

The End of the V Curve

1. Growth and Continuous Optimization – The Formulas for Sustainable Corporate Growth

Summary:

Growth is the key goal of management. It is not just an indicator of a company's performance, but also the basis for its future success. But growth doesn't just mean getting bigger – it also means getting better. In other words, growth must be profitable, otherwise it destroys rather than increases the company's value long term. And this is not the only challenge. Growth must also be made continuous. The traditional cycle of alternating phases of growth and contraction no longer applies in today's fast-moving economy with its fiercer competitive pressure. In the past companies tightened their belts during lean years when recession hit and loosened them again during years of plenty. But the days when this formula worked are well and truly over: the so-called V curve no longer applies. Today, companies must follow a parallel strategy of growth coupled with restructuring, in the sense of permanently increasing efficiency. These two goals must be pursued at one and the same time. Can this be done in practice? How can management find a successful growth course and stay on it? In this chapter we present our answers to these central questions. We also reveal how the companies that are "growth champions" manage this in practice, as shown by the findings of our study of how the 1,700 largest corporations worldwide manage growth.

Growth Means Getting Bigger and Better

Stagnation means decline. There are plenty of hungry firms out there just waiting to gain ground at the expense of their competitors. The only way a company can prevent this happening is to grow at least at the level of the market – or, better still, grow faster than the market and so gain market share. The advantages of having a large market share – including economies of scale in purchasing, production, and distribution – in turn provide a further stimulus for growth.

Companies must grow, then, in order to establish a permanent basis for their future success. But we are not just talking about growth in a quantitative sense here: high sales figures and a large staff are not assets in themselves. Even titans fall. And there have been spectacular examples of titanic firms going under in all stages of business history – PanAm, WorldCom and Enron to name but three.

Sustained growth rests on a synthesis of quantity and quality. Growth means getting both bigger and better. Only those companies that meet their customers' needs better, invest in innovation and service, penetrate new markets, improve their cost structure and so on are firmly on the path to long-term solid growth. In other words, they can achieve growth that is sustainable and therefore profitable. If this sounds like it should be taken for granted, that is evidently not the case – as shown by a global study of leading firms carried out by Roland Berger Strategy Consultants, whose results we shall come to in a moment. For the moment, let's be clear about one thing: growth is the indicator that a company is pursuing the right strategy with the correct business models and optimum business processes.

The Growth Imperative – Why Companies Have to Grow

Sales growth has traditionally been the yardstick of business success. Indeed, sales growth is the only lever that allows all of a company's performance indicators – profits, cashflow, total shareholder return, etc. – to be optimized in parallel. It can give firms a clear indication of how they must respond to the market-driven compulsion to grow. But before we look at how growth can be generated, we should briefly identify the key aspects that feed this compulsion to grow:

- 1) *The demand for increased value:* In simplified terms, the notion of shareholder value is based on a method of discounting future cashflows. Grow these cashflows and you add value. However, since potential returns diminish as a result of constant optimization, over time it becomes less and less possible to generate ever greater cashflows (or, to be precise, free cashflows – net of existing financial obligations) purely from measures to improve efficiency. Higher cashflows therefore require (sales) growth.
- 2) *Economies of scale:* Learning-curve effects depend on rapid growth. A company can capitalize on the benefits and economies of scale only when it has attained a critical mass. Lower transaction costs and new management possibilities based on improvements in information and communication technology (ICT) are increasingly tilting the balance in favor of large companies and are thus forcing enterprises to either grow or fall behind. We discuss the business implications of this in Chapter 3.
- 3) *Increasing pressure on margins:* Many markets in industrialized nations are now saturated. Consumers have practically all the consumer goods they need, and industry is well stocked with capital equipment. Increasingly saturated markets erode margins as competition becomes ever more fierce. If sales remain constant, that inevitably leads to shrinking profits. So higher profitability demands higher sales.

- 4) *Building and maintaining positive prospects:* Only growing companies offer positive prospects to the very best people. International projects, sufficient variation, career development opportunities and excellent compensation packages are the top factors that motivate high performers. These are things that only companies that grow can guarantee long-term. Hence growth makes a company a more attractive employer, as numerous surveys have shown.
- 5) *The globalization of many lines of business:* Only international businesses are able to operate on a global scale. This is critical because international transactions are growing faster than GDP (see Figure 1). What is more, the real growth markets with high volumes lie beyond the borders of the traditional industrialized countries – namely in China, the ASEAN countries, and specific countries in Central, Eastern and Southern Europe. Companies that currently lack an international orientation must grow if they are to compete successfully on the global stage. Similarly, only companies that produce sufficient quantities of goods in large enough batch sizes can carry out production abroad and so exploit global cost factor advantages.

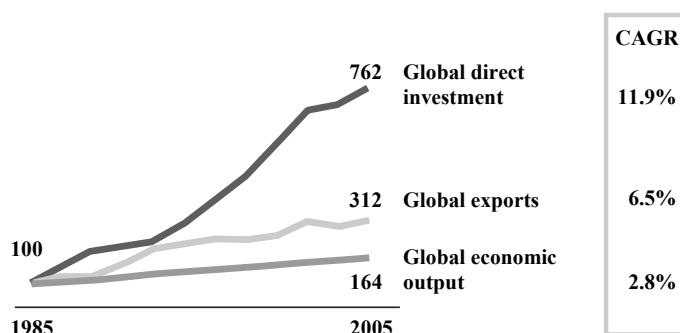


Fig. 1: Global growth rates [1985 = 100] (Source: WTO, OECD, UNCTAD)

Companies can only grow successfully when they have developed a strategy, set appropriate goals to back it up, and agreed it with the organization. This must be part of a fundamental process involving all business units. The strategy should address some key questions: Who are the company's primary customer groups? What business model will be most successful? What trends will affect the sector in future? What products or product innovations could change the market radically? How is the company currently positioned in the value chain? And what position in the value chain does it want to achieve in the future? In this sense, strategy is a long-term (or, at least, reasonably long-term) concept – in spite of the fact that strategic planning's range has shortened as the general environment has become more dynamic.

