As companies expanded globally in the 1990s, most of them failed to prosper. Why was this and what did the winners do to succeed?

Matching global growth to industry structure

by James Root and John Smith

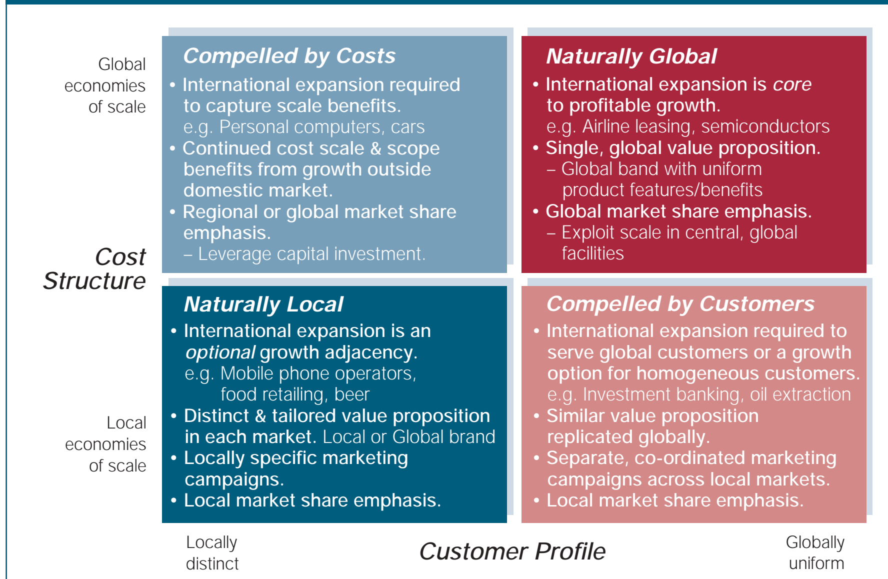
The world is a cold place these days for businesses seeking profitable international growth. That was so even before global economic slowdown, war and epidemic made an already difficult objective even harder to achieve. Think of the companies that have built thriving domestic businesses, only to stumble when attempting to expand overseas. Swissair's international buying spree ended in bankruptcy. Home Depot experimented for three years in Latin America before exiting in late 2001. Merrill Lynch spent four years trying to grow a retail brokerage business in Japan after buying Yamaichi Securities, but was forced to retreat when Japanese customers showed little inclination towards US-style mutual fund investing.

These are not isolated examples. Companies have invested billions to expand abroad in recent years, yet going global has not delivered the profitable growth that many hoped for. Indeed, as firms expanded globally in the 1990s, most failed to prosper. Why? And what did the winners do to succeed?

We analysed the financial results of 729 publicly traded companies from seven developed economies between 1996 and 2000, and came to a surprising conclusion: only one company in six achieves sustained, profitable international growth, even when the hurdle is relatively modest – growing foreign revenues and profits by at least the rate of GDP plus inflation for a five-year period. The mix of international and domestic revenues for these companies as a group barely changed over the five-year period. In 1996, foreign revenue as a percentage of total revenue averaged 33 per cent for the group, rising to 35 per cent in 2000. In addition, our research showed that operating margins earned by companies outside their home countries were eight per cent on average during the five years, often below and almost never above the margins earned at home.

Research background

We began our analysis with 7,500 public companies from seven countries – France, Germany, Italy, United Kingdom, Japan, Australia and the United States – and identified 729 with more than $500m in revenue in 2000, for which we had five years of segment reporting that separated out domestic and international revenues. We then selected companies that managed to grow annual average revenues by more than eight per cent from 1996 to 2000 – a good approximation of GDP plus inflation for the seven countries during the five-year period. Only 233 companies or one in three met that standard. We further selected companies that grew total operating income by eight per cent or more, which reduced the group to 182 or about one-quarter of the overall sample. Then we screened for international revenue growth of eight per cent or more, winnowing the group to 153 companies or 21 per cent. Finally, we looked for those companies with international operating income growth of at least eight per cent.



