

Looking For Growth In All The Right Places

How can corporations find sources of growth? Without a granular view, any executive will struggle in making sound business portfolio decisions

By Patrick Viguerie, Sven Smit And Mehrdad Baghai

What are the sources of corporate growth? If you take a middle-of-the-road view of markets, as many executives do, the answers may surprise you: averaging out the different growth rates in an industry's segments and sub-segments can produce a misleading view of its growth prospects.

Most so-called growth industries include sub-industries or segments that are not growing at all, while such relatively mature industries as European telecommunications often have segments that are growing rapidly. Broad terms such as "growth industry" and "mature industry,"



while time-honored and convenient, can prove imprecise or even downright wrong upon closer analysis.

Our research on the revenue growth of large companies suggests that executives should "de-average" their view of markets and develop a granular perspective on trends, future growth rates and market structures. Insights into sub-industries, segments, categories and micro-markets are the building blocks of portfolio choice.

Execution is Secondary

A pair of unexpected findings emerged when McKinsey & Company studied 100 of the largest U.S. corporations in 17 sectors during the two recent business cycles (1984-93 and 1994-2003). We found that, first, top-line growth is vital for survival: a company whose revenue increased more slowly than GDP was five times more likely to succumb in the next cycle, usually through acquisition, than one that expanded more rapidly.

Second, many companies with strong revenue growth and high shareholder returns appeared to compete in favorable growth environments, or industry micro-segments. In addition, many of these companies were active acquirers.

Probing deeper into what really drives revenue growth, we've since disaggregated the recent growth history (1999-2005) of 200 large companies around the world. The results indicate that 80 percent of a company's growth is affected largely by market expansion or contraction in the industry micro-segments where it competes, as well as by the revenue it gains through M&As. A third element, whether a company gains or loses market share, explains only some 20 percent of its growth. At first blush, our findings seem counterintuitive, as great execution in existing portfolio markets is typically considered the key to achieving full growth potential. But further investigation bears out that execution and market-share growth are secondary drivers of corporate growth. Real growth is driven by an intelligent and granular approach to market segmentation, and by an M&A strategy that taps into the power of momentum in selected segments.

For example, from 1999 to 2005, the compound annual growth rate of 10 large European telecom companies was 9.5 percent. In this scenario, market-share performance accounted for -0.6 percentage points of the 9.5 percent gain, while portfolio momentum was responsible for 7.1 percent of the gain and M&As achieved 3.0 percent of total growth (See Telco Growth Rates chart, p. 40). Clearly, companies in the same sector grow not only at different speeds but in different ways, and selecting those ways can be a matter of corporate life and death.

The range of growth in European telcos was between one and 25 percent annually—a variation that can be mostly explained by individual portfolio choices and the resulting exposure to segments with different rates of growth. Wireless grows faster than fixed line, for example, and the growth rates of each vary by country.

In a nutshell, all industries have certain growth rates in the aggregate yet significant variable single-company growth performance. In a representative set of high-growth tech companies, for example, growth rates varied from -6 percent to 34 percent from 1999 to 2005. Such variation was present in all industries studied, including construction, consumer goods, energy, financial services, high-tech and utilities. What's interesting is that across industries, companies that outperformed on top-line growth and shareholder value tended to do so in high-growth micro-segments, or granular markets. The portfolios of outperforming utilities, for example, enjoyed growth momentum two percentage points higher than the overall industry. In fact, when we compared the growth rates of industries with the growth rates of companies in our database, we could explain why some grew faster than others only by zooming in and taking a granular view of sub-industries and product categories by continent, region and country.

