... calls that even excellent managers can misjudge

Our work shows that even the most sophisticated management teams can make mistakes in identifying growth opportunities. They think they are moving into a highly related business, but in fact differences in the new business's cost structure or customer base actually diversify operations – and correcting a misstep course is painful.

What is the problem with the other 25 constituents of the Hang Seng Index? Too many local companies operate as holding companies, trading at a discount to the underlying value of their core assets. Very few successful growth companies are conglomerates. General Electric is an exception.

Many poor performers relied on property as their core. For the average Chinese family company in the 1950s, the easiest path to increased wealth was property ownership, development and management. Unlike in the US and Europe, the increasing real value of commercial and residential property over a long period of time was the most attractive "rising tide" for local companies. Manufacturers and service companies in Hong Kong faced higher operations costs. The tide shifted at some point in the early 1990s, and the winning eight companies are not property-holding companies.

Other companies relied too much on Hong Kong alone. Expansion into China and globalisation were critical to success for the successful eight. In fact, a number of the eight are not based in Hong Kong. Hong Kong is high cost for operations because it is a services and logistics centre for high-value businesses, not a location for labour-intensive manufacturing or services.

What distinguishes profitable growth into new areas? Executives should step back and apply their strategic judgment and operating knowledge to assess opportunities along five key dimensions:

1. How much does this opportunity strengthen our core business franchise?
2. What are the chances of our becoming a leader in the new segment or business?
3. Could this move have a defensive benefit, pre-empting our present or future competitors?
4. Does the investment position our core business strategically for an even stronger future opportunity or hedge against uncertainty?
5. Can we be certain of superbly executing implementation?

Asking and answering these questions should increase your odds of joining the eight. But they are difficult decisions. They are calls that even excellent managers can misjudge in choices.

The present economic downturn and the turmoil driven by terrorism require clear thinking for survival and future profitable growth. The first step is to clearly identify your core business, and therefore your most valuable customers and assets. Protect your core as a priority.

Look for acquisitions and organic growth opportunities that reinforce your core. Shut down any expansion that does not meet the criteria for successful growth. Now is not the time to be fighting for incremental gains in opportunistic battles against marginal opponents.

Your best competitor will be attacking your core.

Chris Zook directs Bain & Company's strategy practice and is the author, with James Allen, of Profit from the Core: Growth Strategy in an Era of Turbulence (Harvard Business School Press). Jim Hildebrandt is managing director of Bain & Co (Hong Kong)