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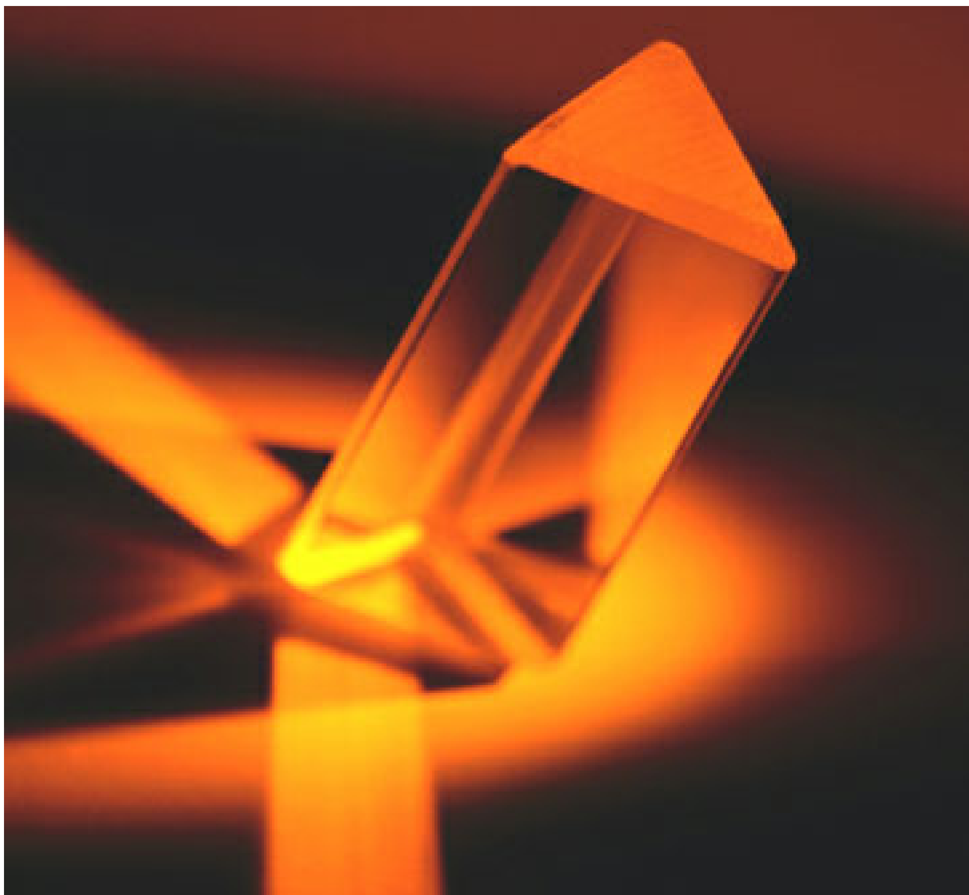
# Zeroing in: A focused approach to business growth

## The importance of the core business

A white paper from the Economist Intelligence Unit



Written in co-operation with
Bain & Company

*Zeroing in: A focused approach to business growth* was written by the Economist Intelligence Unit in co-operation with Bain & Company.

The Economist Intelligence Unit bears sole responsibility for the content of this report. The Economist Intelligence Unit's editorial team conducted the online survey and the interviews and wrote the report.

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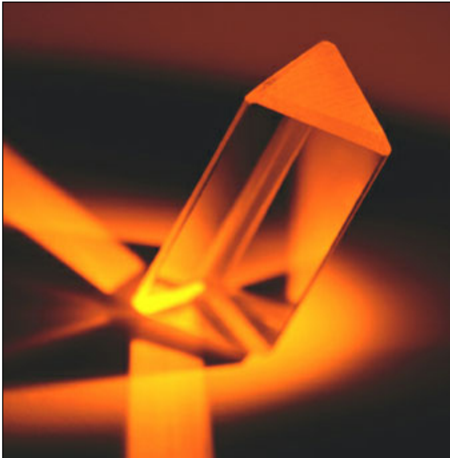
Our deepest gratitude is due to the many senior executives who shared their insights during in-depth interviews and the online survey conducted as part of the research for the report.



# Zeroing in: A focused approach to business growth

## The importance of the core business

Companies that focus on their core business—rather than being seduced by newfangled fashions or dreams of becoming a conglomerate—are most likely to succeed. That's the conclusion of a ten-year study into the sources of profitable growth by the consultancy Bain & Company. And it's a finding that's been confirmed by an online survey of 150 senior executives and a series of in-depth interviews, both conducted over recent months by the Economist Intelligence Unit.