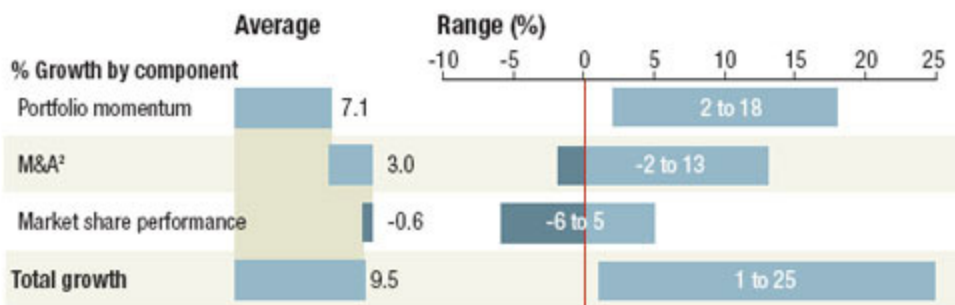
Examining Granularity

European Telco Growth Rates

Over the past 20 years the world economy has grown by roughly 7 percent a year, and by 2005 its total output had reached \$81.5 trillion. To what level should companies break this massive global pie down into granular growth

A wide range

Compound annual growth rate (CAGR) of revenues for 10 large European telcos.¹ 1999-2005.



¹Based on local currency; companies with headquarters in European Union.

²Includes impact of changes in revenue base caused by inorganic activity and share gain/loss.

Source: Analyst reports; company reports; Dealogic; Global Insight; Hoover's; McKinsey analysis

benchmarks? Then how can these benchmarks guide the selection of profitable portfolios?

The Global Industry Classification Standard (GICS) carves up the global economy into industry groups, such as energy and capital goods. On average, these groups have a market size of \$3.5 trillion. Plotting the growth of industry

groups and companies shows no obvious correlations, which supports our point that talk of "growth industries" is meaningless. The growth rates of different industry groups vary from approximately 2 to 16 percent- far less than the 13 to 48 percent spread at the company level.

We break down the industry groups into 151 industries; for instance, the food, beverages and tobacco group becomes three separate industries. The average size of these industries—more granular than the industry groups but still huge—is around \$500 billion. At the industry level, differences in the portfolio exposure of companies explain little more of the variation in organic top-line growth than they did at the industry group level.

Now it gets interesting. Our growth database builds on the finest level of data that companies report to the markets, so we can look at sub-industries, and sometimes at broad product categories, divided by continents, regions or countries. Examples of sub-industries within the food industry include frozen foods, savories, edible oils and dressings. At this level, the world market has thousands of segments ranging in size from \$1 billion to \$20 billion.

The growth rates of sub-industries explain nearly 65 percent of a typical company's organic top-line growth; in other words, at this level market selection becomes more important than a company's ability to beat the market. That point supports our finding that the composition of a portfolio is the chief factor in determining why some companies grow faster than others.

In a few cases we've used internal company data to dig deeper and explore categories within sub-industries (such as ice cream within frozen packaged foods), or customer segments in a broad product or service category (such as low-calorie snacks). At this level of granularity the world economy has millions of growth pockets that range in value from \$50 million to \$200 million.

Our analysis found that a company's selection of categories often explained its organic growth even better than the sub-industries did. This is the level of granularity on which companies must act when they set growth priorities and make the real decisions about resource allocation. These findings should encourage companies in industries with slow overall growth. Seeking growth is rarely about changing industries—a risky proposition at best. It's more about focusing time and resources on faster-growing segments where companies have capabilities, assets and market insights.

