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Viewpoint

Why the biggest and best **struggle to grow**

The largest companies eventually find size itself an impediment to creating new value. They must recognize that not all forms of growth are equal.

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The largest, most successful companies would seem to be ideally positioned to create value for their shareholders through growth. After all, they command leading market and channel positions in multiple industries and geographies; they employ deep benches of top management talent utilizing proven management processes; and they often have healthy balance sheets to fund the investments most likely to produce growth.

Yet after years of impressive top- and bottom-line growth that propelled them to the top of their markets, these companies eventually find they can no longer sustain their pace. Indeed, over the past 40 years North America's largest companies—those, say, with more than about $25 billion in market capitalization—have consistently underperformed the S&P 500,[1] with only two short-lived exceptions.

Talk to senior executives at these organizations, however, and it is difficult to find many willing to back off from ambitious growth programs that are typically intended to double their company's share price over three to five years. Yet in all but the rarest of cases such aggressive targets are unreasonable as a way to motivate growth programs that create value for shareholders—and may even be risky, tempting executives to scale back value creating organic growth initiatives that may be small or long-term propositions, sometimes in favor of larger, nearer-term, but less reliable acquisitions.

In our experience, executives would be better off recognizing the limitations of size and revisiting the fundamentals of how growth creates shareholder value. By understanding that not all types of growth are equal when it comes to creating value for shareholders, even the largest companies can avoid bulking up on the business equivalent of empty calories and instead nourish themselves on the types of growth most likely to create shareholder value.

What holds them back?

At even well-run big companies, growth slows or stops—and for complex reasons. Ironically, for some it's the natural result of past success: their portfolios are weighed down by large, leading businesses that may have once delivered considerable growth, but that have since matured with their industries and now have fewer natural avenues for growth. At others, management talent and processes are more grooved to maintain, not build, businesses; and their equity- and cash-rich balance sheets dampen the impact growth has on shareholder value. For all of them, their most formidable growth challenge may be their sheer size: it takes large increments of value creation to have a meaningful impact on their share price.

The other crucial factor is how management responds when organic growth starts to falter. This is often a function of compensation that ties bonuses to bottom-line growth. In any case, management is often tempted to respond as if the slowing organic growth were merely temporary, rejecting any downward adjustment to near-term bottom-line growth.

That may work in the short run, but as individual businesses strip out controllable costs, they soon begin to cut into the muscle and bone behind whatever value-rich organic growth potential remains—sales and marketing, new product development, new business development, R&D. At one industrial company we are familiar with, management proudly points to each savings initiative that allows them to meet quarterly earnings forecasts.

But the short-term focus on meeting unrealistically high growth expectations can undermine long-term growth. Ultimately, the scramble to meet quarterly numbers will continue to intensify as cost cutting further decelerates organic growth. If the situation gets more desperate, management may turn to acquisitions to keep bottom-line growth going. But acquisitions, on average, create relatively little value compared to the investment required, while adding enormous integration challenges and portfolio complexity into the mix. Struggling under the workload, management can lose focus on operations. In this downward spiral management chases growth in ways that create less and less value—and in the end winds up effectively trading value for growth.

Some companies seem to have recognized the danger in constantly striving to exceed expectations. One company's recent decision to vest half of its CEO's stock award for simply meeting (rather than handily beating) the five-year share price appreciation of the S&P 500 may be one such bow to good reason. Ironically, relieving the CEO of the pressure to substantially outperform the market may have given him the freedom he needs to focus on longer-term investments in value-creating organic growth.

All growth is not created equal

The right way for large companies to focus on growth, we believe, is to differentiate among entire classes of growth on the basis of what we call their value creation intensity.[2] The value creation intensity of a dollar of top-line growth directly depends on how much invested capital is required to fuel that growth—the more invested capital, the lower the value creation intensity. Sorting growth initiatives this way requires understanding the timeframe in which shareholder value can be created—as short as a matter of months for some acquisitions or more than a decade for some R&D investments. It also requires assessing the size of an opportunity by the amount of value it creates for shareholders, not merely how much top-line revenues it adds. These are the particularly crucial factors for very large companies, where smaller investments can get lost on the management agenda, long-term investments fail to capture management's imagination, and the temptation is to invest in highly visible near-term projects with low value creation intensity.

To illustrate, we dipped into M&A research to see how much value creation even top-notch acquirers can reasonably expect. We have also modeled the value creation intensity of four different modes of organic growth, by estimating results for prototypical organic growth opportunities in the consumer packaged goods industry.

While this specific hierarchy of value creation intensity may not hold for every industry, it can serve as a useful example.

New product/market development tends to have the highest value creation intensity. It provides top-line growth at attractive margins, since competition is limited and the market is growing. We estimate that the prototypical new product in the consumer goods industry can create between $1.75 and $2.00 in shareholder value for every dollar of new revenue. Ironically, while this type of growth creates the most value, it's particularly difficult for really large companies. Creating new demand for a product that did not previously exist requires outstanding innovation capabilities—and big companies that have tightened the screws on operational performance are notorious for cutting away at research and development spending.