Focusing on the core, these studies agree, doesn't excuse a defensive posture, however. Aggressive growth continues to dominate senior managers' minds, with more than 86% of respondents to the Economist Intelligence Unit survey saying that tapping new sources of profitable growth is one of their top three priorities. But once companies have defined a core activity, they must be careful not to move too far or too fast away from it, even in search of growth.

"Focusing on the core is absolutely critical for sustained growth," affirms Nigel Reynolds, director of strategic change at Charles Schwab Europe.

This white paper, written by the Economist Intelligence Unit in co-operation with Bain & Company, is designed to help companies understand the concept of defining a core business and then using it as a source of profitable growth. No one suggests that achieving sustained growth is easy, but leveraging the core is essential to improve the odds of success.

## Introduction

Even in the best of times, it's not easy to build bigger, better businesses. Bain studied the performance of 8,000 publicly listed companies in the G7 economies (the US, the UK, Germany, France, Japan, Italy and Canada) over the past ten years. After whittling the group down to firms with revenues in excess of US$500m, Bain found that only

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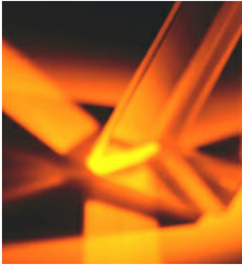

**Box 1**

### What is profitable growth?

The Bain study, analysed in *Profit from the Core: Growth Strategy in an Era of Turbulence*, published in 2001, considered more than a dozen possible definitions for sustained, profitable growth, ranging from total shareholder returns, to market value, to profit per employee. Ultimately Bain chose three criteria: revenue growth, profit growth and total returns. The screening criteria were set at 5.5% revenue and income targets, about double the real growth in the G7 economies over the past ten years. Companies were required to earn their cost of capital over ten years. The initial set of 8,000 publicly held companies in the G7 nations was whittled down to the 1,850 that posted more than $500m in revenues. In this group, more than 60% of firms satisfied these criteria over any two-year period, but only 13%, or 240, satisfied it on average over ten years. When the growth-rate hurdle was raised to 8%, the incidence of sustained, profitable growth fell to one in ten.

Despite the unprecedented economic boom of the 1990s, 90% of big publicly listed companies failed to achieve sturdy, sustained growth. Now that economic conditions have become more ominous, this dire statistic sends a clear message to chief executives and shareholders: it's very hard to achieve sustained, profitable growth.

It's all the more important, then, to learn from the fraction of companies that were able to demonstrate long-term growth. And according to the Bain study, 85% of the elite group of thriving companies shared one major characteristic: disciplined leadership, concentrated on making the most of a well defined, core business—not moving on to the "next new thing".

13% of the companies they surveyed had actually achieved profitable growth, defined as a 5.5% average annual rise in profits and revenues, over a ten-year period while repaying the cost of capital. When the growth-rate hurdle was raised to 8%, the incidence of sustained, profitable growth dropped to one in ten (see box 1).

Those success rates are likely to fall even further in today's difficult environment. "Executives are facing a 'perfect storm' of three converging forces," argues Christopher Zook, Director of Bain's Worldwide Strategy Practice and author, with James Allen, of *Profit from the Core: Growth Strategy in an Era of Turbulence*, published in 2001 by Harvard Business School Press. These forces are a weak global economy,


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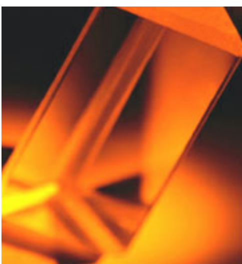
unrealistic growth expectations and shortened investor time horizons.

First, the economy. The Economist Intelligence Unit forecast in March 2002 that while a global recovery is now under way, world growth for the year would average 2.7% (measured using purchasing power parity weights), barely better than the rate in 2001—which was the weakest for almost a decade. The Economist Intelligence Unit characterised the world economic slowdown of late 2001 as the most severe deceleration since the 1974 oil-price shock and OECD economies are expected to grow just 1.1% in 2002, capping the worst two-year performance for that group since 1974-75.

"What to do when markets slow down is perhaps the greatest challenge a manager faces, other than initially getting started and surviving the start-up pressures," says Professor Paul Tiffany, a senior lecturer in management at The Haas School of Business at the University of California, Berkeley. "There are no easy formulas for success here, or they would have been discovered long ago."



Second, businesses are menaced by unrealistic growth expectations. Even though earnings forecasts have been downgraded across the board in response to the economic slowdown, companies are still projecting growth beyond even Bain's 5.5% growth-rate criteria for sustainable, profitable expansion—a benchmark the vast majority of large listed companies have already failed to hit over a ten-year period.

