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Disrupting beliefs: A new approach to business-model innovation

Marc de Jong and Menno van Dijk

In a disruptive age, established business models are under attack. Here's how incumbent companies can reframe them.

Let's face it: business models are less durable than they used to be. The basic rules of the game for creating and capturing economic value were once fixed in place for years, even decades, as companies tried to execute the same business models better than their competitors did. But now, business models are subject to rapid displacement, disruption, and, in extreme cases, outright destruction. Consider a few examples:

- Bitcoin bypasses traditional banks and clearinghouses with blockchain technology.
- Coursera and edX, among others, threaten business schools with massive open online courses (MOOCs).[1]
- Tencent outcompetes in Internet services through microtransactions.
- Uber sidesteps the license system that protects taxicab franchises in cities around the world.

The examples are numerous—and familiar. But what's less familiar is *how*, exactly, new entrants achieve their disruptive power. What

[1] Rich Lyons, "Haas dean confidently predicts demise of business schools," interview by Della Bradshaw, *Financial Times*, April 10, 2015, ft.com.

enables them to skirt constraints and exploit unseen possibilities? In short, what's the *process* of business-model innovation?

For incumbents, this kind of innovation is notoriously hard. Some struggle merely to recognize the possibilities. Others shrink from cannibalizing profit streams. Still others tinker and tweak—but rarely change—the rules of the game. Should it be so difficult for established companies to innovate in their business models? What approach would allow incumbents to overturn the conventions of their industries before others do? Our work with companies in telecommunications, maritime shipping, financial services, and hospitality, among other sectors, suggests that established players *can* disrupt traditional ways of doing business by reframing the constraining beliefs that underlie the prevailing modes of value creation.[2] This article shows how.

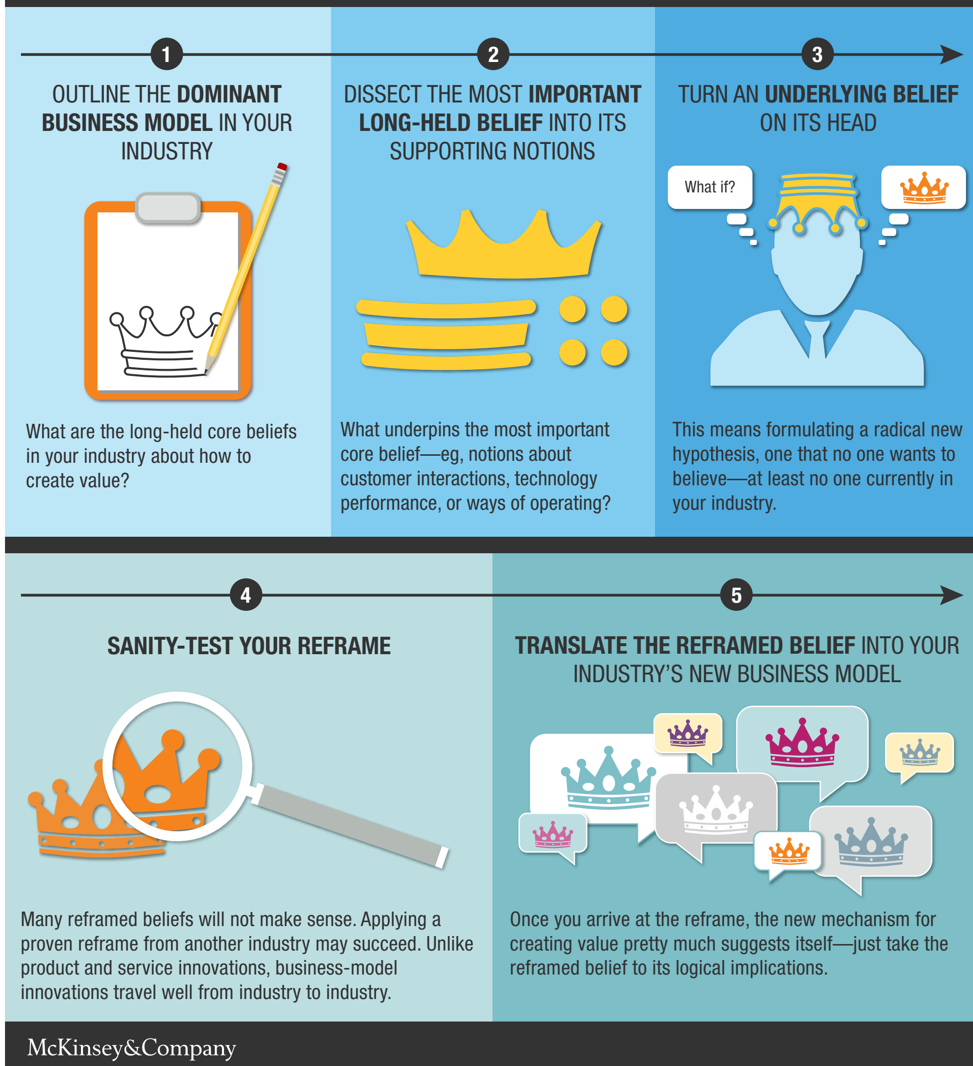
Reframing beliefs

Every industry is built around long-standing, often implicit, beliefs about how to make money. In retail, for example, it's believed that purchasing power and format determine the bottom line. In telecommunications, customer retention and average revenue per user are seen as fundamental. Success in pharmaceuticals is believed to depend on the time needed to obtain approval from the US Food and Drug Administration. Assets and regulations define returns in oil and gas. In the media industry, hits drive profitability. And so on.

These governing beliefs reflect widely shared notions about customer preferences, the role of technology, regulation, cost drivers, and the basis of competition and differentiation. They are often considered inviolable—until someone comes along to violate them. Almost always, it's an attacker from outside the industry. But while new entrants capture the headlines, industry insiders, who often have a clear sense of what drives profitability, are well positioned to play this game, too.