One hundred and twenty-four companies that met all the criteria not only achieved sustained, profitable international growth, they also delivered impressive financial results in their overall businesses. Their foreign revenues grew by an average of 33 per cent over the five years, more than three times the rate of average firms trying to expand internationally. The group's total revenues also grew by 22 per cent on average over the five years, compared with seven per cent for the rest of the sample. Operating margins for profitable international growth companies were 14 per cent, compared with eight per cent for the rest. And their share prices appreciated 1.7 times faster than the major stock indices in the US, UK and Japan.

Why is profitable international growth within reach for certain companies but elusive for the majority? Successful global growth companies excel at defining the boundaries of their businesses. They clearly understand whether the cost structures and customer profiles for their industries compel them to expand overseas, or whether they are better off viewing global expansion simply as one growth option among many. And they base their global expansion strategies on a rigorous understanding of how money is made in their industries, which guides their decisions to acquire foreign assets, build from a beachhead, or pursue strategic alliances.

A compulsion to be global

In a few industries, firms have to be global if they are to achieve leadership. Computer makers like Dell or Hewlett-Packard have cost structures that keep improving with the increased scale of going global. Pharmaceutical companies like Pfizer, or software companies like Oracle, must sell globally to amortise their enormous product development costs. Investment banks are driven to expand globally because their core clients operate in all major financial markets around the world. The profit economics of these industries are global: in some cases, their customers respond to a single, global value proposition; in others, the companies can capture benefits of world-scale facilities.

Yet, even in an era of liberalising trade regulation and, some argue, converging consumer tastes, international expansion is more often a choice than a necessity. Winning in food retailing or beer, for instance, is the result of building market power and influence at the national or regional level, not globally.

It's important to recognise, however, that international expansion remains a growth option even when an industry's profit economics are not global. In a 'naturally local' industry like mobile phone service, for example, Vodafone understood the power of individual country market share. Regardless of whether a mobile phone brand is global or local, customers expect service that's tailored for their market. Profits accrue first to the individual market leader, not to the service provider with global reach. So when Vodafone began earnestly pursuing international growth in the mid-1990s, it first acquired controlling stakes in leading wireless players in continental Europe and – for a while – let them be. Each market had different characteristics and requirements.

Vodafone's recognition that relative market share in each country is the key to profitability allowed its management team to ride a well-understood strategy into unfamiliar markets. Gradually, the company introduced pan-European service contracts, and began to integrate product development and branding at the European level; it also leveraged its purchasing power with network equipment and handset manufacturers.

For companies in 'naturally global' industries, on the other hand, the world is one big market. In microprocessors, for example, companies cannot afford to manufacture unless they are a certain size. A new semiconductor fabrication facility costs Intel several billion dollars to build, and produces chips that sell mostly for tens or hundreds of dollars. To earn a return on its investment, Intel must sell globally. Other factors reinforce a global orientation. Once Intel turns on a fabrication facility, scaling up to increase production adds only incremental cost. Computer chips are inexpensive to transport relative to their value, so there is no particular reason to

locate the 'fabs' close to customer locations. And customers have comparable needs: Nokia's requirements for cell phone chips are not that different from Motorola's or Samsung's.

The power of a strong core

What is the profile, then, of a profitable foreign growth company? Our research shows that industry, country and size are not good predictors of successful international growth. Neither is scale of operations overseas: International growth stars have the same mix of foreign revenue as the rest of the pack (an average of 36 per cent for both groups). Far and away the best predictor of success is starting with a strong core business in the domestic market. Over 90 per cent of profitable foreign growth companies built their international expansions from a solid core business at home.

This may seem obvious, at first glance: Leadership at home gives profitable foreign growth companies the cash flow and management resources to invest in international expansion. But the implications run deeper. Building a strong core business requires a management team to fully understand the boundaries that delineate the business, recognising clearly which customers, costs and geographies are part of the core, and which are not. Through that lens, they see global expansion either as an essential extension of their core ('naturally global' industries) or as a growth option to be evaluated alongside other opportunities. Foreign norms and local market knowledge are important — but not as critical, it turns out, as having a well-honed system for making money at home. In fact, 'going global' will mislead companies that have not first understood the profit dynamics of their industry.