A company that wants to grow successfully must not wait for the market to tell it what it can, or should, do. It must anticipate developments and trends in the markets – including both the markets where it already operates and the new markets it would like to penetrate. Clearly, then, strategy is not just about copying the patterns that others have followed successfully by others: it is not enough to simply imitate your competitors' best practices. It is generally impossible for a company to repeat the specific approach taken by an established competitor, since one of the following usually apply:

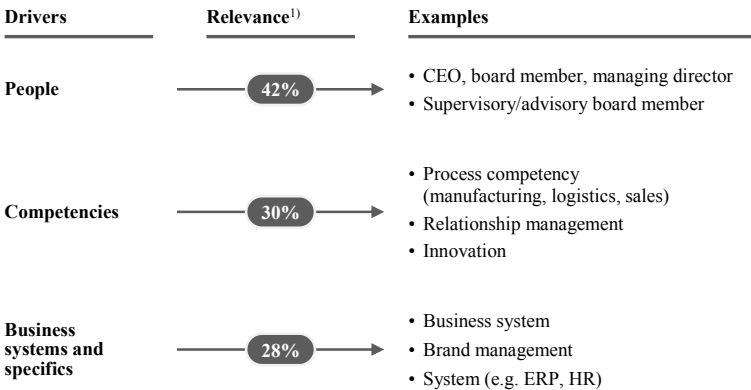
- The competitor provides a service that cannot be readily copied (e.g. Sony, Nokia)
- Its key competence lies in a specific process or product (e.g. Coca-Cola, H&M, Ikea, Aldi)
- It has cornered the market as "first mover" (e.g. eBay, amazon.com, Microsoft, Apple)
- Or it is protected by a strong brand (e.g., Porsche, Harley Davidson, Nike).

As the examples show, companies can achieve the desired success by taking a conscious strategic approach and – most importantly – implementing it consistently. However, this also means that they have to focus in on certain selected areas from among the wide range of possibilities. There is no single recipe for growth, but rather different basic patterns and strategies that must be adapted to the specific (industry or company) context to be fully effective. And companies must keep one thing in mind: a high level of engagement from management is necessary if the growth strategy is to really take off. Growth does not spring up from nothing: it must be actively fostered. And even the most finely honed strategy depends upon the people implementing it for its success or failure. Having the right people in the right places is what brings a strategy to life and makes it successful. The human factor is crucial when it comes to deciding who will ultimately enjoy the advantages of growing most strongly.

The Willingness to Grow

In fact, companies are fully aware of the importance of the human factor. In the spring of 2004 we carried out a survey of top German and Austrian managers. The findings were clear: from the perspective of our respondents, the most important instigators of growth are the people at the top – the board members, CEOs and company promoters. These individuals were ranked far above competences and systems as the key drivers of growth. The reason is obvious: their attitude and behavior lay the necessary cultural groundwork (see Figure 2). Employees can't identify with abstract guidelines – they need human examples. This is what we call a company's "willingness to grow": a supportive culture which connects and involves all the employees and inspires them to walk the difficult path to expansion.

If the employees can get excited about the growth plan, then they will also acknowledge it as a top-down directive and be prepared to commit to it personally.



1) Weighted survey findings

Fig. 2: Key factors in a company's willingness to grow

But that's not all our survey showed. Many companies admitted that practice does not match up to theory. They recognized that their own organizations had significant deficits in the key management components that support growth: staff motivation, top-down targets, personal customer proximity, selection of managers and an innovative corporate culture. Paradoxically, companies appear to lack precisely the high-ranking characteristics promoting growth, while they often display the characteristics that respondents themselves describe as growth inhibitors (see Figure 3).

And there's more. The survey also revealed that companies are often too defensive about growth. Almost half the respondents said that the management of their firms did not give any explicit sign to let everyone in the organization know that they were about to enter a growth phase. This reticence is based on the fear that adverse market conditions will mean they will miss their targets. But our study shows that it is ambitious targets that in fact create the necessary drive – that make the company really put its back into the growth effort. Yes, it's easier to meet low targets, but such targets won't help companies achieve an accelerated growth course. To put it in a nutshell, for companies to grow they must first show the will to grow.

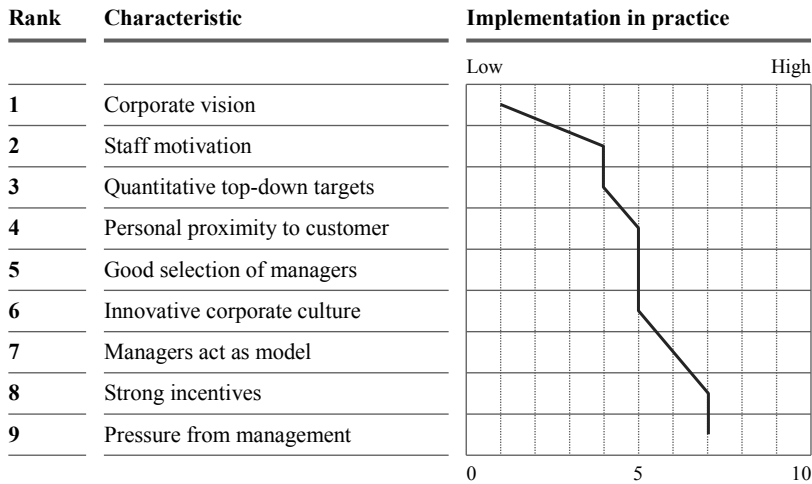


Fig. 3: Management qualities supporting growth and their implementation in practice

This brings us to a key finding of our study. Companies that want to achieve profitable growth must recognize that their organization, corporate culture and management are the key drivers of growth, and prepare them for growth accordingly. The first step is for companies to examine themselves critically, identifying and dealing with any internal barriers. Once this has been done, growth can begin.

A Further Requirement: Growth Must Be Profitable

One more thing. It's not enough for companies to grow – they have to grow profitably. If they don't, they will fail to generate shareholder value. Hence their growth course must be backed up by a value management system geared toward meeting the following conditions:

- Additional sales must generate profits either by being intrinsically profitable or by helping to make the entire business system more profitable (e.g. through synergies, cross-selling, realization of critical mass, shared services, etc.).
- If the company wishes to increase its value, additional sales must, in line with the value management system, at least earn the cost of capital – the minimum threshold for profitable internal growth. If this condition is not met, extra sales will reduce and ultimately destroy value through unprofitable growth. In the case of external growth through takeovers, the acquisition premium (the difference between the actual value of the target company and

its purchase price) must never exceed the forecast synergies – which, of course, must then be realized in practice.