How can incumbents do so? In a nutshell, the process begins with identifying an industry's foremost belief about value creation and then articulating the notions that support this belief. By turning one

[2] For broad application of reframing as a methodology, see Karim Benammar, *Reframing: The art of thinking differently*, Amsterdam: Uitgeverij Boom, 2012.



of these underlying notions on its head—reframing it—incumbents can look for new forms and mechanisms to create value. When this approach works, it's like toppling a stool by pulling one of the legs.

The fuller process and the questions to ask along the way look like this:

1. Outline the dominant business model in your industry. What are the long-held core beliefs about how to create value? For instance, in financial services, scale is regarded as crucial to profitability.

2. Dissect the most important long-held belief into its supporting notions. How do notions about customer needs and interactions, technology, regulation, business economics, and ways of operating underpin the core belief? For instance, financial-services players assume that customers prefer automated, low-cost interfaces requiring scale. Because the IT underpinning financial services has major scale advantages, most of a provider's cost base is fixed. Furthermore, the appropriate level of risk management is possible only beyond a certain size of business.

3. Turn an underlying belief on its head. Formulate a radical new hypothesis, one that no one wants to believe—at least no one currently in your industry. For instance, what if a financial-services provider's IT could be based almost entirely in the cloud, drastically reducing the minimum economic scale? Examples of companies that have turned an industry belief on its head include the following:

- Target: What if people who shopped in discount stores would pay extra for designer products?
- Apple: What if consumers want to buy electronics in stores, even after Dell educated them to prefer direct buying?
- Palantir: What if advanced analytics could replace part of human intelligence?
- Philips Lighting: What if LED technology puts an end to the lighting industry as a replacement business?
- Amazon Web Services: What if you don't need to own infrastructure yourself?
- TSMC: What if you don't need to develop your own process technology or invest in your own infrastructure?
- Amazon Mechanical Turk, TaskRabbit, and Wikipedia: What if you can get stuff done in chunks by accessing a global workforce in small increments?

4. Sanity-test your reframe. Many reframed beliefs will just be nonsense. Applying a reframe that has already proved itself in another industry greatly enhances your prospects of hitting on something that makes business sense. Business-model innovations, unlike product and service ones, travel well from industry to industry: Airbnb inspires Uber inspires Peerby. So look again at the reframes described in step three above. All of them have broad application across industries.

5. Translate the reframed belief into your industry's new business model. Typically, once companies arrive at a reframe, the new mechanism for creating value suggests itself—a new way to interact with customers, organize your operating model, leverage your resources, or capture income. Of course, companies then need to transition from their existing business model to the new one, and that often requires considerable nerve and sophisticated timing.[3]

Four places to reframe

Executives can begin by systematically examining each core element of their business model, which typically comprises customer relationships, key activities, strategic resources, and the economic model's cost structures and revenue streams. Within each of these elements, various business-model innovations are possible. Having analyzed hundreds of core elements across a wide range of industries and geographies, we have found that a reframe seems to emerge for each one, regardless of industry or location. Moreover, these themes have one common denominator: the digitization of business, which upends customer interactions, business activities, the deployment of resources, and economic models.

Innovating in customer relationships: From loyalty to empowerment

Businesses should strive for customer loyalty, right? Loyal customers tell their friends and contacts how good a company is, thereby lowering acquisition costs. Loyal customers stick around longer,

[3] For more about this transition, see Constantinos Markides and Daniel Oyon, "What to do against disruptive business models (When and how to play two games at once)," *MIT Sloan Management Review*, June 26, 2010, sloanreview.mit.edu.

keeping the competition at bay. Loyal customers provide repeat business, a bigger share of wallet, and more useful feedback about problems and opportunities. No wonder companies in so many industries emphasize locking in customers by winning their loyalty.

But the pursuit of loyalty has become more complicated in the digital world. The cost of acquiring new customers has fallen, even without loyalty programs. Customers—empowered by digital tools and extensive peer-reviewed knowledge about products and services—now often do a better job of choosing among buying options than companies do. Switching costs are low. Most significant, the former passivity of customers has been superseded by a desire to fulfill their own talents and express their own ideas, feelings, and thoughts. As a result, they may interpret efforts to win their loyalty as obstacles to self-actualization.

Instead of fighting that trend, why shouldn't companies embrace the paradox that goes with it: the best way to retain customers is to set them free. The invention company Quirky, for example, lets the ideas and votes of its online community guide the products it designs and produces. MakerLabs, an interactive design–build collective, provides its members with the tools and expertise they need to build what they want.

Established companies can also make the switch from loyalty to empowerment. Consider the pension and insurance industry, long governed by the belief that complex investment decisions are best made by experts (companies or intermediary financial advisers) on behalf of account holders. A multinational insurance and pension provider reframed that belief by proposing the opposite: what if customers preferred to make their own investment decisions, even if they didn't have the credentials of investment professionals? The company now provides customers with web-based investment information and decision-making tools, along with appropriate risk warnings. These enable customers to invest a percentage of their funds directly in businesses of their choice. This effort is in its early days, but customer pick-up and the profitability of products are promising.

Innovating in activities: From efficient to intelligent

One of the most dominant beliefs governing today's big companies is that improving efficiency is the most reliable way to increase profits. Especially if market requirements change only gradually, companies have plenty of time to minimize the production costs of their existing products. Today, of course, constant efficiency improvements are a prerequisite for a healthy bottom line.

They may be necessary, but they're not sufficient. In today's rapidly changing markets, many products become obsolete before they have been "leaned out," so managers get less time to optimize production processes fully. Companies are therefore building flexibility and embedded intelligence directly into the production process to help them adapt quickly to changing needs. Embedded intelligence can, over time, help companies to improve both the performance and the value-in-use of products and services and thus to improve their pricing. In essence, digitization is empowering businesses to go beyond efficiency, to create learning systems that work harder *and* smarter.