And it's not just large companies that profess unrealistic expectations. Start-ups often hype their projections to attract investors. "When a company is launched and a business plan formed, a lot of people will change market assumptions simply to show the return on investment," says Charles Schwab's Mr Reynolds. This sets a vicious cycle in motion, as investors and venture capitalists seek the returns they were promised and lose sight of a company's core business, products and customers. "All they focus on then is the bottom line and the balance sheet," Mr Reynolds adds.

Such unrealistic expectations drive the third and final force in today's stormy market: investor impatience. Today, executives have less and less time to deliver on shareholder expectations, and face swift punishment when they fall short. According to Challenger, Gray and Christmas, a US outplacement firm, the average tenure of US CEOs who left their jobs in October 2001 was just 4.2 years, down from 5.5 years for CEOs who cleared their desks in September.

Trigger-happy shareholders may be sacrificing companies' long-term health

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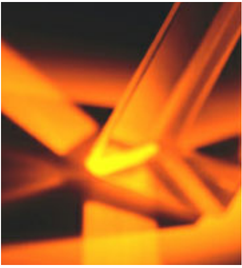


for dubious short-term gains.
"Wall Street pressures keep firms from fully exploiting their knowledge and capabilities in their core businesses," says Mr Tiffany of the Haas School. "Financial markets exert much too much of a demand for short-term results, and this distorts management decision-making."

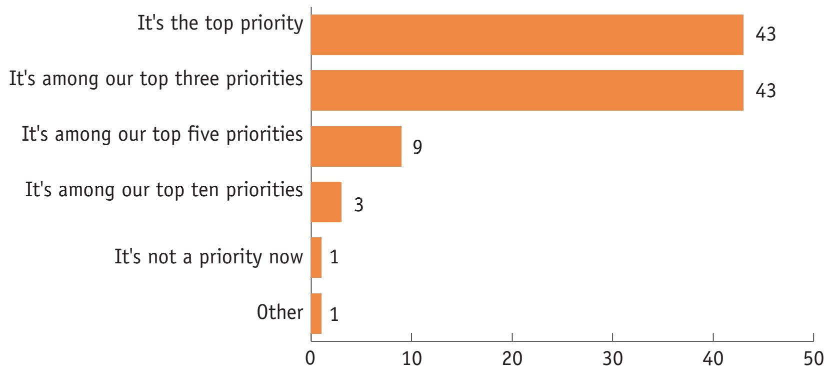
## Core values

This confluence of forces—a gloomy economic outlook, excessive expectations and shareholder impatience—puts corporate bosses in a bind. The pressure to achieve growth has never been higher, yet the conditions to deliver it have seldom been worse. In this situation, executives have almost no margin for error. Plotting out a clear and realistic path to growth assumes critical importance, and executives must decide whether that means to expand or consolidate, diversify or hunker down, look abroad or stick to familiar marketplaces close to home.

Judging from the results of the Economist Intelligence Unit survey, conducted in July, the quest for growth is nearly universal. The overwhelming majority of the 150 respondents said that the search for new, profitable sources of growth was among their top three priorities, and 43% identified it as their number-one priority. Just 1% said growth was not a priority (see chart 1). The problem, as Bain's Mr Zook points out, is that "profitable growth is scarce and getting harder to come by".

What's the best place to look for such growth? If it is to be found anywhere,

Chart 1
**Where does the search for new, profitable growth sources rank on your business priority list?**
% of respondents




**Source:** Economist Intelligence Unit online survey, July 2001.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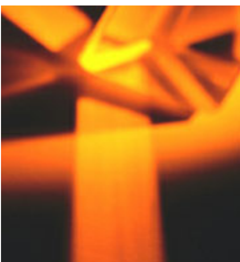
the Bain & Company analysis suggests, it is most likely to reside in or around the strongest core business. The 13% of companies to meet Bain's definition of profitable growth shared a strong common pattern of growth centred on a core activity. And of those companies that failed to clear the bar, many either failed to exploit their core business or moved away from it into areas where they were no longer leaders. In the process, they often wasted large sums on unnecessary investments.

US toy company Mattel, for example, undertook a disastrous expansion strategy that included the $3.5bn purchase in 1999 of computer-software company Learning Co. The acquisition, which haemorrhaged dollars and shattered management credibility, helped push Mattel shares down to about $11 in February 2000, from a high in the mid-$40s in 1998. Robert Eckert, the former president of Kraft Foods, was hired as chief executive in May 2000 to restore Mattel 's health. He immediately vowed to return the company to its core toy expertise, and unloaded the Learning Co.



By contrast, US household services company ServiceMaster, whose brands include Terminix, TruGreen, Rescue Rooter and Merry Maids, has been diligent in unloading non-core assets in a bid to retain its focus on the domestic residential consumer markets. In late 2001 it sold off its management services business, which served institutional customers, and decided to close some unprofitable interests, freeing up funds to invest in its core businesses.