- Growth usually requires investment. The company must therefore have enough free cashflow or be able to free up enough cash through restructuring and optimization in the near future. Alternatively, its debt/equity situation must provide room to acquire new financing. We return to this question in detail in Chapter 6. Essentially, either option means that only profitable companies can chart a growth course.

So growth is important, but profitable growth is even more important. This is an indication of the fact that the market is demanding more and more expectations on companies are increasing. It is no longer sufficient for companies to meet yesterday's or today's benchmarks – this is no proof that they can hold their own against the competition, nor does it make them attractive for the two resources currently in short supply, investment capital and intellectual input. Today's companies cannot content themselves with being the sales leader in their own sector: only profitable growth can keep them on the growth track in the long run.

The Advantages of Size

Large companies can bring strong advantages to bear. As a result, they enjoy greater growth potential. When it comes to growth, it seems that "big is beautiful". But why should this be so? Here are our answers:

- Companies must achieve a critical mass in order to take full advantage of economies and advantages of scale. Today's sinking transaction costs and rapid progress in ICT mean that diseconomies of scale are disappearing and companies can exploit the economies of scale better. This development – discussed in depth in Chapter 2 – naturally favors large companies. Such companies have an easier time reducing costs, for example by transferring best practices and exploiting learning curves. And lower costs means additional value for the company.
- Large companies find it easier to play an active part in an increasingly integrated global economy. This is because they generally have more funds at their disposal than smaller firms. They can enter and penetrate new markets more quickly, whether off their own back or with the help of their partners. They can also profit more quickly from globalization by exploiting the cost advantages of specific locations. Companies can only go international if they have achieved critical mass. Only then can they position themselves properly in foreign markets and exploit the cost factor advantages offered by certain countries. Moreover, large companies have options in their internationalization strategies that smaller players would find difficult to pull off, such as collaborations and strategic alliances.

- As a rule, large companies have more financial clout than small ones. This makes it easier for them to come up with the money needed for investments either from within the company or by attracting external financing. Although corporate financing by the capital markets is theoretically also available for smaller firms, in practice it is only really viable for large companies.
- A transformation is taking place as we move from an industrial economy, to a service economy, and ultimately to a knowledge economy. In the future, a company's ability to use information – its knowledge – will be crucial for its success. And there can be no doubt that large firms generally have better resources of knowledge than small ones. However, the last ten years in particular have shown that simply having knowledge is not enough. Companies must also be able to transfer this knowledge. In other words, it is how a company applies its knowledge in concrete processes and products that gives it its competitive edge. Knowledge must be applied in order to bring returns in the form of growth.
- In a knowledge economy, a company's greatest capital is the minds of its employees. It thus becomes a matter of supreme importance for companies to attract talented and motivated individuals, and retain them over time. Again, big companies are at an advantage here. High potentials find large firms more attractive as employers than medium-sized companies. Indeed, they even prefer working for large companies to running their own businesses. And this is true not just for continental Europe, but also for the US, where the percentage of people running their own businesses is not higher despite a more widespread entrepreneurial culture.

Naturally enough, all these arguments apply not only to large firms but also to larger medium-sized companies. (The only exception is the last point – here, a change is needed in the mindset of young graduates.) Larger medium-sized companies are also benefiting from economies of scale, going international, making use of the capital market and building on the efficient use of their knowledge (which is often outstanding in their own particular area of specialty). They, too, can leverage economies of scale to achieve more growth and increase efficiency still further. Germany, in particular, has many examples of larger medium-sized firms that are excellently positioned and are enjoying strong growth.

So what about small companies? If they remain isolated, they miss out on all the advantages of scale. If, on the other hand, they can form networks or join virtual organizations, then they too can profit from the scale achieved by this means. As part of a network they can enjoy greater purchasing power, for example through bundling, or share expertise in research and development. Networks also allow small companies to generate economies of scale by having a joint sales platform. However, networks also have their problems in practice. This is perhaps why they are less common than one might expect, given their potential benefits. From a technical point of view, the use of different systems often hampers smooth coop-

eration. Corporate cultures may also clash, which can be just as much of a problem. What is more, many companies are afraid to work shoulder-to-shoulder with their competitors in case their expertise leaks out and their competitive position is put at risk.

The Growth Algorithm – Starting the Perpetual Motion and Keeping It Going

Growth strategies are a complex matter. As we have already seen, they have to meet a number of targets in parallel: increased sales, value growth, operational excellence and financing growth are all closely interlinked. But there is good news, too. Once a company has found the right "growth algorithm" (this will vary between different companies and industries), growth becomes to a certain extent self-perpetuating. The logic behind this is actually rather simple, especially compared to the complexity of defining strategy. Here's how it goes. Operational excellence – shown by greater productivity, falling unit costs, etc. – forms the basis for bigger free cashflows. These can then be invested in growth. As long as growth remains profitable and is properly managed, this in turn generates new, size-related benefits (such as economies of scale and lower factor costs due to globalization). Companies can then use these advantages to generate even bigger free cashflows, and so growth becomes self-perpetuating (see Figure 4).



Fig. 4: The growth algorithm

But the pivotal question for business is how to start this perpetual motion going. Well, first companies must bid farewell to the traditional V curve as a management strategy. This concept was based on the idea that companies develop in cycles of alternating efficiency optimization and growth. In simple terms, firms put on weight during years of plenty and slim down during lean years. But nowadays

this yoyo pattern is no guarantee of sustainable growth. In today's competitive markets, companies must strive to continuously improve their efficiency, at the same time as growing. Indeed, only a parallel strategy of "growth and restructuring" can bring success in the long term. Incidentally, this sort of restructuring should not be confused with the structural reorganization that can help companies in crisis. In the context of growth, restructuring means modernizing processes and structures with the aim of improving efficiency.

A Global Analysis: How Do the Biggest Companies Grow?

Over the last two years, we at Roland Berger Strategy Consultants have carried out a number of internal studies to try to identify the best strategies for growth. These studies have dealt with some central questions facing management:

- Is there some formula for growth, or identifiable patterns that make growth processes work?
- What are the critical issues when it comes to developing and executing a growth strategy?
- How must a company be structured and, more importantly, managed to ensure lasting growth?

