

Focus

by Julian Critchlow and Rob Koczkar

In the guarded language of central bankers, it's the nearest you get to reckless optimism. "Recent evidence suggests economic expansion is already well under way," said Federal Reserve chairman Alan Greenspan. Eddie George, Governor of the

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Bank of England, also has a spring in his step. "We're seeing recovery in the global economy," he noted.

But the good times seem a long way off to most UK business leaders, many of whom are still in the throes of redundancy programmes and cost-cutting initiatives. Nearly 60% of FTSE 100 companies laid off staff in 2000 and 2001 and real investment by UK companies shrank by 2.5% last year - after five years of 5% annualised growth. Today, many businesses are struggling too hard to keep their heads above water to think about investing for the future. Their priority, as it invariably is when the economy tumbles, is to batten down the hatches, cut costs and preserve cash.

An understandable response, perhaps, but it wastes what could be a unique opportunity to raise your sights and set your company on a more ambitious path to growth. Our research shows that leaders with the courage to reinvest in their core business in a downturn will be handsomely rewarded. Look at Dell. In 1993, the computer company faced its first loss of \$36 million. Critics thought its "direct to customer" business model had reached the end of the line and further growth could only be achieved through retail and distributor channels. Michael Dell disagreed. He took the bold decision to ditch the retail channel and refocus on his core direct model. The result: a return to profits within 12 months and growth over the next five years of five times the industry average.

Or take Chrysler. The automobile manufacturer hit rock bottom in the global downturn of 1990/91 when demand for its cars plummeted. Instead of wringing their hands, Chrysler's managers sold non-core assets, outsourced as many related operations as they could and aggressively cut costs. Proceeds were reinvested in new product development and R&D and the results were swift and impressive. In 1992 it earned \$723 million - the only one of the Big Three US car companies to turn in a profit.

Dell and Chrysler's leaders invested heavily in their core business by divesting or harvesting non-core activities. Each challenged its core businesses to achieve full potential through market leadership and then reinvested the profits back into that core business.

Such success stories are not peculiar to the US. Research by Bain & Company shows that now is exactly the right time for UK companies to be thinking about focused investment. The facts speak for themselves: a significant majority of

the most successful UK companies began their growth stories with key investment decisions taken during the last recession.

Bain & Company research identified 42 UK companies that have grown both revenue and profit consistently over the decade and returned their cost of capital. Of these, 34 made significant strategic decisions in the early 90's. Twenty-two companies decided to invest in their core business, either through acquisition or internal growth, in many cases after jettisoning non-core activities. Another 11 companies invested in adjacencies which would enhance the core, while one company redefined its core altogether (see Chart 1 "UK growth companies in the 1990/1 recession").

Each of these companies took advantage of the turbulent conditions to make the strategic decisions that best positioned them for strong growth coming out of the downturn. Rather than just cut back or defer strategic decisions, they actively 'doubled down' and invested in core or core-reinforcing activities.

Focus on a few core businesses

To see how effective bold decisions can be when times are hard, look at Stanley plc, a betting and casino operator and one of our UK growth companies. Its managers used the recession to double the bet it placed on its own core business and proved this was much less of a gamble than doing nothing or spreading its bets too widely.

At the start of the recession in 1990, Stanley found itself in a sector highly sensitive to reduced discretionary spending and lumbered with a business - printing - that was unrelated to its core.

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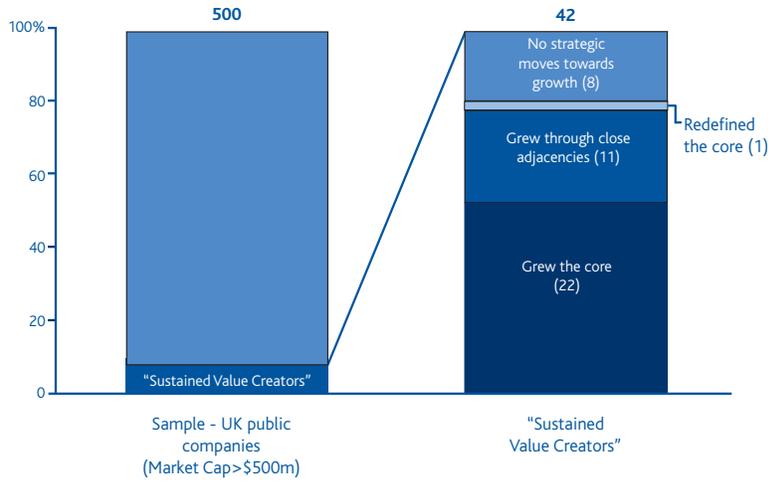