Among the companies with sustained, profitable growth, Bain reports that nearly 80% had one core business with clear market leadership. Shining examples include Intel, the chip-maker that refocused its resources on one, strong product –microprocessors–to accelerate out of the computer component downturn of the late 1980s. In the process, Intel outstripped its key competitors, AMD and National Semiconductor, to lead the industry. Another success story of focus is single-minded Nokia, the cellular phone maker that has surpassed less-focused Motorola.

Conglomerates or highly diversified companies represent only 5% of sustained value creators, notes the Bain report. The most successful and famed is General Electric, the only company among the Dow Jones industrials that was listed on the index a century ago. But the GE exception is more apparent than real. Under its recently retired CEO, Jack Welch, the company decreed it would become either number one or two in a business—or exit. From this perspective, GE is not so much a conglomerate as a collection of

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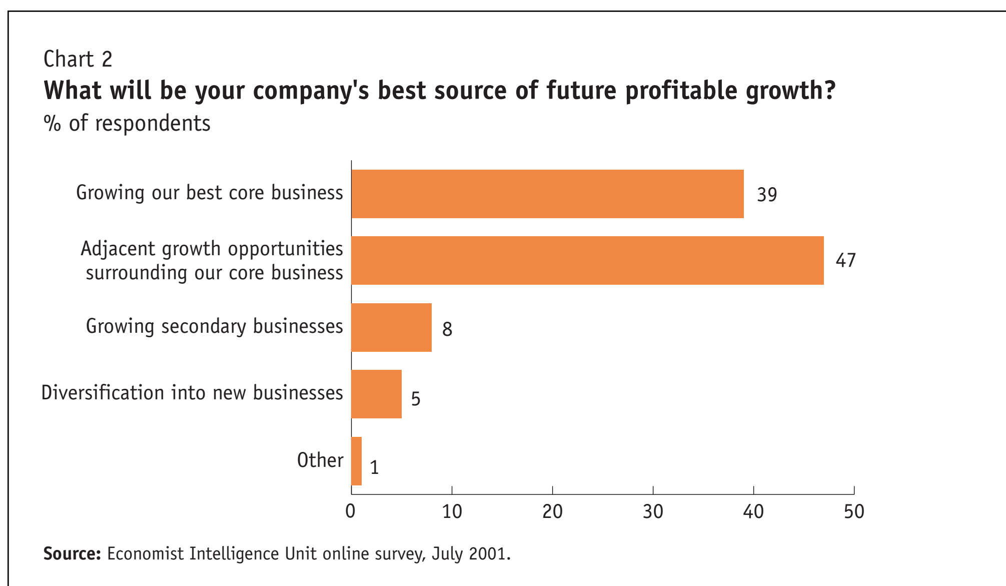
dominant core businesses. And much of GE's recent value creation came from one division, its dynamic financial arm, GE Capital. GE Capital is a natural adjunct to GE's traditional businesses. When GE builds a jet engine, for example, the financing arm helps customers buy it.

For mere mortal companies, a focus on one key business helps long-term corporate health. "To know how to compete well in one business is difficult enough, but as the number of different businesses and/or industries proliferate, human capability is stretched too thin with the result of poor financial performance," says the Haas School's Mr Tiffany. "The more broadly diversified a firm is, the less management really knows what it is doing in these businesses."

This seems to be a lesson executives have taken on board. Respondents to the Economist Intelligence Unit survey affirm the value of focusing on the core. A striking 86% of respondents consider either their core business or adjacent growth opportunities as their best source of future profitable growth (see chart 2).

In the Economist Intelligence Unit survey, a mere 5% of respondents favoured diversification into new businesses. It's no wonder, when you consider how such forays have tripped up so many firms. One example of the perils, explored in detail in Mr Zook's *Profit from the Core*, is Bausch & Lomb, the one-time leader in contact lens and other optical equipment whose expansion into hearing aids and dental products allowed Johnson & Johnson to move in on its optical leadership.

Unheroic though it sounds,





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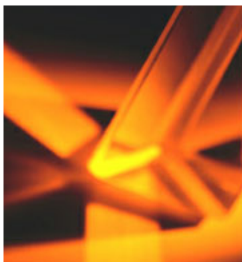
achieving profitable growth is much more likely to be about basic incremental changes than radical re-engineering. Almost 80% of the value-creating companies studied by Bain were found in established, traditional, straightforward industries—a brewer such as Heineken, a supermarket chain such as Britain's Tesco, a catering giant such as France's Sodexho. "Each has displayed a remarkable ability to grind out fast growth from what was perceived as a slow-growing core," observes Bain's Mr Zook.