In an initial quantitative study we looked at the 1,700 top companies in the triad regions: the 900 leading companies in Western Europe, the companies listed in the S&P500 index in the US and the companies listed in the Nikkei-300, effectively the barometer of Japan's stockmarkets. We analyzed the development of all relevant indicators from 1991 through 2005, focusing in particular on sales growth and pre-tax profits, as well as company value (measured in terms of total shareholder return, i.e. share price gains plus dividends). We also examined the operating cashflow, productivity and changes in the number of employees. The period selected by the study spans more than one complete economic cycle, starting with the end of the recession in the early 1990s, continuing through the subsequent upswing and record growth levels across the globe from 1998, and then including the fresh slump in the second half of 2000 and the difficult years from 2001 to 2003 and the subsequent years of upswing again. To minimize the influence on the results of the poor economic years 2001 and 2002, we calculated the mean of the annual growth rates for all values.

And what were the findings of our analysis? The panel's median growth level came to 8.7% p.a. for sales and 17.4% p.a. for earnings before interest and tax (EBIT). Moreover, despite the extreme deterioration in the stockmarket climate

that began in early summer 2000, total shareholder return for the world's leading group of companies remained a respectable 14% p.a.

The first thing we see is that, even after adjusting for inflation, the world's largest companies grow faster than GDP on average. Size equals success, if companies want to perform better than the general economy. Of course, this is only an initial, quick analysis. To see the true pattern, we need to dig a little deeper.

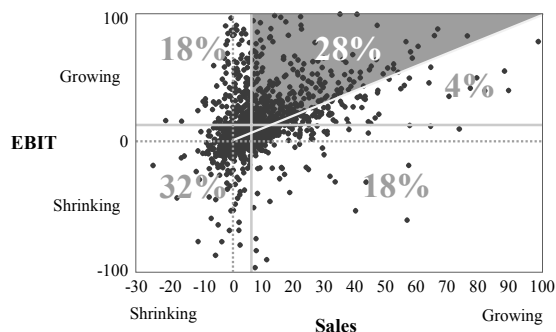


Fig. 5: Changes in pre-tax profits and sales for 1,700 triad companies

To get a clearer picture of how companies performed, we constructed a scatterplot matrix out of the pre-tax profit and sales figures (see Figure 5). We divide the chart into sectors using global averages rather than zero-lines. This gives us a four-field matrix in which the upper right quadrant contains the best companies in the world – those that show above-average growth in both EBIT and sales. Within this group there are also some true stars. We identify them by drawing a diagonal through the upper right quadrant; above the diagonal companies show a higher average rate of growth in their pre-tax profits than in their sales. If growth is supposed to be profitable, then these firms score a perfect ten. Indeed, we might call them "disproportionately profitable". These firms are our *outperformers* (or profitable growers), and they make up 28% of the companies investigated.

Below the diagonal in the upper right quadrant we find the 4% of companies whose growth rates were above the worldwide average, but whose profits grew more slowly than their sales. We call these the *expanders*, and they display considerable potential for the future. If they can improve their operational excellence, they have every chance of joining the ranks of the outperformers. But a glance at the upper right field of the matrix tells an interesting story: many more top companies fall above the diagonal than below it. This means that companies that grow faster than the worldwide average also have a good chance of being disproportionately profitable.

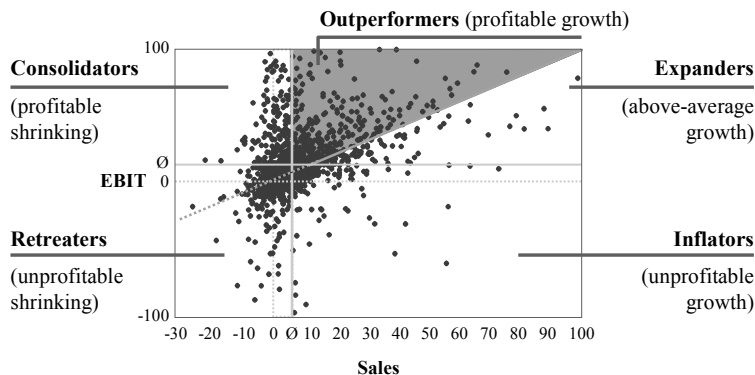


Fig. 6: Five-field matrix showing the development of pre-tax profits and sales

We identify three groups that perform below the overall average (see Figure 6):

- Some 18% of the companies generated above-average sales growth, but were unable to translate this into a corresponding rise in profitability. These are the *inflators* in the lower right quadrant who both destroy value and fail to achieve operational excellence. Sooner or later they will have to prune their growth in order to become profitable. Otherwise they run the risk of slipping back into the ranks of the *retreaters*.
- Just under a third of the companies surveyed saw both sales and profits shrink – with profits falling at an above-average rate in the majority of cases. In other words, these firms did not manage to successfully cut costs to compensate for dwindling sales caused by the difficult market situation. These *retreaters* are caught in a downward spiral and are fighting for survival. Downsizing has not brought about the hoped-for increase in cashflow that could be invested in the growth process. Instead, it has undermined their ability to grow. This demonstrates that permanent cost-cutting can only boost a company's prospects if accompanied by a growth strategy. Without this, companies risk literally saving themselves to death.
- Another 18% of companies managed to grow their profits at an above-average rate despite below-average or even negative sales growth. These *consolidators* (upper left quadrant) are restructuring through a program of downsizing. In the long run, however, this will not create value, as the growth imperative is not satisfied. The firms in this group will need to combine operating cashflows and investment in growth to begin to grow again. If they fail to do this, they will be relegated to retreator level, where they risk disappearing from the market altogether. Indeed, our analyses show that many firms have already gone this way. This is further evidence that the V curve no longer applies: a strategy of pure restructuring, such as that followed by

the consolidators, is extremely risky and all too often topples companies into a downwards spiral.

