

Grow fast or die slow: The role of profitability in sustainable growth

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How can software and online-services companies determine the right balance between growth and profitability?

It is clear to most in the software and technology community that the days of growth at any cost are behind us, at least for now. Of course, growth is still important—it remains one of the most important factors in valuation, access to capital, and shareholder return, as well as the ability to attract top talent. Although some companies, investors, and shareholders are still focused solely on rapid growth, many in the start-up ecosystem are increasingly pushing for sustainable growth, which balances high growth rates with evidence of a path to profitability. These investors and operators view sustainable growth as the leading indicator of a software company's overall health and potential.

While this increased focus on sustainable growth is well founded, a one-size-fits-all approach can leave value on the table. This is particularly true for software businesses, in which benefits tend to accrue disproportionately to players with scale. Context also matters when considering the optimal trade-off between growth and margin, including a company's stage in the growth cycle, the macroeconomic environment, availability of capital, market dynamics, competition, and the chosen strategy for driving adoption and achieving scale.

To understand these nuances, we examined McKinsey's database of publicly traded software companies, which contains information on about 3,000 players from around the world. The data spans the years from 1980 through 2013, making it possible to identify long-term patterns. While our previous research focused on revenue growth, our current investigation also looks at the role of profit margins.

We uncovered several important insights about the trade-off between growth and margins. Software businesses that have achieved \$100 million in revenue, and are beginning to see the benefits of

scale, generally place less emphasis on profitability than companies that have reached \$1 billion in sales. We also found that while this strategy may benefit companies seeking to surpass the \$100 million threshold in the short term, they must eventually increase their focus on profitability to achieve sustainable growth (as evidenced by the increased focus on profitability among those that have reached \$1 billion). These insights relate to another major finding: most software businesses fall into five specific categories based on their growth and profitability profile, and the strategies for value creation differ for each category.

Scale influences strategy

We began by dividing the companies in our analysis into two groups based on annual revenue thresholds—those that had reached \$100 million annually and those that had reached \$1 billion—since a company's size has an important impact on outcomes. Their divergent paths become most clear when we contrast their earnings before interest, taxes, depreciation, and amortization (EBITDA) margins. First, consider the two most prominent trends seen with \$100 million players (Exhibit 1):

- **Slight annual declines.** Since 1980, public software companies that crossed the \$100 million revenue threshold have, in aggregate, seen EBITDA margins decline slightly over the past three decades. There were a couple periods when there was a sharp spike in the number of companies in the \$100 million revenue category with negative EBITDA margins, such as the dot-com era and the years immediately preceding the financial crisis.
- **Greater spread.** In the 1980s, most software companies that passed the \$100 million threshold had margins of between 10 and

20 percent. The spread in the last decade has been more than five times that amount.