on the **Core Business**



Focus on the core business Bain and Company

Chart 1: UK Growth Companies in the 1990/1 recession



Selling the printing business was the first step. The next was to drive growth in the core gaming business in the teeth of a downturn. Between 1989 and 1994 its managers spent £44 million acquiring 185 betting shops and 10 casinos as well as investing in refurbishing its high-street network. At the same time, managers took measures to whittle down the high fixed costs of running a network of betting shops and casinos. Between 1991 and 1995 revenues grew at an annualised rate of nearly 12% and operating margins increased from 3.8% to 6.4%; all this in an industry that saw revenues shrink in real terms by 5.3% between 1990 and 1993.

Amersham plc - another UK growth company - also viewed the downturn as a chance to ramp up its core operation. Like Stanley, it did this by selling off non-core assets and reinvesting heavily in the core business to become a leader in its industry.

The company, born out of the UK government's 1982 privatisation of its radioactivity applications business, had seen its profits slide from £25 million in 1988 to £17 million in 1991. In 1990 new management conducted a strategic review that defined the core business as life science research products and radiopharmaceuticals. It disposed of a non-core clinical reagent business and acquired Medi-Physics from Roche to drive towards its full potential in the radiopharmaceuticals business.

Between 1991 and 1995, Amersham increased sales by 8.3% per annum and increased operating margins from 8% to 14%. Its market capitalisation leapt from £174 million in 1991 to £4.7 billion today.

Extract the full potential from your core

Amersham undertook a major acquisition to consolidate its position. It made good sense to acquire a competitor when valuations were low, but the main driver behind this acquisition was

the need to bolster the core business, not an impulse to pick up an undervalued asset. Not all leaders are so prudent. Just as risky as a management "go slow" when times are hard is a management tempted into buying diverse, unrelated assets just because they are cheap. Far from growing the company, this diverts management's attention and capital from the core business, which is where the best opportunities for sustainable value-creation reside.

Managers justify this type of expansion by arguing that the core has hit its full potential so expanding into other areas is the only way to grow. This is rarely the case. In fact, our research

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shows that the better performing your business the more likely it is to be performing below its full potential. This counterintuitive finding is explained by looking at the virtues of market leadership. The better your business is performing, the more likely it is to achieve market leadership. And market leaders achieve an average 22.1% return on capital invested compared with a 14.3% return for competitors that are at near parity. Higher revenues, in turn, enable market leaders to reinvest at nearly twice the rate of their competitors and thus reinforce or increase their leadership position.

Consider high street newsagents WH Smith. Searching for growth opportunities in the mid-1990s, its leaders decided to broaden its range of products. They introduced toys, music and even typewriters to its stores. Far from strengthening its position, sales per square foot per week fell from £8 in 1994 to £7.20 in 1996. In that year, losses amounted to £195 million. A new management team was brought in which swiftly refocused the business back to its core. Proceeds from the sale of non-core assets were used to acquire rival John Menzies and within a year the company was back in profit.

Expand into closely adjacent businesses

Only when you have exhausted every opportunity to invest in the core business should you consider investments in related business areas. Identifying the right kind of expansion is tough and success turns on whether or not an opportunity is genuinely adjacent to your core. Something that looks a lot like a hole in your core would certainly qualify, but sometimes the right adjacency is not the most obvious one.

For UK life group Prudential plc, international expansion turned out to be the right adjacent move. In 1990, Prudential was a general insurance and pensions company active both in the UK and internationally, with a loss-making estate agency network and other financial services activities. When Mick Newmarch took over as CEO he reviewed its operations in light of the recession that had started to bite. Newmarch realised he would have to make some bold changes to grow the company.