The results of our growth study thus paint a very diverse picture of the growth strategies and capabilities of the largest companies in the global business economy. Only just over a quarter of the companies were outperformers – but these companies outperformed their peer-group in no uncertain terms (see Figure 7):

- The outperformers boosted their sales by an average of 16.7% p.a., compared to just 6.3% for the rest of the companies in the study.
- The outperformers' pre-tax profits rose by an average of 42.7% per annum, compared to a mere 11.5% for the others.
- The value of each company (total shareholder return) in the leading group grew at an average rate of 19.3% p.a., against only 12.7% for the others.
- The outperformers also displayed outstanding results for the other performance indicators. For instance, the average number of new jobs created each year stood at 12.4%, compared with just 3.5% for the other companies (with merger effects factored into both figures). Productivity in the top group rose by an average of 7.4% p.a., against 4.3% for the rest of the panel. Cashflow too – the source of further growth – expanded at an average annual rate of 50.1%, while the other firms could only manage 41.9%.

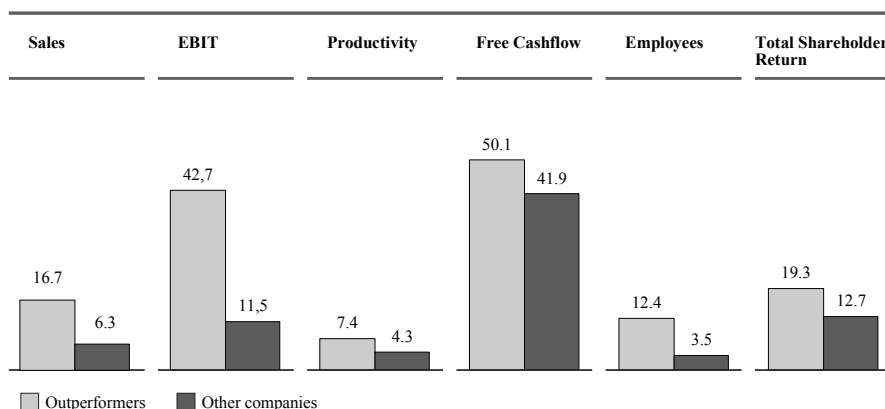


Fig. 7: Average growth rates of 1,700 triad companies between 1991 and 2005 [% p.a., mean value]

Our empirical analysis underscores two important principles. The first is that growth and value creation do not spring out of nothing: the fact that only 28% of all the companies in the study were able to set themselves apart from the rest of the panel reveals the immense importance of good management. The second is that the wide gap between the scores achieved by the leading group and the rest of

the field, plus the varying positions achieved in the competitive matrix, indicates potential that remains to be tapped. This leads us to believe that there are future growth opportunities out there just waiting to be grasped.

The European Leadership Model – Driving Growth on the Old Continent

Comparisons of European companies with companies from other parts of the world – especially the USA and Asia – often emphasize the Europe's need to catch up. Europeans profits are too low, and they pay too little attention to shareholder value. These and similar criticisms are frequently leveled at firms on the Old Continent. Is this true?

If one resists the temptation to "tar them all with the same brush" and instead take a closer, more analytical look at Europe's corporate sector, however, a far more varied picture emerges. A considerable number of European companies are enjoying excellent growth and maintaining a keen competitive edge in the global arena. To find out what distinguishes the successful from the rest was the intention of our competition "Best in European Business" that we conducted for the first time in 2005. Jointly with some of the most renowned universities and business schools, we established a concept and a new methodology to identify and award Europe's most competitive enterprises out of 6,000 companies.

The national competitions in seven countries (France, Germany, Great Britain, Italy, Poland, Portugal, and Spain) identified winners in four categories: growth, value creation, innovation, and strategies for the New Europe. The winners in the growth category posted sales growth in recent years well above that of their respective industries. This assessment also considered whether or not the growth was generated in-house.

Our analysis clearly showed that the winners' impressive performance is actually attributable to these companies peculiarly European approach – what we call the "European leadership model". This model encompasses all aspects of company management, i.e. management objectives, the way in which the company is organized, managed and controlled, and the management culture.

European and non-European companies differ in the leadership models they apply. At first glance, this statement may well raise objections. In the age of globalization, is it not safe to assume that corporate management styles all over the world have long since converged? By no means. Deep-rooted perceptions and practices that have grown up over many decades are extremely resilient. In the context of leadership models, these perceptions and practices notably include different views on stakeholder management, the nature of the goals that guide a company, the

precise manner of leading people, and accepted behavior in dealing with collaboration partners. Which are the main characteristics of the European leadership model?

- **Consideration for All Stakeholders and a Commitment to Durable Value Growth**

Companies operate within a web woven by different groups of stakeholders. Owners, employees, creditors, customers, suppliers, the government, society at large and even the media all pursue their own interests and objectives. These objectives are condensed into the claims and expectations they place on companies. Shareholders, for example, expect the value of the capital they have invested to grow. They are therefore interested in stock price gains and dividend payouts. Employees seek job security.

When studying the different groups of stakeholders, it is important to understand one principle: Long-term shareholder orientation and stakeholder orientation are not mutually exclusive. Precisely the reverse is true: When a company focuses its actions on sustainably increasing its value, this serves both the interests of the shareholders and those of all the other stakeholders. This combination – reconciling the need to increase company value in the long term with consideration for the interests of all stakeholders – is a typically European approach.

- **Empathizing with Collaboration Partners and Customers**

European companies have one crucial factor in common in the way they approach the outside world: They are all accustomed to working with companies from different cultural backgrounds and with different languages. Back in the days when national borders were perhaps more important than they are today, this skill was vital if companies were to realize economies of scale and put cross-border clusters to profitable use. The ability to empathize with all kinds of different collaboration partners naturally benefits European companies not only "at home" in Europe, but also throughout the globalized economy.

- **Corporate Social Responsibility as an Integral Part of the Corporate Culture**

Today's companies can no longer afford to ignore the world around them and concentrate solely on maximizing their profits. Public opinion and the influence of the media have grown too powerful: The impact of such corporate action would no longer go unnoticed. Defective products, pollution of the environment, the manipulation of balance sheets and other forms of managerial malpractice are brought to light very quickly and can do enormous damage to a firm's reputation. The only thing that helps is transparency and collaboration in respect of all company's shareholders. We have already noted how important such collaboration is – and the enviable position enjoyed by European companies on this score.