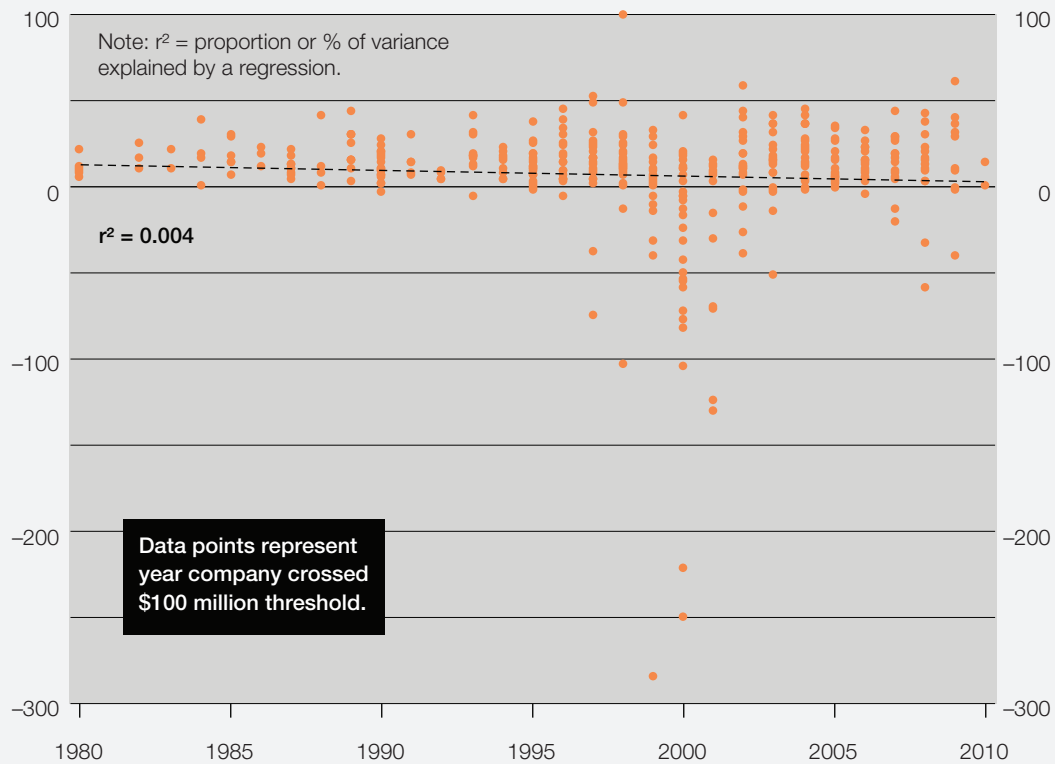
The slight annual declines, combined with the greater spread, could be occurring because most software companies followed a perpetual-license model prior to the early 2000s. That meant they generated most of their customer lifetime value at the initial purchase, resulting in higher profit

margins from the start. However, many software companies are now following a software-as-a-service (SaaS) model, where they typically have negative margins early on as they invest in customer acquisition, success, and retention.

Now consider the companies that made it all the way to the \$1 billion revenue threshold (Exhibit 2). Like the companies that crossed \$100 million in

Exhibit 1 The EBITDA margin for companies that reached \$100 million in annual revenue has generally decreased over time.

Earnings before interest, taxes, depreciation, and amortization (EBITDA) margin for companies that reached \$100 million in revenue,^{1,2} %



¹ Database includes 3,197 software companies that were public between 1980 and 2013; they were classified into 1 of 4 categories: Internet software and services, application software, system software, or home-entertainment software.

² Nominal revenue used; n = 370 (subset of original companies that had reached \$100 million revenue threshold for which EBITDA data was available).

Source: McKinsey analysis

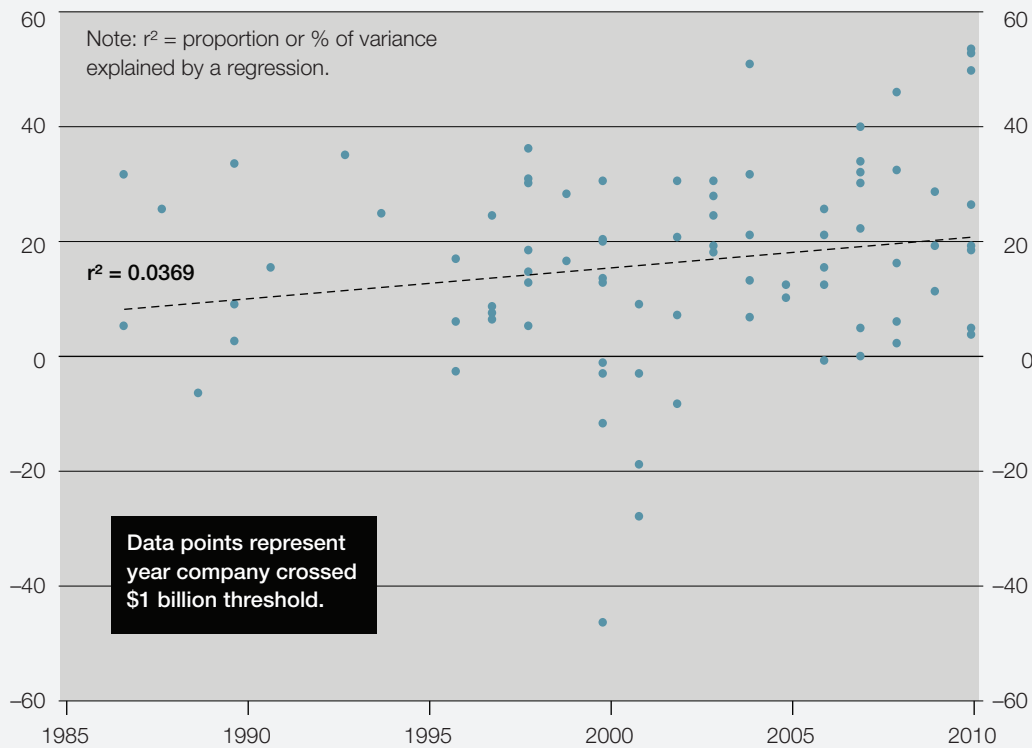
revenue, they experienced greater spread over time, particularly around the dot-com era. But the EBITDA margins of these companies—measured at the time they crossed the \$1 billion revenue threshold—have consistently increased over the years.