Buy, build or borrow

Profitable foreign growth companies clearly reflect their strong core businesses in their choice of a model for international expansion. Most companies choose one of three ways to grow overseas. They 'Buy', 'Build' or 'Borrow'. Each strategy is suited to different circumstances, and each takes its cues from the dynamics of a company's core business.

Acquisitions are most appropriate for companies operating in mature industries, where adding new capacity might drive down returns, and where the basis of competition is superior execution. Italy's Luxottica has used this strategy to become a world leader in eyeglasses. The company quickly recognised the importance of retail distribution for profitable growth: Direct access to eyeglass wearers provides unique data on what customers are buying, and allows Luxottica to market its own products. When the firm began to expand abroad, Luxottica's managers looked for acquisitions to establish a strong presence in distribution or retail. With that in place, the company can begin to extract value through its integrated business — the efficiency of its manufacturing and its expertise in marketing and product selection.

Luxottica followed this pattern when it entered the US, a key move in its international expansion. Rather than add to a saturated retail market for eyewear in the US, Luxottica acquired two leading eyeglass retailers - Lens Crafters in 1995 and Sunglass Hut in 2000. The close links between manufacturing, distribution and retailing which provided a competitive advantage for Luxottica in Italy, translated into a measure of market influence in the US and other foreign countries, with strong results. In this mature industry, Luxottica's foreign expansion through acquisitions has contributed to revenue growth averaging 17 per cent over the past five years, and net income growth of 24 per cent.

In contrast, profitable foreign growth companies with proprietary products or business models usually expand abroad by building rather than acquiring. Manpower, a pioneer in the temporary employment business, has replicated its model across the globe, building offices in 63 countries and providing employment to two million people annually. In the early phase of global expansion, Manpower had few competitors of significant size with the same focus on clerical and professional employees. The company's proprietary systems to test, assess and predict the performance of potential employees further set the company apart. Who could Manpower have acquired to grow overseas?

Yet, Manpower's multinational customers needed temporary employment services to staff their operations in countries around the world. Manpower responded with a strategy of organic global growth, building a network of foreign offices. Although the cost structure for temporary help services was tied closely to local economies of scale, Manpower could contain its costs by replicating its value proposition for customers around the globe. The company's training software — an important element of its core business — needed little modification for foreign offices. The focus of the country offices, however, remains local, with separate but co-ordinated marketing campaigns, and an emphasis on building local market share.

Building can be expensive, and sometimes slow, so a small number of companies opt for a hybrid approach, borrowing the assets they need to enter foreign markets. Drug companies, for instance, often use licensing agreements to piggyback on existing local infrastructure. This borrow model enabled Swedish Astra (later teamed with Zeneca) to quickly distribute its blockbuster gastrointestinal drug Losec around the world. Through co-marketing agreements, joint ventures and licensing arrangements, the company rolled out Losec in France, the UK, the US and Japan, in close succession. Clorox has used the same model to introduce its bleach products in Latin America, leveraging local partners' market knowledge and sales capabilities.

Global endurance

Successful international expansion is not enough to keep a business growing, of course. Overseas empires rise; they also fall. Corporations wanting to avoid the pattern of imperial decline should invest to strengthen their core business first, understand if global growth is a must do or simply a growth option, and then pursue an expansion plan consistent with how the money gets made in their industries. Blindly following the Pied Piper of Globalisation will lead to an uncertain and probably unprofitable outcome.

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EDITOR'S NOTE

The typology used to describe the diversity of international markets has been used by other authors but for different objectives than the ones pursued in this article. Previous work can be found in:

- **Goshal S. and Nohria N. (1993), Horses for Courses: Organisational Forms for Multinational Corporations, *Sloan Management Review*, Winter, pp.23-35**
- **Begley Th.. M. and David P. Boyd, The Need for a Corporate Global Mindset, *MIT Sloan Management Review*, Winter 2003, pp.25-32.**