Consider how a web-based global hotel-booking platform used quick feedback cycles to reframe the focus of its business model from efficiency to user satisfaction, thereby opening new revenue opportunities. The hotel-booking industry's central belief has been that success depends on two things: negotiating power with hotels and a reliable web interface for customers. The company reframed this dominant belief by asking if customers booking a hotel room might look for more than convenience, speed, and price. It tested this reframe through a series of iterations to its website. Even minor changes—such as the use of photographs, a warmer (or sometimes cooler) tone for the site's text, and the inclusion of testimonials from happy customers—raised the click-through rate. This insight confirmed the reframe: a booking site is more than just a functional service; it can also become an engaging customer experience.

As a result, the company has integrated constant feedback loops and daily experiments into its key activities, creating a true learning system. Now it improves and adjusts its site daily to boost customer engagement and increase revenue. It may well be on its way to becoming the industry's global standard.

Innovating in resources: From ownership to access

One widespread premise in business is that companies compete by owning the assets that matter most to their strategy. Competitive advantage, according to this belief, comes from owning valuable assets and resources, which tend to be scarce and utilized over long time periods, as well as firm and location specific. Thus ownership (rather than, say, leasing) frequently appears to be the best way to ensure exclusive access.

But what if assets are used infrequently or inconsistently? In these cases, digital technology, by increasing transparency and reducing search and transaction costs, is enabling new and better value-creating models of collaborative consumption. As a result, ownership may become an inferior way to access key assets, increasingly replaced by flexible win-win commercial arrangements with partners. On the consumer side, the examples include Peerby, an app that allows neighbors to share tools and other household items that would otherwise sit idle in garages, and Uber, which allows any driver with a qualified vehicle to provide taxi service. House- and room-sharing programs apply the same thinking to underused real estate. In every case, consumers opt to access rather than own these assets.

Big companies are following suit—for example, by reducing sourcing costs through "cradle-to-cradle" approaches that collect and repurpose what they previously considered waste.[4] Instead of buying (and thus owning) the raw materials needed for products, companies access these materials in previously sold products and repurpose them. Similarly, the global sourcing firm Li & Fung limits risk, increases efficiency, and enhances flexibility by using broad networks focused on access to (rather than majority ownership of) suppliers. The software maker Adobe Systems no longer licenses new versions of its products to customers through one-time sales; instead it provides access to them through monthly subscriptions. (For more on Adobe's transition to its new business model, see "Reborn in the cloud," on mckinsey.com.)

The move from ownership to access mirrors a more broadly evolving societal mind-set toward open-source models. For example, in 2014 the electric-vehicle company Tesla made all of its intellectual-

[4] See Hanh Nguyen, Martin Stuchtey, and Markus Zils, "Remaking the industrial economy," *McKinsey Quarterly*, February 2014, mckinsey.com.

property patents freely available in an effort to encourage the manufacture of clean vehicles.

These possibilities penetrate deeply into traditional industries. Consider how a big European maritime port embarked on a large-scale land-management program. The industry belief reframed by the port was that large liquid-bulk-load ships valued private access to storage tanks. The underlying assumption was that shipping companies wanted the ability to deliver their bulk loads anytime and therefore required entry to their tanks at close range.

In response to this perceived need, most maritime ports have developed jetties to which they provide individual shipping companies private access—essentially the equivalent of "ownership." As a result of each company's varying schedules and traffic, many jetties ended up being mostly unused, but others weren't sufficient for peak times. Seeing this problem, the port's management reframed the industry belief by asking if customers cared more about access on demand than exclusivity. The port now intends to help all customers use any jetty to access any fuel tank, by developing a common-carrier pipe connecting them. Just as Peerby in effect shifts a neighborhood's "business model" by increasing the utilization of underused assets, so the maritime port is making more of underutilized jetties and storage tanks by shifting the business model so that shipping companies pay for access to jetties and storage rather than the exclusive use of them. In the future, this model may evolve into a dynamic multi-user slot-booking system that matches the real-time availability of jetties with demand for liquid-bulk-carrier ships.

Innovating in costs: From low cost to no cost

According to historian Peter Watson, humans have been trading goods and services for more than 150,000 years. During that time, we've always believed that to sell more of an offering you had to produce more of it. The underlying notion was that a single unit of a given product or service could be used only by one customer at a time. Any increase in production therefore required a commensurate increase in labor, resources, and equipment. While volume advantages did translate into lower average costs per unit, economies of scale could never get the average cost down to zero.

Digitization is reframing this ancient belief in powerfully disruptive ways. In fact, of all the reframes discussed here, this one has had the most devastating effect, since it can destroy entire industries. What's driving prices to zero is the reframe that multiple customers can simultaneously use digital goods, which can be replicated at zero marginal cost. Massive open online courses, for example, provide a nearly zero-marginal-cost education.

Consider the implications for telecommunications, where the dominant belief has been that value is best captured through economies of scale—the more telephone minutes sold, the lower the unit cost. As a result, the larger the mobile-phone plan, the lower the cost per minute. One telecommunications company is upending this belief by making customers an "all you can eat" offer. It realized that unlimited use of voice and texting units comes at no additional cost to itself, so it can compete against emerging voice-over-IP competitors. As a result, the telco started to offer unlimited texting and voice plans by focusing its economic model on making money from data usage and from its investments in a huge data network and storage capacity. Such plans eliminate confusion among customers and increase their satisfaction. As soon as the network has reached its planned return on investment, incremental data service will also be free.

Big companies have traditionally struggled to innovate in their business models, even as digital technology has brought business-model innovation to the forefront of the corporate agenda. Yet big companies can be disruptive, too, if they identify and overcome common but limiting orthodoxies about how to do business.

The authors wish to thank Karim Benammar, Berend-Jan Hilberts, and Saskia Rotshuizen for their contributions to this article.