We are convinced that the European model holds out the promise of greater success. We believe that a focus on sustainability and the willingness to factor all stakeholders' interests into corporate strategy will pay dividends in the long run. Therefore, Europe's companies need not fear comparison with firms from other regions of the world. On the contrary, certain aspects the European leadership model give the region's indigenous companies a clear advantage in international competition. Even more importantly, Europe already has enterprises that possess the skills they need to enjoy lasting competitive success. Many of these skills are either specifically European capabilities, or they are hard to copy. Either way, they constitute a competitive advantage. As market conditions continue to change, European companies must nevertheless consistently develop and improve in order to consolidate and build on their lead. In other words: They have to pursue the strategy of growth and continuous optimization.

Different Paths to Growth

In practice, we can observe companies taking a wide variety of paths toward achieving their growth targets. As part of our comprehensive investigation of the growth question, we have attempted to bring this variety into some sort of order. Traditionally, growth is achieved internally or externally. More recently, we have also observed the rise of growth via partnerships between companies. Here are the details:

- *Internal growth:* Typically, internal or organic growth is realized on the basis of the company's own strength and using its own resources. By definition, internal growth takes place without acquisitions. But relatively small acquisitions, involving sales organizations or production plants, for example, can generally still be considered part of an organic growth strategy. Internal growth strategies of this kind are usually less risky. However, organic growth usually requires the company to take a longer-term perspective, as the processes need more time and do not result in sudden leaps forward in growth.
- *External growth:* This includes all strategies in which growth is achieved by buying in external resources. Mergers and acquisitions allow a company to make substantial advances in growth within a short space of time. The factors that motivate such strategies are obvious: swift penetration of new market segments, consolidation of saturated markets, internationalization of business activities and vertical or horizontal integration along the value chain to improve the company's cost position. Growth via acquisition is also a natural choice where a company wishes to acquire an established brand or buy in expertise.
External growth tends to happen in leaps and bounds, and some mergers have doubled sales at a stroke. But external growth strategies also harbor

enormous risks – the figures on failed mergers or shrinking value following fusions speak for themselves. The special feature below examines some of the risks and success factors associated with mergers.

- *Growth via partnerships:* In the traditional approaches described above, companies try to incorporate growth within the limits of the existing company. They either build growth from within, or they buy growth in. However, many companies have been taking a third approach of late: they set up project-specific (or target-oriented) alliances with the aim of achieving "virtual growth". This strategy boils down to farming out part of the value chain – which, of course, fits in well with a policy of concentrating on core competencies. Accordingly, they expand their use of external service providers or join forces with a strong partner on the sales side who can distribute their output effectively on the market. This is a good growth strategy particularly for companies wishing to expand internationally, or who want to offer packages of products and services.

The advantage of such an approach is that the entrepreneurial risk is split between the two partners and growth does not have to be supported by either partner on its own. The arrangement between the two companies can also be flexible, depending on how the contract is drawn up between them.

"Virtual growth" via partnerships is made possible by two key factors: global economic integration and technological integration. The removal of barriers to trade and investment, coupled with growing legal stability, has made international relationships between companies much easier, and in some cases possible for the first time. Moreover, information technology infrastructures can now better manage and control the division of labor (even on an interregional basis). Since more fundamental innovations are on their way in this field, we should expect to see further structural changes reshaping the business landscape. In this context, the concrete opportunities for growth hinge on the question of whether collaboration really can provide an adequate answer to existing size-related limitations.

Special Feature: Cold Calculation, Not Euphoria – The Success Factors Behind Growing and Enhancing Value Through Mergers

The 1990s saw a continuous rise in the number of mergers between companies. This wave peaked in the year 2000, when there were over 13,000 mergers (with publicly announced purchase prices) representing a total volume of more than EUR 4,000 billion. But the euphoria didn't last. Soon afterwards, reality kicked in, as companies realized that they had overlooked a number of risks:

- The strategies behind the mergers hadn't been thought through properly
- There were culture clashes between the newly merged companies

- The hoped-for synergies didn't materialize, or were a long time coming – i.e. the acquisition premium turned out to have been too high.

This last point in particular lay behind the ultimate failure of many mergers. Companies had overestimated the potential synergies and gotten caught up in the euphoria, rather than proceeding with the proper care and caution. Indeed, the success of mergers hinges on a number of unknowns, all of which influence the synergy potential. How stakeholders (customers, staff, shareholders, etc.) will react to the merger is just as much of an unknown as the reaction of competitors. The company may end up being forced to pass on the synergy potential to its customers. And focusing on the merger can lead companies to neglect the running of their day-to-day business. Also, it is all too easy for companies to make mistakes when calculating the potential synergies. This is, after all, a somewhat subjective matter. And companies must not forget that they are working against time when it comes to realizing the synergies: as a rule they only have two to three years to realize the potential of the synergies. This comparatively short time-span makes it particularly important that companies quantify the synergies accurately, and then put all their energy into quickly realizing them in the initial period after the merger. At the same time, they must not neglect their day-to-day operations or lose sight of the longer-term cultural implications of the merger.

After the year 2000, the level of mergers initially fell drastically, both in terms of the number of deals and their volume. Thus, in 2003, the volume had slumped to one-third of its record year 2000 level.

Things have picked up again since 2004. There are clear signs that takeovers are back in fashion, and sometimes on a grand scale. Sanofi-Synthélabo started the ball rolling with its acquisition of Aventis. This was followed in 2004/2005 by mergers in the software industry (Oracle acquiring Peoplesoft), telecommunications sector (Sprint acquiring Nextel) and electronics sector (Honeywell acquiring Novar).

Driving these new fusions is the old hope of realizing synergy effects and penetrating new markets. Growing profits mean that more money is available for acquisitions. At the same time, the level of trust in company supervision, both internal and external, has increased, creating a better climate for mergers. The supervision of stock exchanges has become stricter and corporate governance guidelines have been tightened up. As a result, companies are less worried today about falling victim to "creative accounting" or paying fancy prices far in excess of the real value of the target company.