The Case of GoodsCo

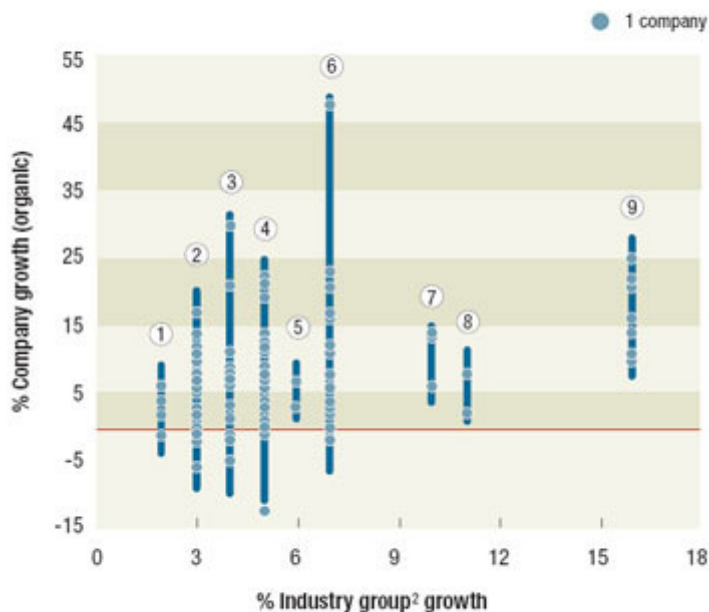
The Aggregated Performance chart on page 44 shows a disaggregated performance view of GoodsCo, a disguised multinational consumer goods corporation. Note the segmentation by product category as well as region. Note also the color-coding scheme of characterizing granular segments where the company performs in an exceptional, great, good or poor manner due to the growth drivers of 1) organic portfolio momentum, 2) mergers and acquisitions, 3) market-share performance. Our dis-aggregation of GoodsCo growth revealed that it delivered stable, albeit slow, growth from 1999 to 2005. M&A drove almost all of the company's growth in the U.S.; however, in Europe positive exchange rates propelled modest growth. Organic revenues rose strongly only in emerging markets, such as Africa,

Latin America and the Middle East. In fact, the North American and European markets that made the largest revenue contribution were in the bottom quartile for our full sample of companies.

Annual Growth Rates

A greater spread at the company level

Compound annual growth rate (CAGR) for selected companies by industry group,¹ 1999-2005. %



Industry groups²

- 1 • Household and personal products
- 2 • Banks
• Capital goods
• Food, beverages, and tobacco
• Retailing
• Technology hardware and equipment
- 3 • Automobiles and components
• Commercial services and supplies
• Media
- 4 • Consumer durables and apparel
• Diversified financials
• Pharmaceuticals, biotechnology and life sciences
• Telecommunications services
• Transportation
• Utilities
- 5 • Insurance
- 6 • Consumer services
• Food and staples retailing
• Materials
• Software and services
- 7 • Health care equipment and services
- 8 • Semiconductors and semiconductor equipment
- 9 • Energy

¹1207 representative companies selected from total for readability.

²Industry group classifications by Global Industry Classification Standard (GICS), developed by Morgan Stanley Capital International (MSCI) and Standard & Poor's.

Source: Global Insight; Global Vantage; Thomson; McKinsey analysis

With all the granular (but not too granular) portfolio cards on the table, it becomes much easier to assess and determine segments in which to step up efforts to develop new products and businesses, or in which to innovate, riding on segment momentum and working within the associated headroom for growth. It's also easier to determine which companies to divest and acquire, as well as what categories in which to focus operational excellence initiatives or other attempts to improve execution.