These EBITDA trends—the drop for companies that crossed \$100 million in revenue and the increase for those with more than \$1 billion in

revenue—suggest that profitability increases in importance as a company matures. There are several possible “cause and effect” explanations for this dynamic. On one hand, scale effects may make it easier for companies with \$1 billion in revenue to achieve a higher EBITDA margin. On the other hand, it is also possible that these companies place more emphasis on profitability as their growth opportunities become more limited.

Exhibit 2 The EBITDA margin for companies that reached \$1 billion in annual revenue has generally increased over time.

Earnings before interest, taxes, depreciation, and amortization (EBITDA) margin for companies that reached \$1 billion in revenue,^{1,2} %



¹ Database includes 3,197 software companies that were public between 1980 and 2013; they were classified into 1 of 4 categories: Internet software and services, application software, system software, or home-entertainment software.

² Nominal revenue used; n = 83 (subset of original companies that had reached \$1 billion revenue threshold for which EBITDA data was available).

Source: McKinsey analysis

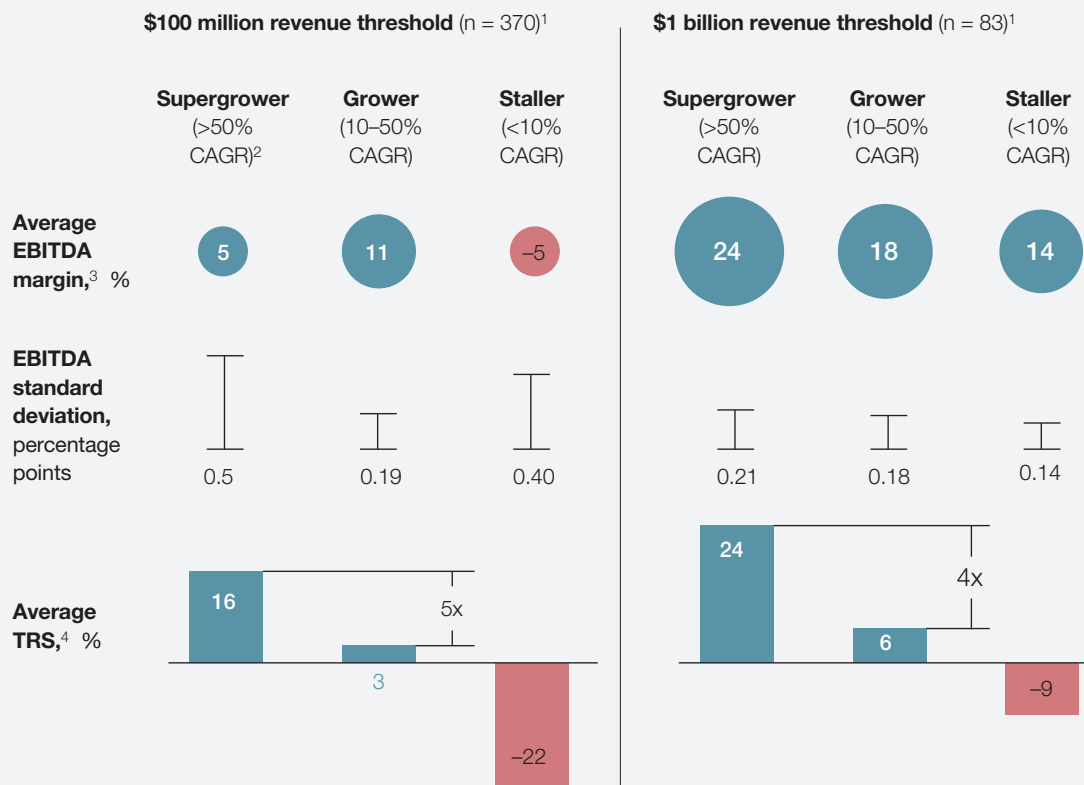
Growth rates influence profitability

To understand the trade-offs made between growth and profitability, we divided the companies in our database in a different way. We separated them into three groups based on the growth profile that they demonstrated when they crossed the \$100 million threshold: “supergrowers,” with greater than 50 percent compound annual growth rate (CAGR); “growers” (10 to 50 percent CAGR); and “stallers” (less than 10 percent CAGR).¹ This is

the same categorization used in our original 2014 analysis of companies in the Grow fast or die slow database. We then determined the average EBITDA margins and total returns to shareholders (TRS) of each profile at both the \$100 million and \$1 billion revenue milestones (Exhibit 3).

Our analysis identified some themes in the strategies that companies in each growth category are pursuing, as well as the underlying market dynamics at play.

Exhibit 3 Each category demonstrated different average EBITDA margins and total returns to shareholders.



¹ Excludes companies that did not cross threshold or where EBITDA margin was not available (reduced data set).

² CAGR = compound annual growth rate.

³ EBITDA = earnings before interest, taxes, depreciation, and amortization; excludes companies that did not cross threshold or where 2-year CAGR could not be calculated (ie, those that hit threshold in last 2 years, were acquired, or went bankrupt within 2 years of reaching threshold).