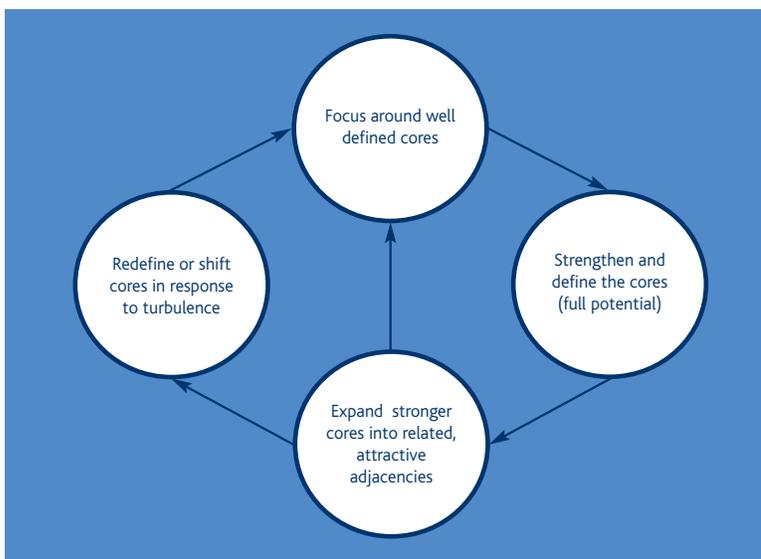
He divested some non-core activities - most notably the estate agency network - and invested in the core business and in profitable adjacent businesses. The core UK life assurance business was reorganised and money was spent restructuring and training the UK direct sales force, enabling them to grab market share from competitors. Newmarch then focused on international growth, particularly the US, Australia and South East Asia.

Between 1990 and 1995, Prudential performed well in a challenging sector, growing operating profit from £267 million in 1991 to £804 million in 1995. Today, Prudential's market cap is £16 billion, up from £3.4 billion in 1991.

Prudential's leaders recognised that what distinguishes an adjacent move is the extent to which it draws on the customer relationships, technologies or skills in the core business to build competitive advantage in a related arena. "I believe we need to concentrate on the things we are really very good at," said Newmarch at the time.

Prudential demonstrates that growing by selecting the right adjacent business in which to move reinforces the profitable core, encouraging a virtuous circle of expansion and consolidation (see Chart 2 - 'elements of successful growth strategy').

Chart 2: Elements of successful growth strategy



When to redefine the core

To work out where you are most likely to win, ask yourself the following questions: Who are your most profitable customers? What is your most differentiated and strategic capability? What are your most critical product offerings?

Answer these questions honestly and you might find your best business is not what you consider your core business today.

This was the experience of Bodycote, another of our UK growth companies. The company's original business was textiles. It moved into industrial work wear and safety products in the 1970s and into metal technologies in 1979. By 1991, Bodycote's range of activities included contract food blending and packing, insurance and metal technology. Its managers recognised the need to focus on a single core business and sell the rest. But instead of turning to its textile roots they decided the best platform for future growth was in fact the relative newcomer, metal technologies.

Bodycote's leaders invested in its existing activities and acquired metal technology operations in the UK, Europe and the US. By consolidating a fragmented industry the company bucked the industry slowdown: between 1991 and 1994 revenues increased steadily by 4.9% each year and operating margins increased from 17% to 23%. Bodycote's market capitalisation shot up from £64 million in 1991 to £569 million today.

It is not easy to redefine your core. Bain & Company research shows that only 5%-10% of profitable and growing companies have transformed or redefined their core business in the past decade. But for leaders like Bodycote that are forced to reassess the viability of their major businesses, doing nothing is not an option.

Conclusion

There is no better time than now to pull ahead of your competitors by doubling down on your core business. A stronger FTSE, a slight fall in the January unemployment number and record UK car sales indicate the first delicate shoots of recovery. Meanwhile, your competitors may be in better shape than you think. The roaring stock markets that prevailed through much of the 1990s has left many companies better capitalised (with a lower ratio of debt to equity) than they were at this point in the last recession, making them better able to make decisive investments themselves.

To ensure you don't miss out on this opportunity, challenge your business on these five key questions.

1. Are you focused entirely on weathering the storm or do you have a **plan to capitalise on today's opportunities?**
2. Are you clear on which **few core businesses** you will drive to leadership or are you attacking on too many fronts?
3. Are you **investing differentially to drive the core businesses to their full potential** or are you spreading your bets evenly so as to win nowhere?
4. Is **adjacent expansion reinforcing the core** or distracting management from maximising the potential of the core?
5. Do you need to **redefine the core** or should you be focusing on your existing core?

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