That's not to say there's never a rationale for diversification. But caution is always the rule. "There needs to be a compelling reason to deviate from your core business, such as our business is going away—like the horseshoe business, or Wang and word processors," warns Bill Bass, senior vice-president of Lands' End's e-commerce and international business. Even in such dire straits, moving into a related business, not jumping into something entirely new, is still the best option. Even if an industry is experiencing long-term decline, says the Haas School's Mr Tiffany, "This is no reason for management to move into unknown waters in the hope that just getting into an attractive growth market will lead to success there."



And even when a decision to diversify is made, the original core business should be the guiding light. "Firms that [diversify] best are those that move into 'related' businesses," says Mr Tiffany. "In this way, management is best able to generate synergistic cost savings or achieve a competitive advantage from its existing capabilities that are applied to related opportunities." The greater the overlap between the core business and the adjacent business, agrees Bain's Mr Zook, the higher the chances of success.

## Core definitions

Realising the value of the core business is only the first step to profitable growth. The next is to define what that core is, a difficult process that requires assessing the boundaries of your customer and product reach, and the costs shared between them. Nonetheless, fully 93% of survey respondents said they have a clearly defined core business. One problem, however, is that defining a core business is more of a constant process than a finite decision. Executives need to address the issue continuously, lest corporate attempts to evolve in response to a constantly changing marketplace lead them unwittingly into new lines of business.

Today, for example, firms increasingly offer expertise with, or in place of, actual physical products.

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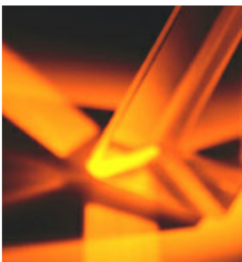
"Companies are shifting from selling products to selling services", says Rob Tercek, president of applications and services at PacketVideo, a young, San Diego, California company working to bring video to mobile phones. US car dealers, for example, sell car services through lease agreements, in which consumers buy the use of a car but not the car itself. Such services—whether they involve cars, software or other products—can be far more complex than physical products to define and perfect as a core business. "Even a bad tire is worth something," notes Mr Tercek. "But bad service is worthless."

Such redefinitions are often a good thing, but companies need to recognise when they cross a boundary into a new line of business. Self-awareness is key. At a minimum, executives must know which of their products are most profitable, who their best customers are and, crucially, how their product and services differentiate them from the competition—now and in the future as new opportunities appear and players change.



Lands' End, the Wisconsin-based catalogue retailer, is an example of a company that has undergone a dramatic evolution yet never lost touch with its core business. Lands' End began selling apparel to Americans through a catalogue business in the 1960s. In the 1980s it found that its focus on "updated classics" was flexible enough to expand to household goods, such as sheets and towels. In the early 1990s the firm had so many requests for its catalogues from overseas that it began to set up units abroad. Then in 1995 it launched one of the Internet's pioneering online shops. The website logged $162 in sales in its first month of business in July that year. But last year Internet sales exceeded $200m, accounting for more than 20% of Lands' End's overall business.

To achieve growth like this takes more than simply identifying an industry as a core activity. Lands' End focuses on clothing, but its target is a very specific segment of the apparel industry: 40-somethings who want quality clothing but aren't label-conscious. This distinction keeps Lands' End from bumping up directly with other clothing companies such as The Gap or Polo Ralph Lauren.

Identifying a defined target segment is relevant to other industries. Belgium's Interbrew and the Netherlands' Heineken are both Benelux brewers, but each has a distinct expertise and specialisation. Heineken has one strong brand and concentrates on leveraging it for sales around the globe. Interbrew, by contrast, cultivates a wide range of local breweries acquired in multiple small markets, and uses them to whet local appetites for its own elite Belgian speciality brews.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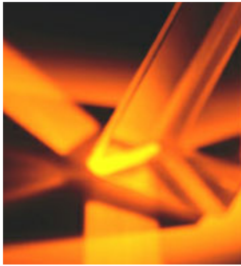


Core business definitions must have some flexibility, of course. Markets are constantly in flux and even the most stable of businesses can get caught off guard. Sears is a retailing icon that long dominated US sales of white goods and other appliances. But over the past decade newcomer Home Depot has stolen business with a low-cost, no-frills warehouse-store approach. As Sears mustered its response, Home Depot grew to a US$10bn company. Defining a core business is thus an ongoing balancing act that must keep track of and allow for changing customer, market and competitive forces.