⁴ TRS = total returns to shareholders; defined as 3-year rolling average TRS calculated as geometric mean in 3rd year after crossing threshold.

Source: McKinsey analysis

Supergrowers

Supergrowers report an annual CAGR of greater than 50 percent. Companies with \$100 million in revenue have an average EBITDA margin of 5 percent, compared with 24 percent for companies that have passed the \$1 billion threshold. This group includes some of the most well-known software businesses today, including Facebook, Google, and Microsoft.

Supergrowers at the \$100 million revenue level are primarily rewarded for their high growth rates. Investors typically focus on how much market share these companies capture in pursuit of becoming “the winner” in their space, often at the cost of profitability. If these companies do indeed win their category, they will eventually resemble the supergrowers with \$1 billion in revenue, having both high margins and fast growth rates.

Growers

Companies in this group have an annual CAGR of 10 to 50 percent. Growers with \$100 million in revenue have an average EBITDA margin of 11 percent, compared with 18 percent for companies that have passed the \$1 billion threshold. Companies such as Monster, Sage, and Symantec were classified as growers when they passed the \$100 million revenue threshold in the late 1980s and early 1990s.

As their name implies, growers are still achieving healthy revenue growth. However, they may not be able to achieve the even higher CAGRs seen with supergrowers. As these companies perceive that their growth is reaching its limits, they begin to focus more on profitability. Since the grower category has the highest average EBITDA margins of all groups for companies at the \$100 million revenue threshold, it is possible that these companies are limiting their growth for the sake of showing profitability earlier.

Growers that reach the \$1 billion threshold have solid margins, but they are still lower than those of supergrowers in the same revenue category. Two external forces often limit their profitability:

- These companies operate in markets where the winner-takes-all dynamic is relatively weaker.
- The upper limit of the total available market (TAM) is relatively low for growers compared with supergrowers. As such, new entrants and competition erode their margins to a greater extent.

External forces are not the only factors to affect margin, however. Some growers might limit growth simply for the sake of showing higher profitability. While this strategy may produce short-term benefits, the few companies that reach the \$1 billion revenue threshold risk losing the high margins enjoyed by the highest-growth players that reach the \$1 billion revenue threshold.