Expanding into adjacent markets typically requires incremental invested capital that leads to lower, though still very attractive, value creation intensity in the range of $0.30 to $0.75 per dollar of new revenue. Facilitating adjacent market expansion requires outstanding execution skills and organizational flexibility.

Maintaining or growing share in a growing market requires substantial incremental investments to make the product and its value distinctive. But as long as the market is still growing, margins are not competed away. As a result, we estimate value creation in the range of $0.10 to $0.50 per dollar of new revenue.

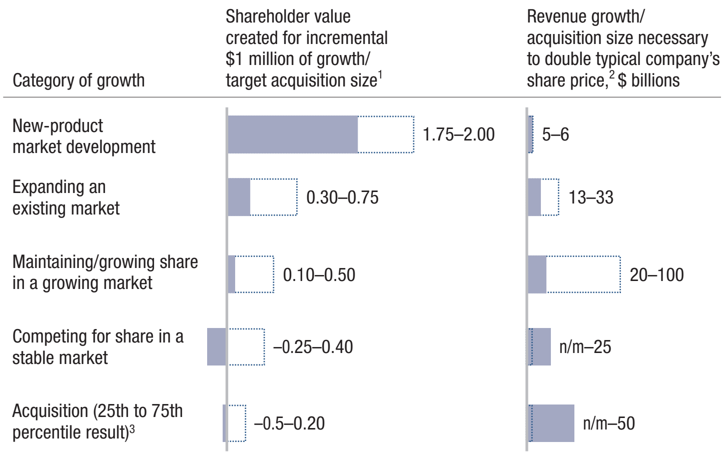
Growing share in a stable market does not always create value. While incremental investments are not always material, competition for share in order to maintain scale is typically intense, leading to lower margins. We estimate that increasing share in a relatively mature market may *destroy* as much as $0.25 or *create* as much as $0.40 of shareholder value for every dollar of new revenue. And for companies whose growth is already stalling, growth in a stable market merely postpones the inevitable.

Acquisitions. While they can drive a material amount of top-line growth in the relatively short order, it is now widely accepted that the average acquirer captures relatively little shareholder value from its deals.[3] In fact, the numbers suggest that even an acquirer who consistently enjoys a top-quartile market reaction in each of its deals will create only about $0.20 in shareholder value for every $1 million in revenues acquired.[4]

Obviously, the size and timing of growth opportunities are determined by business fundamentals within each industry. Typically, though, they tend to come in relatively small increments and mature over multiple years. In the packaged consumer goods industry, one study[5] found that almost half of product launches had first year sales of less than $25 million, and the largest was only a little more than $200 million. The number of these sorts of top-line growth projects needed to move the needle for the biggest companies is daunting. When we stand back from this analysis, we can't help but draw a very dispiriting observation for very large companies: there are remarkably few growth opportunities that are large and near-term and highly value creating all at the same time. Put another way, the amount of top-line growth required to achieve a doubling in shareholder value varies

EXHIBIT

Modes of organic growth vary in value creation intensity—consumer goods industry



[1] Stylized results based on consumer products examples.
[2] Assumes a $50 billion market cap, all-stock company with $23 billion of revenue expected to grow at GDP rates and constant return on invested capital (ROIC)
[3] Examination of 338 deals revealed short-term value creation for acquirer of 11% for 75th percentile deals and –1% for 50th percentile deals.

Source: McKinsey analysis

dramatically by mode of growth, and is huge in even the most favorable modes of growth (Exhibit).

Some executives will no doubt find uncomfortable the shift to a perspective that emphasizes the value creation intensity of growth initiatives. Though such a shift would serve shareholders well, it may also lead to lower overall levels of top-line and earnings-per-share growth.

Executive credibility will be on the line in communicating this message to the markets. One executive we've worked with, for example, recognized that his company lacked the credibility to quickly lower his overall EPS growth targets in favor of a richer mix of value-creating growth without getting pummeled by the markets. Instead, the company made one more big push on operations, letting only enough of the savings fall to the bottom line to meet the company's short-term growth projections. The rest of the savings was redirected toward slower, but more value creating, organic growth, with the expectation that once the company had built some credibility in that respect with shareholders, it could more easily make its case to the markets.

When growing gets tough in the largest companies, tough executives must learn to get growing in value creating ways. Rather than bulk up on the business equivalent of empty calories, they should explore the value creation intensity of different modes of growth to build shareholder value muscle. **MoF**

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[1] Credit Suisse First Boston, "The pyramid of numbers," *The Consilient Observer*, Volume 2, Issue 17. September 23, 2003

[2] Shareholder value creation per dollar of top-line revenue growth.

[3] *See*, for example, Hans Bieshaar, Jeremy Knight, and Alexander van Wassenaer, "Deals that create value," *The McKinsey Quarterly*, 2001 Number 1, pp. 64–73.

[4] It is important to note, however, that market-entering or capability-building acquisitions designed to fuel subsequent organic growth are more likely to create value than market-consolidating acquisitions designed to capture cost efficiencies.

[5] Innen, Steve, Ed. "Innovation awards 2002," *Food Processing*, December 2002, pp. 35–40.