Today's merger decisions have a more solid basis than during the hype of 2000. Indeed, this is a major factor in the current upswing in the number of takeovers. Acquisition prices have normalized as companies are taking a less euphoric, more realistic view of the benefits of a potential merger. This is reflected in lower prices on the stock exchange. Today's managers are also better prepared to shape a merger successfully. They have learned from past mistakes – mistakes that led to

the failure of many mergers – by analyzing carefully what exactly went wrong. It has been a hard lesson to learn, but it has meant that they now know what it takes to make a merger successful:

- The acquisition must fit in with the company's overall strategy. Growth in size terms alone, whose only effect is to give the firm's leaders greater clout, is leading the company up a blind alley.
- Looking at the absolute value of synergies is not enough: the time-span within which they can be realized must also be taken into consideration. Acquisitions that only promise to deliver synergy effects in the medium term should be looked at especially critically.
- Supposedly "soft" factors – management style, communication, HR – can be just as important as hard factors for the success of an acquisition. The acquiring company must first be fully aware of its own culture, and then take a close look at the culture of the target company. In fact, the two cultures do not have to be identical: it can even be more advantageous if the cultures are complementary. Moreover, both soft and hard factors should be examined by a third party, not by the company itself.
- Before the merger takes place, the company should think about the future relationship between the two companies. This applies to hard as well as soft factors. If the acquired company is to preserve a high level of autonomy, cultural differences will be less important than in a complete fusion for example. A gradual integration of the two companies is also possible – indeed, this is often more successful than immediate integration and it makes it easier to remove any parts that do not fit in with the newly merged company.
- Shareholders' interests are important, but they should not be the only consideration in mergers. Other key stakeholders – clients, staff, suppliers – must be given equal attention. For them, the merger will automatically mean a loss of security at first. This makes proper communication with stakeholders of paramount importance.
- Alternatives should be investigated. These include not just growing on the company's own strength: collaborations, or acquiring a minority interest in another company can bring similar results to a takeover, and with much less risk.

Basic Strategies for Growth Processes

The three basic growth patterns – internal growth, external growth, and "virtual growth" via partnerships – provide the framework for companies to define their own individual growth strategies. Based on our experience from consulting pro-

jects and our global surveys, we identify six basic strategies for growth processes employed by companies around the world. These are discussed in turn below.

Growth Through Improved Market and Customer Penetration

This growth strategy works within the existing business system or delivery program. The usual measures to this end include branding or changes to marketing policy (line extensions, relaunches, brand profiling), the introduction and intelligent use of CRM systems, improvements in the sales organization and so on.

However, this kind of activity generally serves only to safeguard the market position a company has already achieved. At best, it might lead to a slight increase in market share. Accordingly this strategy normally only delivers growth in small increments. It is quite a different situation if a company manages to change the rules of the game in its own favor – for example by setting new standards, supplying add-on offers or developing new business models.

An example of a company that has managed to do this is the Greek mobile phone operator Cosmote. As "third mover" it was able to achieve market leadership within a short space of time by developing services for the mass market – until Cosmote came along, mobile telephones had been considered a business market product in Greece. In a similar way, the market for air travel has been turned upside down by low-cost carriers such as Ryanair, easyJet and hlx.

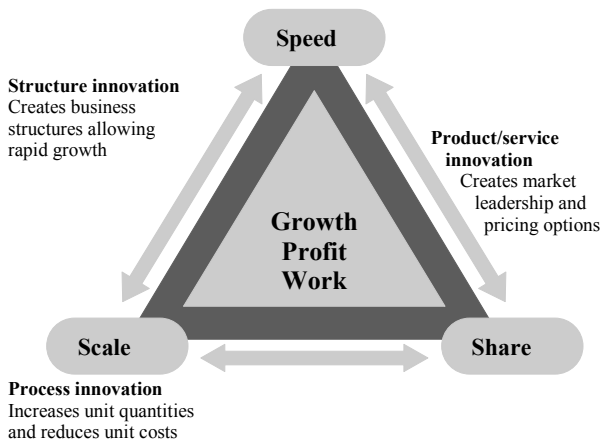


Fig. 8: The three Ss for innovations

Growth Through Innovation

In this strategy, growth is generated by the development and launch of new products. As long as innovation is based on in-house development by the company, the crucial skill here is to master the so-called "3S" process (see Figure 8). Step one is

to ensure speed in bringing the innovation to market. The quicker this is done, the more first-mover advantages the company can enjoy. First-mover advantages allow a company to gain a significant market share, which can in turn be invested to realize economies of scale. Of late, a new growth strategy has emerged here: instead of developing innovations in-house, companies are increasingly buying in market-ready innovations, particularly in the fields of software and biotechnology.

Apple is an example of outstanding innovation and excellent customer focus. In its computers as well as its other products (such as the iPod portable music player), Apple successfully combines innovative technology with innovative design. Nestlé is another good example of a company successfully realizing new growth potential through innovation, for example in the area of nutritional products.

Growth Through Globalization

This strategy involves a company overcoming the limitations to growth inherent in the markets in which it already operates and taking its business international. This can be motivated by various factors, depending on the individual situation of the company. Some companies, for example, globalize because a customer that they act as supplier to sets up a new production plant abroad, and they need to follow. Others hope to win new customers in volume and growth markets themselves. Still others hope to reduce unit costs by exploiting cost differences in goods and factor markets in different locations, or by improving their logistics position. And some companies want to access international expertise so that they can get a lead in innovations.

Examples of firms successfully growing through globalization are Carrefour, the leading European food retailer, and Citigroup, the only globally successful retail bank. Similarly Vodafone, with its long-term worldwide expansion strategy, has become the only mobile network operator that is truly globally active.

Growth Realized by Focusing the Company's Portfolio and Concentrating on Core Competencies

This strategy takes two forms. The first is where a company restricts itself to certain segments in which it has the potential to become market leader, and jettisons its other divisions. Alternatively (or in addition) the company concentrates on the parts of the value chain where it is particularly strong – i.e. it carries out vertical disintegration. In both cases, companies can thus leverage their specialization or experience to arrive at a superior unit cost position and generate higher margins. This also has the welcome effect of rationalizing their portfolio, and they can use the money freed up to finance further growth. How this works exactly is explained in Chapter 6, where we investigate how companies can finance growth.

RWE and E.ON are examples of this strategy in action. They have consistently focused their portfolio on multi-utility business with an international focus, while non-core areas such as telecommunications have been sold off. Another example

is Flextronics, who increased their sales several hundred times over during a period of seven years by manufacturing chips on behalf of hardware producers under outsourcing arrangements. And Porsche has the least vertical integration of all automotive manufacturers and so achieves a maximum of profit.