Stallers

Stallers—those companies with revenue CAGRs under 10 percent—are in a difficult position. At the \$100 million inflection point, they are experiencing slow growth and have an average EBITDA margin of –5 percent. Operating in the red, stallers do not have the option of trading profitability for growth, and most of these software businesses never make it to the \$1 billion threshold. Instead, they go out of business, get acquired, or linger in the \$100 million to \$500 million revenue range.

The few stallers that do reach the \$1 billion revenue threshold have some competitive advantage that allows them to achieve profitability while still growing slowly. However, these companies have an average EBITDA margin of 14 percent, lower than that achieved by the growers or supergrowers that reach the \$1 billion revenue threshold.

Companies fall into five categories based on growth and profitability

Our original 2014 analysis segmented companies into the three categories described previously based on revenue growth rates: supergrower, grower, and staller. After incorporating profitability as a new dimension, we found that most software companies fall into one of five categories based on their growth and profit profiles when they passed the \$100 million revenue threshold (Exhibit 4).²

Each category has several distinct characteristics with respect to CAGR, EBITDA, and TRS. Not

all profiles are created equal—some are more desirable than others and lead to better TRS (Exhibit 5).

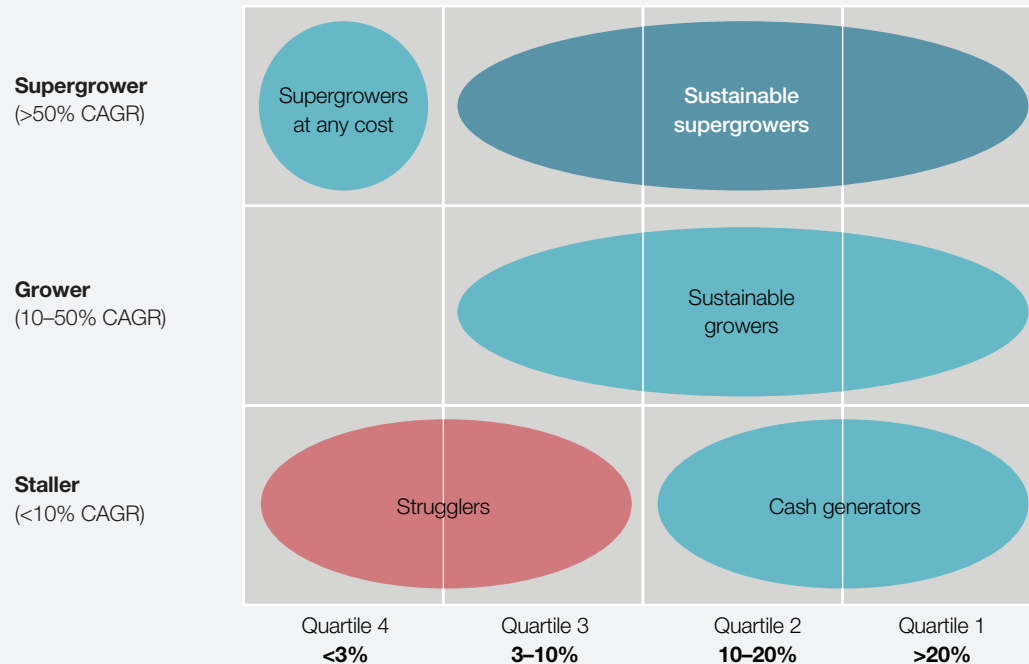
Sustainable supergrowers

Companies with this profile are in the most enviable position, combining supergrower status (more than 50 percent CAGR) with healthy, sustainable margins of 3 percent or more—quite often much higher. Unsurprisingly, the average TRS is the highest in this category (22 percent). Many of today’s largest consumer Internet companies were classified as supergrowers when

Exhibit 4 Software companies can generally be categorized based on their growth and profitability profiles.