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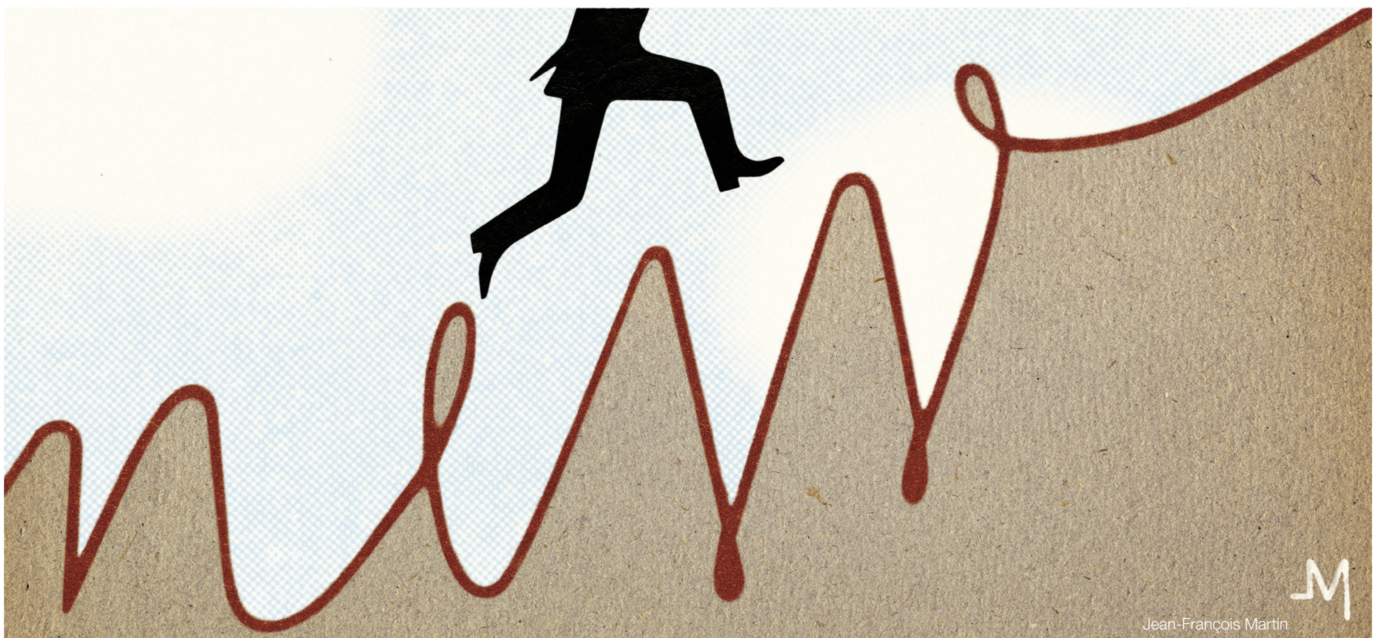
Growing beyond the core business

Most companies are seeking growth outside their core business, according to a new survey. But few have made revenue gains as a result—or have the right capabilities to support it.

A clear majority of executives say their companies are pursuing growth in categories outside their core business—and report a strong belief that doing so has created company value. But a McKinsey Global Survey suggests that over time, companies' aspirations to grow through these activities have produced only modest results and that few companies have the right practices in place to support such growth.[1]

These are the key findings from a survey on how companies expand into product or service categories beyond their core business. Nearly nine in ten respondents say that in the past five years, their companies have either pursued at least one activity in a new category, have considered it, or plan to do so in the next five years. Companies are most likely to pursue new activities through investments in organic growth and with long-term interests in mind. Executives at emerging-economy companies report greater paybacks than their peers at developed-economy firms—but few respondents overall say that over time, the activities have added much to company revenues. This could be because, according to the results, there's much room for improvement in the ways that many companies identify and evaluate new opportunities.



Significant value at stake—and modest results

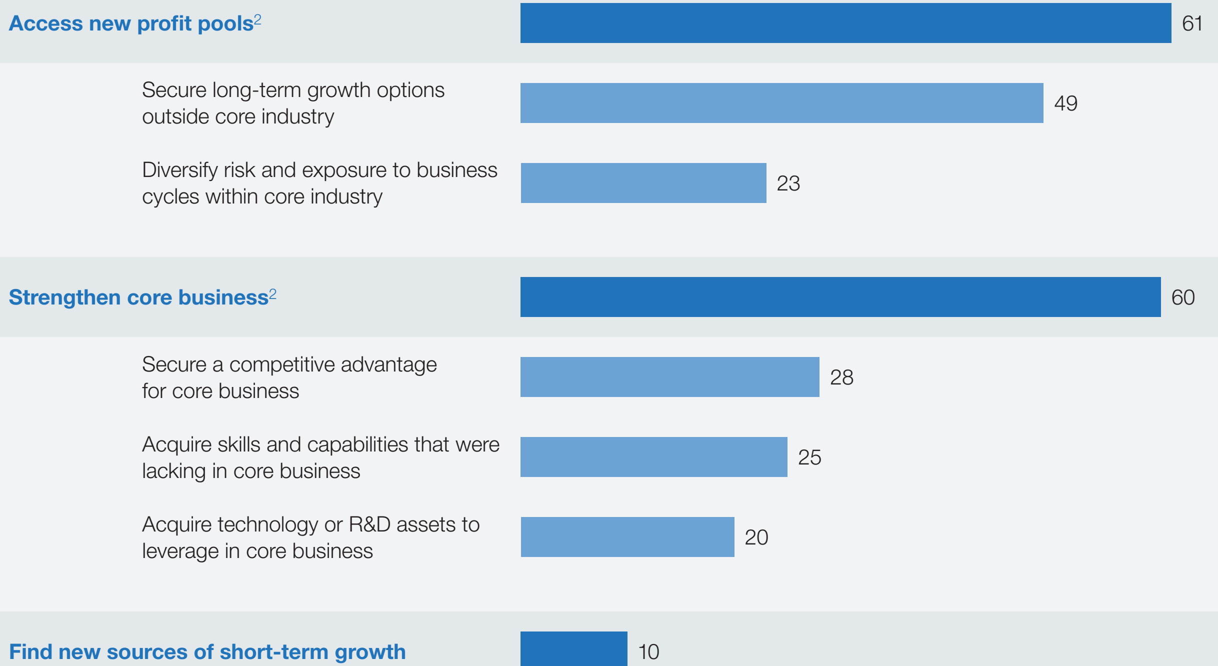
At most companies, pursuing growth in new product or service categories outside the core is already on the agenda. Three-quarters of respondents say that over the past five years, their companies have pursued at least one business activity in a new category. Another 14 percent say their companies have either considered pursuing this growth or plan to do so in the next five years.