Aggregated Performance

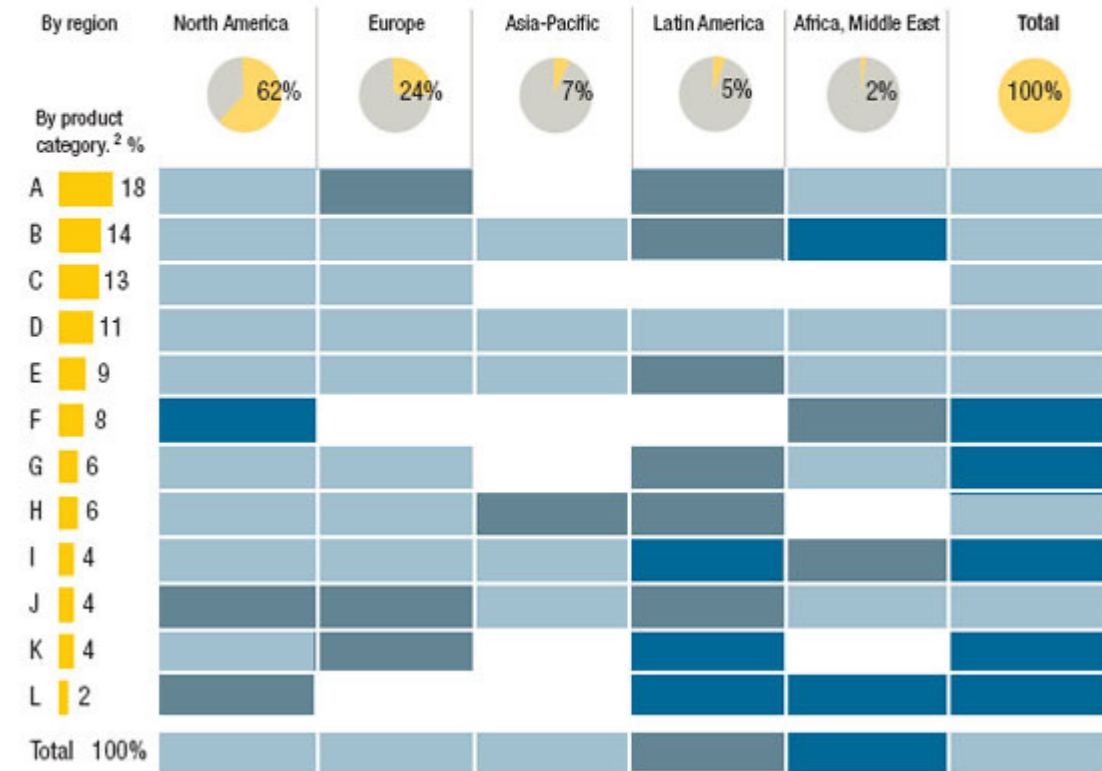
A detailed picture

Disguised example of growth for GoodsCo, a multinational consumer goods company, 1999-2005

Growth¹

Exceptional
 Great
 Good
 Poor
 (not achieved by any segment)

Revenue share



¹Exceptional = outperforming on all 3 growth drivers or outperforming on 1 growth driver at top-decile level without underperforming on more than 1; good = outperforming on 1 growth driver without underperforming on more than 1; poor = underperforming on 2 or more growth drivers or not outperforming on any.

²Figures do not sum to 100% because of rounding.

In the case of GoodsCo, 27 of the 47 segments register as poor in terms of performance. Unfortunately, these segments represent 87 percent of GoodsCo's sales. On the positive side, 20 segments are good or great, but make up only 13 percent of sales. And although a promising growth story is developing in Latin America in most segments, the business is performing poorly in its core ones in Europe and North America. It cannot claim exceptional performance in any segment. GoodsCo has a portfolio problem.

The pros and cons of acquiring businesses-or expanding organically by exploiting positive market-share performance- in segments where GoodsCo enjoys strong portfolio momentum will probably be high on the top team's agenda.

Another issue might be whether to seize divestment opportunities in segments where the company's portfolio momentum is good, though it is losing market share. A third would be whether to acquire a company-and build portfolio momentum-in lackluster segments where management expects market growth to improve significantly.

In any case, without a granular view, any executive will struggle in making sound business portfolio decisions and risk trying to drive growth in poorly vetted markets from ill-positioned divisions of the corporation. A more granular approach, however, will pinpoint segments in which there is ample room for growth and in which the corporation is well positioned to compete.

*Patrick Viguerie and Sven Smit are directors at McKinsey & Company, and Mehrdad Baghai is an alumnus of the company. All three co-authored *The Granularity of Growth: How to Identify the Sources of Growth and Drive Enduring Company Performance*.*