Revenue-growth category, CAGR,¹ by EBITDA² margin quartile

● Least-desirable position ● Potentially desirable position ● Most-desirable position



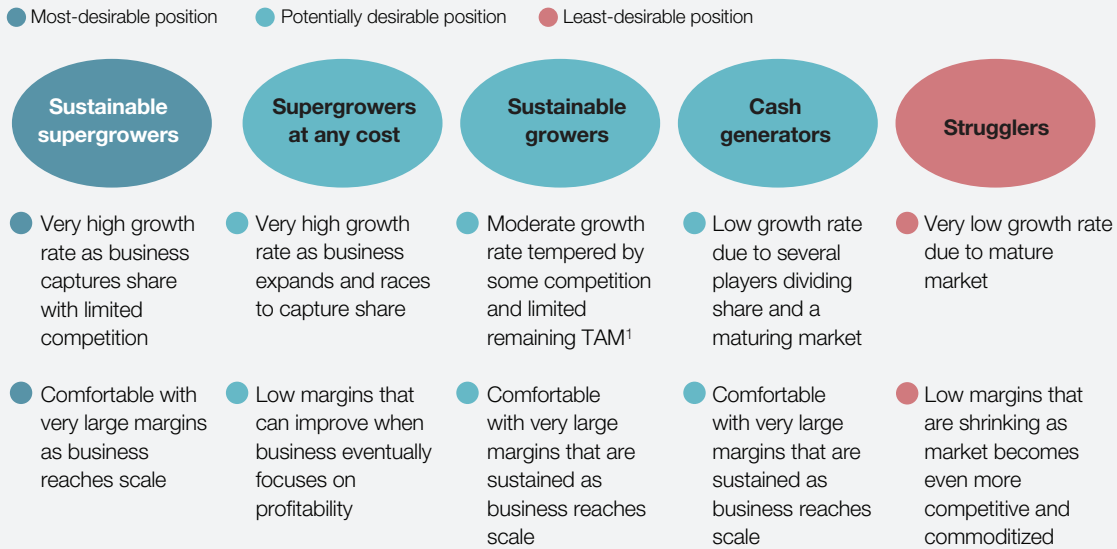
¹ CAGR = compound annual growth rate.

² EBITDA = earnings before interest, taxes, depreciation, and amortization.

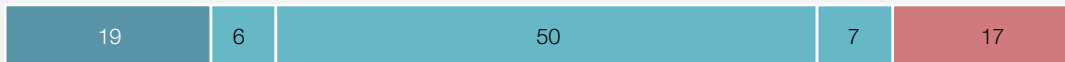
Source: McKinsey analysis

Exhibit 5 Each growth and profitability category has different characteristics.

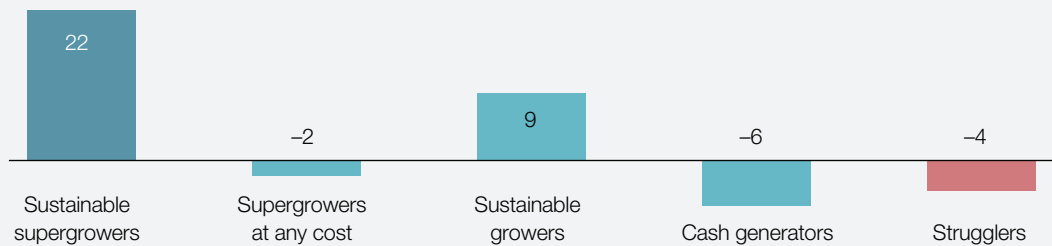
Revenue-growth category characteristics



Companies with more than \$100 million in revenue in category, % share²



Average TRS,³ %



¹Total available market.

²Figures may not sum to 100%, because of rounding.

³TRS = total returns to shareholders; defined as 3-year rolling average TRS calculated as geometric mean in 3rd year after crossing \$100 million threshold.

Source: McKinsey analysis

they crossed the \$100 million revenue threshold, including Alibaba and Google.

Sustainable supergrowers are likely in a very stable position but still not immune to outside

competitive threats. They should focus on solidifying their competitive advantage by increasing scale and reinforcing network effects. For instance, they might be able to increase customer retention through differentiating

features that increase switching costs and discourage multihoming (connecting to more than one network).

Supergrowers at any cost

Companies in this category combine supergrower status with bottom-quartile EBITDA margins (less than 3 percent and often negative). They include players such as Digitas and eBay, both of which fit this profile when they crossed the \$100 million revenue threshold in the late 1990s.