But failing to find or keep a focus can be fatal, as is clear from the many doomed dotcoms that thought they could do everything at once. Amazon.com placed losing bets when it expanded aggressively from books to power tools, consumer electronics and even garden furniture. A clearer example of the perils is First E, an ambitious start-up online savings bank that later added everything from mortgages to life insurance to its product mix. With the company now veering towards bankruptcy, founder Gerhard Huber admits he should have focused better. "I tried to expand too far and too fast," he says.

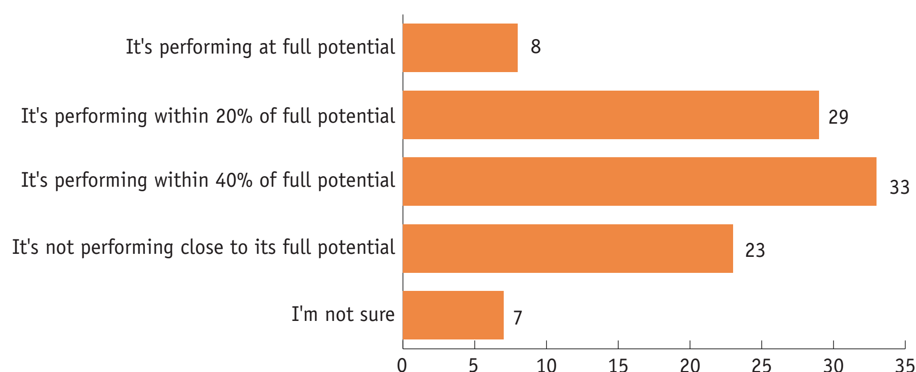
## Growing the core

Even for companies focused around a clear business proposition, there's nothing automatic about growth. "If you go fishing for a killer application, you may strike it rich once," notes Charles Schwab's Mr Reynolds. "But it's not a sustainable business model." The trick is to derive sustainable, profitable

Chart 3

**How closely is your primary core business performing to its full potential for profitable growth?**

% of respondents




**Source:** Economist Intelligence Unit online survey, July 2001.

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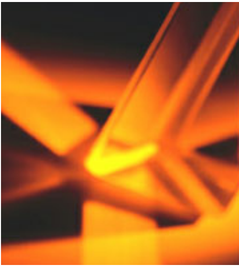


growth from the core business, but this is clearly easier said than done. A mere 8% of the respondents to the Economist Intelligence Unit survey said their primary core business was performing at its full potential (see chart 3, previous page).

The problem, at least for the survey respondents, was not so much a lack of identifiable opportunities for growth, but rather a wide range of obstacles to taking advantage of them, including competition, inadequate financial resources, a negative economic outlook

**Box 2**

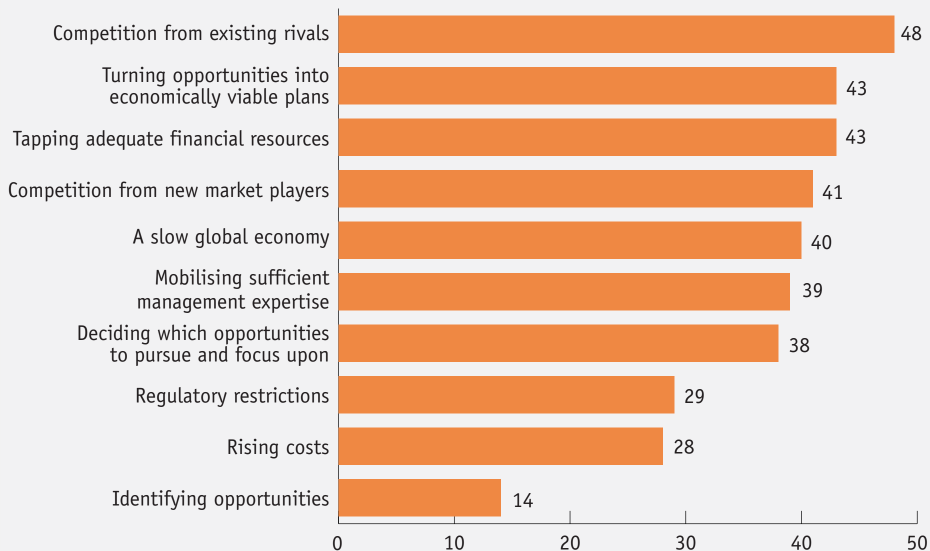
## Impediments to growth

Respondents to the Economist Intelligence Unit survey identified the main challenges to their growth aspirations in July, before the shockwaves of the terrorist attacks in the US reinforced the global economic gloom. But "recession" was already the word on every company's lips. "We saw the effects of the economy on our business even before September 11th," says Claude Demeestere, director of corporate and channel strategy with Amadeus Global Travel Distribution. A slowing global economy and the related problems of getting adequate financing featured prominently as top challenges (see chart 4).

