Growth Isn't Always Good: Knowing When and Where to Grow | By Mark L. Frigo

When and where should a business invest and grow? This is a challenge facing management today. The key is having the insight and discipline to grow in areas that will drive long-term financial value and concomitantly knowing where to disinvest.

One of the lessons from Return Driven Strategy is "Growth isn't always good." Here I will present some guidelines from Return Driven Strategy that can provide a way for management to ensure that investment decisions are truly moving the company in the right direction. I will also share some insights from organizations that have made the right moves and adjustments to growth strategies.

Strategy Should Drive Capital Investment

This is a reasonable premise. Yet how often do we see the reverse situation where management inadvertently lets capital expenditures drive strategy and the direction of the company? Why would this be the case? Competing proposals for capital expenditures will make reference to strategy, of course, but how well are capital expenditures evaluated with a rigorous attention to how the capital expenditure drives financial value creation through the strategy?

Another problem is that operating plans and budget targets, not strategy, many times inadvertently drive investment decisions that work against long-term financial value creation and the business strategy itself. Here we see business units seeking to grow or protect sales and market share despite the fact that returns are below the cost of capital.

Knowing Where to Grow

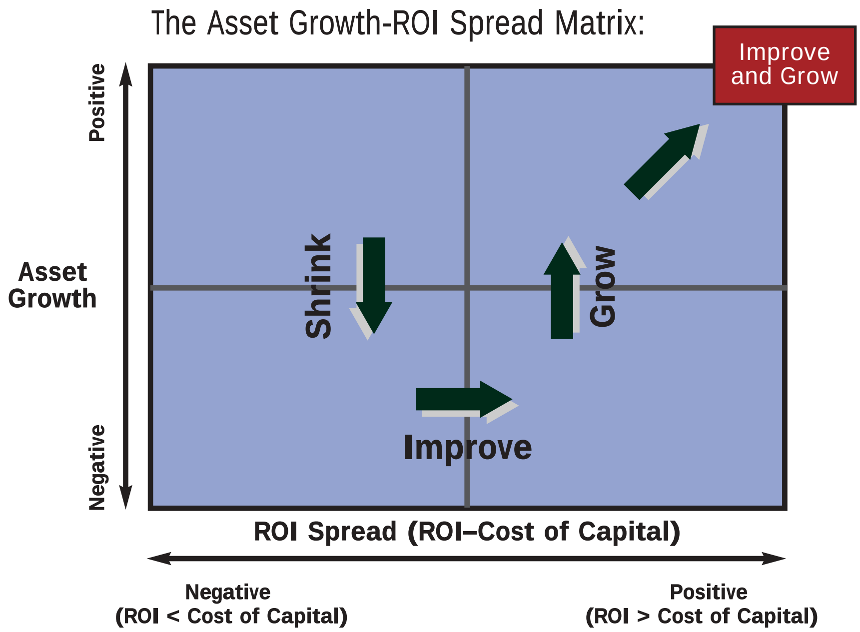
In my ongoing research about the application of Return Driven Strategy, I see what separates great companies from mediocre ones. Many mediocre companies chase growth at the expense of long-term value creation.

High-performance companies, in contrast, show the discipline to grow and shrink in the right areas as determined by the goal tenets of Return Driven Strategy: Fulfill Otherwise Unmet Customer Needs *and* Target and Dominate Increasing Market Segments. These companies continuously align their investments and product and service offerings to fulfill customer needs in the right market segments *and* earn a return on investment above the cost of capital. The ROI "spread" (return on investment minus the cost of capital) of a company will be driven by the degree of the "otherwise unmet" customer need, the size and growth potential of the targeted market segments, and the operational excellence to deliver the offering with returns in excess of the cost of capital.

Companies like General Electric, Wal-Mart, Johnson & Johnson, Danaher Corporation, and Harley Davidson have shown a fervent discipline to invest in the right market segments and pull back investments in other markets. These companies have demonstrated an understanding of the true drivers of value creation inherent in the business strategy.

Figure 1 – The ROI Spread/Growth Matrix

The first foundation of Return Driven Strategy—Strategic Valuation and Performance Measurement—represents in part how and how well the value-creation process is reflected in investment decisions. The ROI Spread/Growth Matrix provides a framework for executives to examine where to grow. Asset growth in the matrix describes where the business unit is investing in or divesting of assets. The "spread" between return on investment (ROI) and the cost of capital should help to determine where to grow and invest, where to improve, and where to disinvest. Here we focus on the three spread scenarios: positive spread, neutral spread, and negative spread.



Business units that are in the right side of the matrix and have positive spreads should grow assets, grow sales, and increase or hold ROI. Business units that are in the middle of the matrix and have neutral spreads should improve margins and asset turns, increase ROI, and then grow. Business units that are in the left side of the matrix and have negative spreads should improve margins and asset turns and should increase ROI and contract assets.

When to Grow, Shrink, or Improve

Here are three case vignettes where business units realigned growth strategies with long-term financial value creation.

Case 1. Maintaining Market Share at All Cost: Growth Isn't Good

An automotive parts supplier had high market share, low growth potential, high asset investment base, low ROI, negative spread, and low competitive differentiation. So what was this business unit doing? It was slashing prices to maintain market share while maintaining and reinvesting in its asset base. The company was granting price concessions to OEMs (original equipment manufacturers) so as not to lose business since it needed to utilize plant capacity and meet budget targets. Although these defensive tactical actions may seem logical in the short term, they aren't good strategy, and, in fact, they destroy value. The lesson here: Growth isn't always good. What should this business unit do? To create financial value, it should realign its strategy to reduce investment base, reduce costs, exit unprofitable businesses, and improve ROI and spread.

Case 2. Maintaining High ROI: Not Growing When You Should

A medical equipment supplier had moderate market share, high growth potential, low asset base, very high ROI, positive spread, and high competitive differentiation. What was this business unit doing? Was it growing and investing in growth opportunities? No. The business unit was maintaining its high ROI percentage business and wasn't investing in capacity or growth opportunities. Why? It was maximizing the spread percentage and ROI percentage. The business unit wasn't exploiting available growth opportunities with good ROIs because the growth opportunity ROIs were lower than the ROIs of its existing base business. The lesson here: Maximizing the rate of return on investment and spread percentage won't maximize value. Using the perspective of the ROI Spread/Growth Matrix (Figure 1), this business unit should invest in available growth opportunities that would increase total returns, total spread, and valuation.

Case 3. Extending a Product Offering to the Wrong Market

An electronic component manufacturer had a great product in a niche market segment. Its innovative product offering was highly valued in this niche market segment, which generated very high margins. But when the business unit tried to take the same product offering to another market segment, the customers in the new market segment didn't value all of the features of the product offering in the same way as those in the niche market did. As a result, the company had to slash prices to sell their product in the new market segment, which resulted in much lower margins and ROI. In effect, the product offering fulfilled an otherwise unmet customer need very well in one niche market segment but overshot the customer needs in the other. The customers in the new market segment weren't willing to pay the full price for the product.

The lesson here: A good product and profitable product in one market may be an unprofitable product in another. Using guidelines from Return Driven Strategy, this business unit should find a way to realign the features and cost of its product offerings with customer needs in the targeted "other" market segment and earn a positive spread, or it should exit that market segment.

The Discipline of Strategic Investment

Take a close look at your investment and growth plans for next year. Is your company making investments in the right areas? Is the company divesting in the right areas? The guidelines of Return Driven Strategy and the ROI Spread/Growth Matrix can provide the strategic discipline for investment decisions that will focus and align your business strategy with long-term financial value creation. ■

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