This category can be a good place to be for a time, despite the low profits. Consider, for instance, insurgent companies or new players that want to compete in a white space where innovative products or services are just emerging. Such players often want to capture as much market share as possible to win the category. Many SaaS businesses have pursued this route during their early days and growth stages, using venture financing to fuel negative margins and high burn rates.

Companies that are supergrowers at any cost should realize that this strategy works only for a finite time and may lead to lower near-term shareholder returns. (The average TRS is -2 percent for this category.) Once the growth rate slows and the companies have captured as much TAM as possible, investors will want to see increasing margins. To prepare, companies in this category should create a clear plan for shifting from growth to profitability and be ready to execute it.

Sustainable growers

As with supergrowers at any cost, this category can also be a good place for a company to reside for a short time. While growth rates are more tempered (10 to 50 percent CAGR), companies in this category have sustainable margins (3 percent or more) and a healthy average TRS (9 percent). Many of the original software businesses founded in the 1980s were classified as sustainable growers when

they crossed the \$100 million threshold, including Adobe, Autodesk, and Symantec.

The healthy margins in this category can be a two-edged sword, since they satisfy investors but also attract competitors. As competition increases, sustainable growers will need to develop new strategies. Some may invest in new areas for growth, such as additional geographies, customer segments, or adjacent markets—a strategy that could turn them into sustainable supergrowers. Other companies might prefer playing a defensive game by protecting their margins from insurgents. That strategy will slow their growth and turn them into cash generators, which is our next category.

Cash generators

Most companies do not begin as cash generators. Instead, they fall into this category after making stops at one or more of the supergrower or sustainable-grower categories just described. Companies that fit this profile when they crossed the \$100 million revenue threshold include Activision, which merged with Vivendi Games to become Activision Blizzard; Macromedia, which was acquired by Adobe; and Reynolds and Reynolds, which provides vertical software for car dealerships.

For cash generators, growth has stalled, giving them a CAGR under 10 percent. They have little white-space opportunity left, but their margins remain very high because their business has achieved scale and has a sustainable competitive advantage. Since the market has historically valued growth above all for software companies over the past few decades, cash generators have the lowest average TRS of any category (-6 percent).

Typically, cash generators are most likely to thrive if they reinvest cash into the business to find new areas for growth, especially if they take action while margins remain high. If these companies follow inorganic strategies, using their cash for

mergers and acquisitions, they can gain access to new customers that can help fuel growth. They will also see faster results from this strategy than from organic attempts to capture additional market share.

Strugglers

Companies that have stalled growth and low margins are fighting an uphill battle—and their average TRS of –4 percent reflects this. A business can land in this category at any point, including relatively early in its life cycle or after many successful years in the market. Strugglers often succumb to unfavorable macroeconomic trends, increasingly competitive market dynamics, or myriad other issues. Their best option for optimizing value creation typically involves looking for a strategic buyer to provide them with an exit option. If that is not possible, strugglers should create a clear and focused strategy that will help them move into another category, provided that they have the necessary execution capabilities.

Tips for jumping categories

In the end, a company's category depends on both external factors, such as network effects and market dynamics, and internal factors, such as product quality and ability to execute. But the category a company resides in does not necessarily dictate its fate. Once leaders understand where their business fits, they can develop strategies to improve their position within a given category or to make a leap to a more desirable one. Both approaches often involve focusing on a few critical operational levers and making some calculated bets. Consider the approach to customer retention,

for example. A company that is a supergrower at any cost might choose to deemphasize churn mitigation, at least temporarily, preferring to allocate more resources to new-customer acquisition. A cash generator, by contrast, might decide to dedicate more resources to customer success, with the goal of protecting the existing base and exploring new cross-selling and upselling opportunities. Of course, companies must reassess their selected approach if they shift from one category to another.



With the rise of SaaS over the past decade, the “growth-at-all-cost” strategy is often appropriate early in a company's life cycle, especially in a winner-takes-all market where a clear path to profitability involves capturing share. But companies that pursue this strategy must eventually shift their focus to profitability, since growth alone will get them only so far. The secret to success is determining how and when they should make this trade-off. ■

¹ Some companies may have transitioned to different categories since passing the \$100 million revenue threshold.

² Ibid.

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