For many of these companies, growth beyond their core business is a long-term play. Among C-suite executives (who respondents most often say are responsible for evaluating these opportunities), only one in ten say their companies consider new activities for short-term returns. C-level respondents also say their companies are equally likely to consider such a move to access new profit pools as to strengthen their core business (Exhibit 1).

Exhibit 1

Companies pursue new activities both to access new profit pools and to strengthen their core business.

% of C-level respondents,[1] n = 273



[1]Respondents who answered "other" or "don't know" are not shown.
[2]These figures reflect the aggregation and recalculation of responses on the individual factors that follow.

No matter the reason, though, few executives report significant top-line results over time from diversifying activities. Only one-third of all respondents say their companies' moves beyond the core generate more than 10 percent of their revenues today. The share of revenues increases with the number of activities that companies pursue. But even at firms that are active in more than ten product or service categories, 35 percent of executives say these activities make up more than 10 percent of revenue. What's more, when asked about the biggest revenue-generating activity of the past five years, respondents most often say this move has created just some financial value for their companies.[2]

The emerging-economy advantage

At the same time, executives also report notable differences in the value that developed-economy and emerging-economy companies see from these growth activities beyond the core. At companies based in emerging economies, respondents are about 1.4 times more likely than their developed-economy peers to say their biggest move in a new category has created significant value for their companies—likely due to structural advantages in their home markets (Exhibit 2).

Exhibit 2

At diversified companies in emerging markets, executives report that structural advantages help them create value.

% of respondents at emerging-economy companies, n = 149

If your company were to pursue a new activity beyond its core business, in what ways would your home market give you an advantage over companies based in developed markets that are also pursuing new activities?[1]

[1]Respondents who answered "don't know" are not shown. This question was asked only of respondents who work at companies that are headquartered in emerging economies.

When asked what gives their companies a distinctive advantage over those based in developed economies, emerging-economy respondents most often cite greater opportunities to reinvest retained earnings in new businesses—easier to do than in developed economies, where relative growth is much slower—and a greater ability to leverage their local knowledge and relationships.

Best practices for expanding beyond the core business

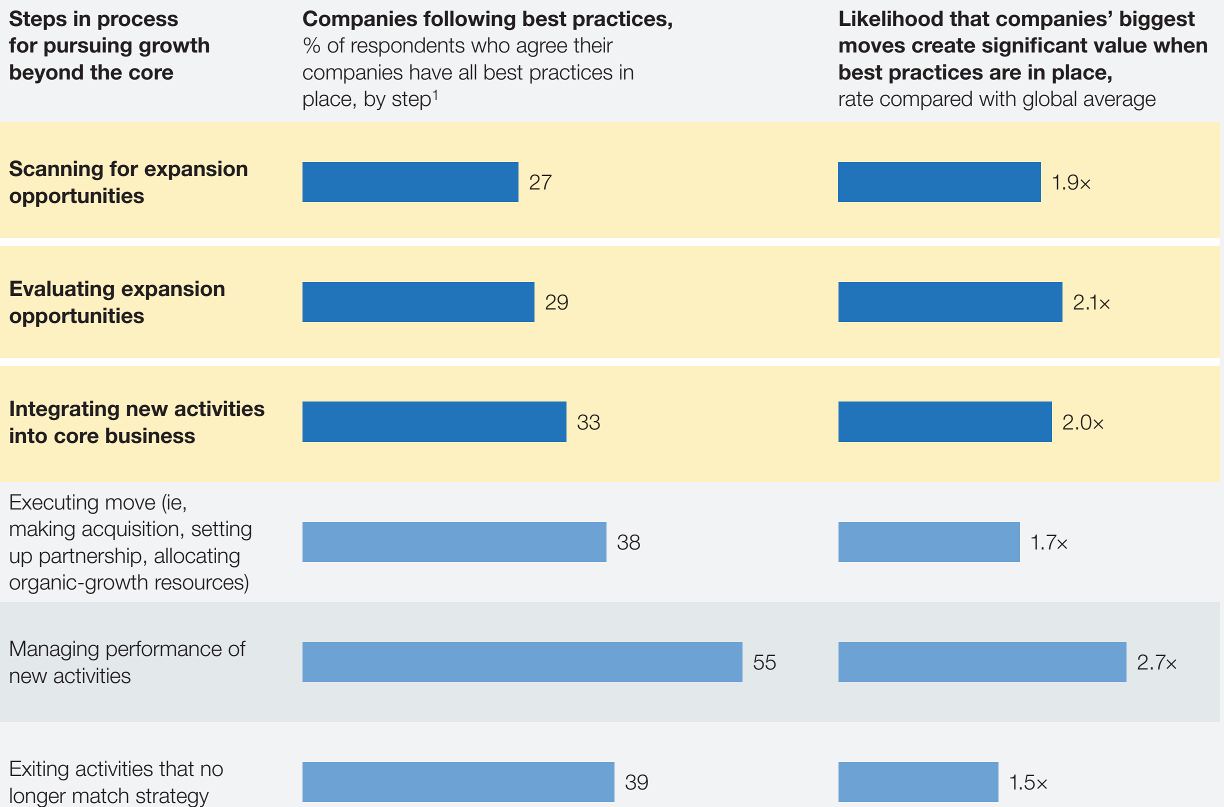
Across regions, respondents at emerging-economy and developed-economy firms agree on the approaches their companies use to grow in new areas: investments in organic growth are cited most often by both groups, followed by mergers and acquisitions.[3] Both groups are likeliest to identify their executive teams and boards as the ones responsible for evaluating opportunities in new categories. There is also consensus among both groups that new activities shouldn't stray too far from the core business. When assessing a move's value potential, nearly two-thirds of all respondents say unique links between the activity and the existing business are the most important criteria their companies consider.