Chart 4

**Challenges to growth aspirations identified as very troubling or troubling**

% of respondents




**Source:** Economist Intelligence Unit online survey, July 2001.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But other challenges also loomed large, with competition from existing rivals being the most troubling. More striking is the fact that 41% of respondents identified competition from new market players as being very troubling or troubling—a finding that reinforces the need to monitor and redefine the boundaries of the core business as new entrants weigh in. “It’s like driving,” says Mr Demeestere. “You always need to watch the rear view mirror to see if someone is coming around the corner to damage your business.”

Further, while companies with all manner of core businesses have no problem identifying new opportunities for growth, choosing between opportunities, turning them into profitable ventures and drawing on management expertise to achieve growth targets are more difficult. Once again, focusing on the core provides a useful road map for selecting and executing growth projects.

The same guidance applies to the challenge of cost control, the number-one corporate priority in an economic downturn. By focusing on core activities—rather than getting distracted by new activities and their new investment requirements—companies can hope to achieve economies of scale. And by ring-fencing expenditure that is crucial to the core business, companies can position themselves for growth. Charles Schwab, for example, has not cut investment in customer research—even as the economy has gone south—because that research supports its core business. “We’re always very hungry to find new things customers want,” Mr Reynolds explains. “Our research budget is being maintained. It saves a lot of time and money to speak with our customers directly.”

and insufficient managerial resources (see box 2, previous page).

There’s obviously no magic formula—each firm has to find its own way to growth. But a look at successful companies provides three useful guiding principles:

- The discipline to assess and reassess the true customer, competitor and product boundaries of your business;
- The flexibility to expand into related fields as markets change; and
- The resolve to abandon such expansion when it hurts the core business.

Charles Schwab, which began as a US discount brokerage in 1974 but now has 7.8m active retail accounts and hundreds of branches around the globe, says its sustainable growth comes from evolving its core brokerage business closely with the customer. “It’s like a mantra we have: if the customer wants something, it’s a fundamental part of what we need to do,” says Mr Reynolds. As more and more consumers took to the web in the

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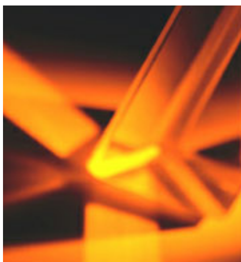
mid-1990s, for example, the brokerage had to take "a leap of faith" and in 1995 launched its site—one of the first online trading businesses. From 1996 to 1998, online accounts grew to 2.2m from 600,000, and online assets grew to $174bn from $42bn. (After the stockmarket decline of 2000-01, the company again responded, moving its focus slightly upmarket.)

If a company has developed a successful strategy based around the core, that strategy can see it through even a stagnant market (see box 3, page 13). Consider the personal computer market. PC sales, long growing at more than 20% a year, have peaked and are now in retreat. When speaking at a university recently, Michael Dell was asked what type of business he would start if he were a student. "It wouldn't be a PC business," he acknowledged.

But PC maker Dell is continuing to thrive, while competitors Compaq and Hewlett-Packard struggle. Dell's direct model allows it to offer lower prices and pick up market share at its rivals' expense. While Compaq spread its energies thinly, acquiring Tandem and Digital Computer, Dell kept its laser-like focus on direct sales. When Dell began selling through discount retailers back in 1993, it made the only loss in its history. Michael Dell quickly diagnosed the problem: a conflict between the profitable direct business and the unprofitable retail. "Every major decision in the core business was set against the question of what it would do to the unprofitable retail part of the business," Mr Dell recalled. "When we realised this, we withdrew immediately."



An ongoing, vigilant focus on the core businesses—especially when expanding into new sectors—has helped many firms grow steadily. Consider Amadeus Global Travel Distribution, whose net income multiplied more than six times to €125m in 2000 from €19m in 1996. After nearly a decade of focus on its core business of providing an online reservation system to professional travel agents, Amadeus decided to expand in the mid-1990s by supplying similar products to new customers, via the Internet, and more recently by outsourcing services to airlines. The company has considered other business opportunities over the years but "the others had no obvious synergies," says Claude Demeestere, director of corporate and channel strategy. "Our two new activities support and consolidate our original activity."

Palm, the US maker of personal digital assistants, or PDAs, recently decided to split into two independent companies—one focused on software and licensing and the other on devices. The move, a reaction to growing competition in the PDA market, aims to help Palm maintain its market lead.