Growth Through Active Market Consolidation

This strategy aims to consolidate the market by means of mergers and acquisitions, and thereby exploit cost advantages through growth. The way this works is clear. Market consolidation forms the basis for removing surplus capacity. Improved capacity utilization then optimizes the cost of the products and services on offer. Saturation in many major sectors is not the only trigger here: there are also external factors, such as the politically motivated opening up and deregulation of markets and rapid progress in future technologies. Outperformers ensure they are at the forefront of such developments and, on the basis of this position, they achieve superior growth. Take Total Fina Elf, for example. It has employed a successful strategy of mergers and acquisitions and managed to turn itself into the only firm in continental Europe that belongs to the group of leading oil producers, which is otherwise dominated by Anglo-Saxon players. Likewise Volkswagen has bought up European competitors such as Seat and Skoda and thus contributed to the consolidation of the market.

Growth Through Network Development

In this strategy, a company aims to generate relative advantages that will enable it to serve existing markets better (e.g. product improvements, innovation) or win new customers. This strategy offers a wide range of options – here are just a few examples:

- Collaboration in research and development (often in the automotive and pharmaceutical industries)
- The definition of common standards that raise the barriers to market entry (often in technology-based segments such as IT, telecommunications, consumer electronics, multimedia, etc.)
- The integration of external service providers to round out the product offer, or the creation of a "one-stop shop" at the front-end with a number of partners working in the background
- The merger of customer bases and creation of joint offers (bonus and purchase programs).

The fast-growing, knowledge-intensive markets of the past decade (information technology, biotechnology and biopharmaceutics, high-tech applications, etc.) made it necessary to combine highly specialized knowledge not only on a technical level, but also in relation to end customers. The formation of networks along the value chain thus became the principal driver of growth. SAP, for example, has

created a unique network of service-provider partners around its software applications, thereby safeguarding its market leadership.

Networks have also sprung up in the more traditional sectors. Star Alliance has shown how a partnership can boost the marketing strength and profitability of its members if their efforts are truly customer-centered. Star Alliance has been immensely successful in setting up a joint network of air routes, introducing common service standards and boosting customer loyalty. The synergies achieved have also meant that the individual airlines could optimize their costs. And branding has also profited from the creation of the network: today, the Star Alliance brand is established worldwide.

The Dual Effect of the Growth Strategies

As we have already seen, successful growth is only possible nowadays if a company continuously improves both on the cost and the process side. These two areas must be optimized in parallel. The previous approach of first restructuring, then growing no longer functions – faster-moving markets, higher investor expectations and increased transparency make this impossible. All the more important, then, that the chosen (combined) strategy aims at the same time at both expansion and excellence. These two goals must be pursued in tandem if a company wishes to achieve business success in the medium and long term. Pursuing one goal in isolation will bring, at best, short-term success.

Growth		Costs	
Improved sales	↩ Market/customer penetration →	↩ Economies of scale, cashflow	→
Differentiation, technical edge	↩ Innovation →	↩ Cost cutting (process innovation/ productivity)	→
New markets	↩ Globalization →	↩ Factor cost advantages	→
Better performance due to partnerships, concentration on core competencies	↩ Outsourcing →	↩ Reduction of fixed costs, replacing fixed costs with variable costs	→
Increased market share	↩ Market consolidation →	↩ Economies of scale, cashflow, productivity increases	→
Access to new markets and/or customers	↩ Network development →	↩ Balancing out diseconomies	→

Fig. 9: The impact of the six basic strategies on growth and costs

What this means is that companies must constantly accompany their growth efforts with measures aimed at improving efficiency. This is where the six basic strategies come into their own (see Figure 9). Our survey findings back this up:

the outperformers have clearly mastered the "trick" of following a dual strategy, and it is this that distinguishes them from the competition.

Some examples will help here. This is how the basic strategies can be effective in two directions at the same time – promoting growth and improving efficiency:

- Improved *market penetration* focuses on growth. However, it also has elements that impact on costs. For example, it can be used as a lever to make the sales organization more efficient or to optimize costs as part of new pricing measures.
- *Innovation* has elements that impact on growth. It can be used to differentiate a company from the competition and thereby give it a competitive lead. The same applies for new business models – here, an optimized sales approach can lead to expansion. Innovation also has an effect on costs: processes innovations and technological progress improve operational performance.
- *Globalization* enables a company to exploit global factor cost advantages. Practices such as global sourcing, global production configurations, and/or the cost-induced closure of domestic sites make the competitive position more competitive on the cost side. This promotes operational excellence, which plays a central role in generating cashflow. At the same time, globalization lays the groundwork for expansion, opening up new markets and hence enormous potential for growth.
- *Active market consolidation through mergers and acquisitions* improves a company's cost and margin position. On the basis of this position, it enables the company to grow and invest the additional cashflow in further improving its own future growth capability.
- As we have seen, *networks* are a highly effective strategy for minimizing growth deficits as regards access to customers or know-how. If used properly, they can also compensate for a company's smaller scale and so also have an effect on the cost side.
- Measures aimed primarily at reducing costs can also have strategic relevance for growth. *Focusing portfolios* is a good example: it frees up cashflow by eliminating activities that are not part of the firm's core business, thereby improving productivity. The funds thus realized can then be invested in areas of growth or in expanding core business activities.

Of course, whether these measures are actually effective in both directions – sinking costs and promoting expansion – depends crucially on the timing. If restructuring is desperately needed because the company has hit a financial crisis, the cash that is freed up by cost reductions cannot be invested in growth. Instead, it will have to be used to service legacy obligations (loans, etc.), so it does not create any prospect of growth. True, such measures ensure the short-term survival and profitability of the firm. But having done that, the company will have to ac-

cumulate the newly earned profits to generate the cashflows that can finance investment in the future. In the best-case scenario, precious time is lost. And in the worst-case scenario, the company is caught in a downsizing spiral from which it will not be able to escape.

The only strategy that promises long-term success is for ongoing (cost) optimization to generate enough free cashflow to tap areas of growth. Raising efficiency and expansion must occur in parallel. And that makes finding the right combination of *cost-reducing* and *growth-promoting* measures a matter of paramount importance.

Making Growth Work

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