When asked about different steps in the process of pursuing growth in new categories,[4] few executives say their companies follow the best practices that make this growth successful. According to executives, firms most often struggle to scan for new opportunities, evaluate those opportunities, and integrate new activities into the core business (Exhibit 3). But respondents at companies that get the practices right are much likelier than others—about twice as likely for each of these three steps—to report that their biggest move in the past five years has created significant company value.

Respondents whose companies follow best practices for scanning, evaluating, or integrating new activities into the core business are twice as likely as others to report significant value creation from diversifying.

Exhibit 3

Most companies lack best practices to expand beyond their core business, especially when scanning, evaluating, and integrating new opportunities.



[1]Includes respondents who "agree" or "strongly agree" that the practices describe their companies. Those who answered "somewhat agree," "somewhat disagree," "disagree," "strongly disagree," or "don't know/not applicable" are not included.

More specifically, the responses in these three areas (scanning, evaluation, and integration) suggest which individual practices link most closely to value creation. When executives say their companies have a clear strategy for expanding into new activities, for example, they are four times more likely than those whose companies have no such strategy to report significant value creation (Exhibit 4). With respect to managing new activities, respondents are also four times more likely to report value creation when their companies actively and regularly review the performance of these activities.

Exhibit 4

Best practices for scanning, evaluating, and integrating growth opportunities beyond the core can drive significant value.

Total n = 666, by use or nonuse of best practice

[1]Includes respondents who "agree" or "strongly agree." Those who answered "somewhat agree" or "don't know/not applicable" are not included.
[2]Includes respondents who "disagree" or "strongly disagree." Those who answered "somewhat disagree" or "don't know/not applicable" are not included.

Looking ahead

- *Understand the market context.* The results indicate that a company's opportunity to grow successfully beyond its core business differs across regions, with respondents reporting that growth in new categories pays off more in emerging economies than in developed economies. We have also seen that diversifying activities can benefit companies in some industries more than others. For companies looking to expand into new activities, it's important to understand first the extent to which growth beyond the core in their region and industry is either an opportunity or a risk.

- *Find growth close to home.* When asked about the criteria their companies use to assess a new activity's potential value, the largest share of executives say unique links between the activity and the core business are most important. Companies would do well to follow suit and start identifying growth opportunities that are close to home—in other words, ideas or opportunities where they can leverage existing capabilities and skills in their core business.

- *Build the right capabilities.* Most respondents report that their companies lack the capabilities (or even a clear strategy) to grow beyond the core, so it's no wonder that most companies see only modest contributions to revenue as a result of such activities. However, companies with the capabilities to scan, evaluate, and integrate opportunities have a much higher chance to create value with these moves. When planning to pursue new opportunities outside of their core business, leaders should assess their companies' capabilities to make sure the right processes and practices are in place to maximize the value that new activities can add. ■

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[1] The online survey was in the field from November 4 to November 14, 2014 and garnered responses from 1,143 executives at companies with annual revenues of $500 million or more, representing the full range of regions, industries, functional specialties, and tenures. Of them, 904 executives say their companies have either pursued or considered pursuing growth in a new product or service category, beyond their companies' core business, in the past five years. To adjust for differences in response rates, the data are weighted by the contribution of each respondent's nation to global GDP.

[2] The largest share (49 percent) of respondents say the biggest revenue-generating move has created some financial value; 28 percent say the move has created significant financial value, 9 percent say it had no effect, 8 percent say it destroyed some value, and 2 percent say it destroyed significant value.

[3] We also asked about joint ventures, which 37 percent of respondents cite as an approach their companies have taken to grow beyond their core business.

[4] The steps are: scanning for new opportunities, evaluating opportunities, executing the growth move, integrating new activities into the business, managing the performance of new activities, and exiting activities when they no longer match the strategy.

The contributors to the development and analysis of this survey include **Francisco Caudillo,** a specialist in McKinsey's Miami office; **Skief Houben,** an associate principal in the Amsterdam office; and **JehanZeb Noor,** a principal in the Chicago office.

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The eight essentials of innovation

Marc de Jong, Nathan Marston, and Erik Roth

Strategic and organizational factors are what separate successful big-company innovators from the rest of the field.

It's no secret: innovation is difficult for well-established companies. By and large, they are better executors than innovators, and most succeed less through game-changing creativity than by optimizing their existing businesses.

Yet hard as it is for such organizations to innovate, large ones as diverse as Alcoa, the Discovery Group, and NASA's Ames Research Center are actually doing so. What can other companies learn from their approaches and attributes? That question formed the core of a multiyear study comprising in-depth interviews, workshops, and surveys of more than 2,500 executives in over 300 companies, including both performance leaders and laggards, in a broad set of industries and countries (Exhibit 1). What we found were a set of eight essential attributes that are present, either in part or in full, at every big company that's a high performer in product, process, or business-model innovation.