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Currently the California company controls more than half of the US PDA market and about 85% of the US market for PDA operating systems, according to Satjiv Chahil, Palm's chief marketing officer. Splitting into two companies intensifies Palm's focus on its core PDA market but also lets the firm take advantage of competitive developments. "This opens a far bigger opportunity for our operating system than was originally perceived," says Mr Chahil, who also stresses the need not to stray too far from the core business. "When companies try to be everything to everybody, they run into trouble. The core business must be the foundation of all new opportunities."

As Lands' End's Mr Bass puts it: "New business needs to be a good fit for the old." When finding that fit, Charles Schwab's Mr Reynolds recommends giving new ventures all the gas they need to speed away, but not to the point where they can't make a necessary turn if it doesn't work out or the market goes bad. "You invest enough to make it viable, but not so much that you can't

**Box 3**

**Ryanair: Flying high**

European airlines have clearly suffered of late. Even before September 11th, traffic was drying up and established carriers such as Sabena and Swissair were struggling.

But one airline, Ryanair, has thrived by sticking to a core focus adopted in 1990-91: a low-fares, no-frills policy that took a leaf from the book of Southwest Airlines in the US, using secondary airports to contain costs. Ryanair, based in Ireland, has prospered by sticking fervently to its strategy during several shocks to the industry.

When EU air transport was fully deregulated around 1997, Ryanair expanded aggressively, but stuck to offering low fares on short-haul intra-European routes using low-cost airports—rather than waging a head-on battle with incumbent flag carriers. Ryanair was well rewarded: customers defected in droves from the established national airlines—and passengers remained happy to use secondary airports like Belgium's Charleroi in order to secure fares that averaged 80% less than those offered by Sabena, Belgium's now defunct flagship carrier.

After the September 2001 terrorist attacks, Ryanair cut prices aggressively to woo nervous passengers, offering a million flights for as little as $9. It also exploited industry malaise to drive a hard bargain on 100 Boeing 737-800 aircraft for delivery over the next decade.

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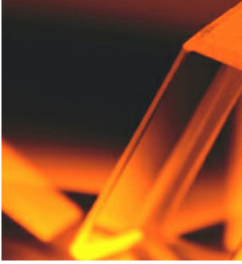

It reportedly negotiated a 30% discount because it was the only buyer in the market.

Ryanair has also embraced the Internet: 91% of its bookings are now done online, up from 71% a year ago. And it continues to defy industry convention by offering low fares throughout the year. It recently offered a million seats at £19 for a one-way journey, inclusive of tax, on every route it flies from the UK for travel between late April and late June 2002.

Ryanair's unerring focus on low costs has a palpable pay-off: now the largest no-frills operator in Europe, it enjoys operating margins of about 23% on sales—compared with about 5% for incumbents; the airline's pretax profits were up 34% in the quarter ended December 31st 2001, defying the broad slump in the air travel sector, and the company's market value has risen ten times since its 1997 IPO. On good trading days, it is worth more than British Airways.

Losing sight of the strategy, or diluting it, is arguably what has undermined others who are trying the low-cost air travel model in Europe. Richard Branson's Virgin Express, for example, is still failing to turn a profit, but Virgin Express flies into high-cost airports such as Brussels and London Heathrow. "Virgin's problem is that it is half the traditional airline model and half the low-cost model," says Corne Zandbergen, an airline analyst at Fortis Bank in Amsterdam. "Ryanair has succeeded because it sticks closely to the low-cost model."

Ryanair chief executive Michael O'Leary knows only too well that focusing on the core strategy is critical. "The worst that can happen to us", he was reported as saying recently, "is something self-inflicted—like an accident, or if we ever had the stupid idea to offer a business class or serve food on board."

get out if your customers don't like it," he says. "We need to make sure we can service our customers in good economic times and bad."

## Conclusion

All businesses—start-ups and market leaders alike—must walk a tightrope between maximising core competencies and growing into new, profitable areas. No one wants to look back on missed opportunities, but a company can easily lose its path to profitability by being seduced into trendy, non-core sidelines.

For sustainable growth, companies should rely primarily on opportunities closely related to their core function, all the while revising and refining



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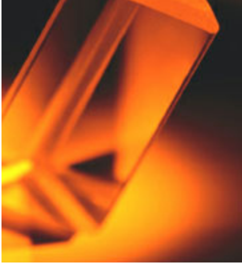

their focus to match ever-changing competitive and economic pressures. "You're constantly battling to define your business not so broadly that you lose focus nor so specifically that you miss opportunities," says Lands' End's Mr Bass.

Companies also need to keep faith with the core in good times and bad. Firms that achieve consistent growth year after year, through the ebb and flow of the economic cycle, have been and will be those that concentrate on what they know best. "It's a business essential to keep a strong focus on the core," summarises Palm's Mr Chahil. "The companies that do well in the long term never lose sight of their core business."

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