Since innovation is a complex, company-wide endeavor, it requires a set of crosscutting practices and processes to structure, organize, and encourage it. Taken together, the essentials described in this article constitute just such an operating system, as seen in Exhibit 2. These often overlapping, iterative, and nonsequential practices resist systematic categorization but can nonetheless be thought of in two groups. The first four, which are strategic and creative

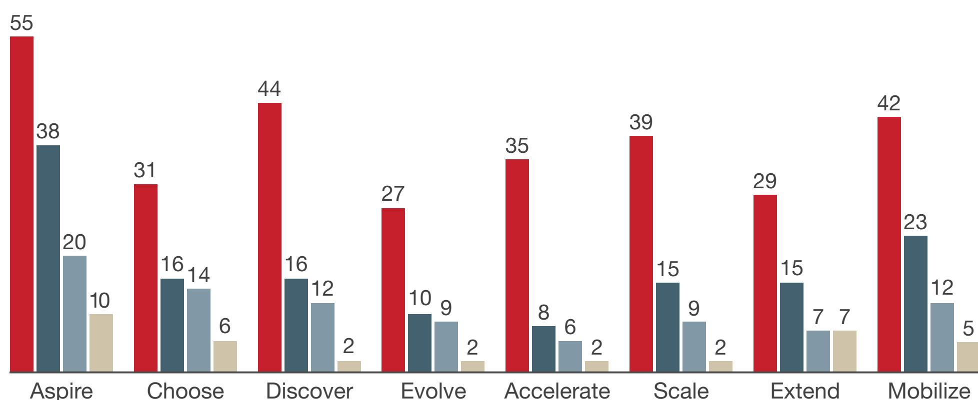
in nature, help set and prioritize the terms and conditions under which innovation is more likely to thrive. The next four essentials deal with how to deliver and organize for innovation repeatedly over time and with enough value to contribute meaningfully to overall performance.

To be sure, there's no proven formula for success, particularly when it comes to innovation. While our years of client-service experience provide strong indicators for the existence of a causal relationship between the attributes that survey respondents reported and the innovations of the companies we studied, the statistics described here can only *prove* correlation. Yet we firmly believe

Exhibit 1

What innovation leaders say they do right

% of respondents by perfomance quartile[1]



[1]N = 623. Performance defined as a weighted index of measures for organic growth (% of growth from new products or services developed in-house) and innovation performance (% of sales from new products and self-assessment of innovation performance). Respondents who answered "yes to some degree," "no," or "don't know/not applicable" are not shown.

Source: McKinsey survey of 2,500 global executives, Nov 2012

that if companies assimilate and apply these essentials—in their own way, in accordance with their particular context, capabilities, organizational culture, and appetite for risk—they will improve the likelihood that they, too, can rekindle the lost spark of innovation. In the digital age, the pace of change has gone into hyperspeed, so companies must get these strategic, creative, executional, and organizational factors right to innovate successfully.

Exhibit 2

Testing for innovation

	Do you really innovate?	Underlying elements
Aspire	Do you regard innovation-led growth as critical, and do you have cascaded targets that reflect this?	• Innovation vision and model • Required growth contribution from innovation • Cascaded targets and accountabilities
Choose	Do you invest in a coherent, time- and risk-balanced portfolio of initiatives with sufficient resources to win?	• Clarity of innovation themes • Portfolio balancing time and risk • Resources sufficient for initiatives to win • Portfolio governance
Discover	Do you have differentiated business, market, and technology insights that translate into winning value propositions?	• Customer orientation • Multiple-lens insight generation • Differentiated value proposition
Evolve	Do you create new business models that provide defensible and scalable profit sources?	• Exploration of new business models • Changing value-chain economics • Diversifying profit streams • Delivery-model changes and new customer groups
Accelerate	Do you beat the competition by developing and launching innovations quickly and effectively?	• Planning and execution rigor • Cross-functional project culture • Customer- and market-based learning
Scale	Do you launch innovations at the right scale in the relevant markets and segments?	• Go-to-market planning • Launch management • Operations ramp-up
Extend	Do you win by creating and capitalizing on external networks?	• Strategic external networks • Collaboration skills • Partner of choice
Mobilize	Are your people motivated, rewarded, and organized to innovate repeatedly?	• People priorities • Enabling structure • Supportive culture • Learning and adaptive organization

Source: McKinsey analysis

Aspire

President John F. Kennedy's bold aspiration, in 1962, to "go to the moon in this decade" motivated a nation to unprecedented levels of innovation. A far-reaching vision can be a compelling catalyst, provided it's realistic enough to stimulate action today.

But in a corporate setting, as many CEOs have discovered, even the most inspiring words often are insufficient, no matter how many times they are repeated. It helps to combine high-level aspirations with estimates of the value that innovation should generate to meet financial-growth objectives. Quantifying an "innovation target for growth," and making it an explicit part of future strategic plans, helps solidify the importance of and accountability for innovation. The target itself must be large enough to force managers to include innovation investments in their business plans. If they can make their numbers using other, less risky tactics, our experience suggests that they (quite rationally) will.

Establishing a quantitative innovation aspiration is not enough, however. The target value needs to be apportioned to relevant business "owners" and cascaded down to their organizations in the form of performance targets and timelines. Anything less risks encouraging inaction or the belief that innovation is someone else's job.

For example, Lantmännen, a big Nordic agricultural cooperative, was challenged by flat organic growth and directionless innovation. Top executives created an aspirational vision and strategic plan linked to financial targets: 6 percent growth in the core business and 2 percent growth in new organic ventures. To encourage innovation projects, these quantitative targets were cascaded down to business units and, ultimately, to product groups. During the development of each innovation project, it had to show how it was helping to achieve the growth targets for its category and markets. As a result, Lantmännen went from 4 percent to 13 percent annual growth, underpinned by the successful launch of several new brands. Indeed, it became the market leader in premade food only four years after entry and created a new premium segment in this market.

Such performance parameters can seem painful to managers more accustomed to the traditional approach. In our experience, though, CEOs are likely just going through the motions if they don't use evaluations and remuneration to assess and recognize the contribution that all top managers make to innovation.

Choose

Fresh, creative insights are invaluable, but in our experience many companies run into difficulty less from a scarcity of new ideas than from the struggle to determine *which* ideas to support and scale. At bigger companies, this can be particularly problematic during market discontinuities, when supporting the next wave of growth may seem too risky, at least until competitive dynamics force painful changes.

Innovation *is* inherently risky, to be sure, and getting the most from a portfolio of innovation initiatives is more about managing risk than eliminating it. Since no one knows exactly where valuable innovations will emerge, and searching everywhere is impractical, executives must create some boundary conditions for the opportunity spaces they want to explore. The process of identifying and bounding these spaces can run the gamut from intuitive visions of the future to carefully scrutinized strategic analyses. Thoughtfully prioritizing these spaces also allows companies to assess whether they have enough investment behind their most valuable opportunities.

During this process, companies should set in motion more projects than they will ultimately be able to finance, which makes it easier to kill those that prove less promising. RELX Group, for example, runs 10 to 15 experiments per major customer segment, each funded with a preliminary budget of around $200,000, through its innovation pipeline every year, choosing subsequently to invest more significant funds in one or two of them, and dropping the rest. "One of the hardest things to figure out is when to kill something," says Kumsal Bayazit, RELX Group's chief strategy officer. "It's a heck of a lot easier if you have a portfolio of ideas."

Once the opportunities are defined, companies need transparency into what people are working on and a governance process that

constantly assesses not only the expected value, timing, and risk of the initiatives in the portfolio but also its overall composition. There's no single mix that's universally right. Most established companies err on the side of overloading their innovation pipelines with relatively safe, short-term, and incremental projects that have little chance of realizing their growth targets or staying within their risk parameters. Some spread themselves thinly across too many projects instead of focusing on those with the highest potential for success and resourcing them to win.

These tendencies get reinforced by a sluggish resource-reallocation process. Our research shows that a company typically reallocates only a tiny fraction of its resources from year to year, thereby sentencing innovation to a stagnating march of incrementalism.[1]

Discover

Innovation also requires actionable and differentiated insights—the kind that excite customers and bring new categories and markets into being. How do companies develop them? Genius is always an appealing approach, if you have or can get it. Fortunately, innovation yields to other approaches besides exceptional creativity.

The rest of us can look for insights by methodically and systematically scrutinizing three areas: a valuable problem to solve, a technology that enables a solution, and a business model that generates money from it. You could argue that nearly every successful innovation occurs at the intersection of these three elements. Companies that effectively collect, synthesize, and "collide" them stand the highest probability of success. "If you get the sweet spot of what the customer is struggling with, and at the same time get a deeper knowledge of the new technologies coming along and find a mechanism for how these two things can come together, then you are going to get good returns," says Alcoa chairman and chief executive Klaus Kleinfeld.

[1] See Stephen Hall, Dan Lovallo, and Reinier Musters, "How to put your money where your strategy is," *McKinsey Quarterly*, March 2012; and Vanessa Chan, Marc de Jong, and Vidyadhar Ranade, "Finding the sweet spot for allocating innovation resources," *McKinsey Quarterly*, May 2014, both available on mckinsey.com.

The insight-discovery process, which extends beyond a company's boundaries to include insight-generating partnerships, is the lifeblood of innovation. We won't belabor the matter here, though, because it's already the subject of countless articles and books.[2] One thing we can add is that discovery is iterative, and the active use of prototypes can help companies continue to learn as they develop, test, validate, and refine their innovations. Moreover, we firmly believe that without a fully developed innovation *system* encompassing the other elements described in this article, large organizations probably won't innovate successfully, no matter how effective their insight-generation process is.

Evolve

Business-model innovations—which change the economics of the value chain, diversify profit streams, and/or modify delivery models—have always been a vital part of a strong innovation portfolio. As smartphones and mobile apps threaten to upend old-line industries, business-model innovation has become all the more urgent: established companies must reinvent their businesses before technology-driven upstarts do. Why, then, do most innovation systems so squarely emphasize new products? The reason, of course, is that most big companies are reluctant to risk tampering with their core business model until it's visibly under threat. At that point, they can only hope it's not too late.

Leading companies combat this troubling tendency in a number of ways. They up their game in market intelligence, the better to separate signal from noise. They establish funding vehicles for new businesses that don't fit into the current structure. They constantly reevaluate their position in the value chain, carefully considering business models that might deliver value to priority groups of new customers. They sponsor pilot projects and experiments away from the core business to help combat narrow conceptions of what they are and do. And they stress-test newly emerging value propositions and operating models against countermoves by competitors.

[2] See, for example, Marla M. Capozzi, Reneé Dye, and Amy Howe, "Sparking creativity in teams: An executive's guide," *McKinsey Quarterly*, April 2011; and Marla M. Capozzi, John Horn, and Ari Kellen, "Battle-test your innovation strategy," *McKinsey Quarterly*, December 2012, both available on mckinsey.com.

Amazon does a particularly strong job extending itself into new business models by addressing the emerging needs of its customers and suppliers. In fact, it has included many of its suppliers in its customer base by offering them an increasingly wide range of services, from hosted computing to warehouse management. Another strong performer, the *Financial Times*, was already experimenting with its business model in response to the increasing digitalization of media when, in 2007, it launched an innovative subscription model, upending its relationship with advertisers and readers. “We went against the received wisdom of popular strategies at the time,” says Caspar de Bono, *FT* board member and managing director of B2B. “We were very deliberate in getting ahead of the emerging structural change, and the decisions turned out to be very successful.” In print’s heyday, 80 percent of the *FT*’s revenue came from print advertising. Now, more than half of it comes from content, and two-thirds of circulation comes from digital subscriptions.

Accelerate

Virulent antibodies undermine innovation at many large companies. Cautious governance processes make it easy for stifling bureaucracies in marketing, legal, IT, and other functions to find reasons to halt or slow approvals. Too often, companies simply get in the way of their own attempts to innovate. A surprising number of impressive innovations from companies were actually the fruit of their mavericks, who succeeded in bypassing their early-approval processes. Clearly, there’s a balance to be maintained: bureaucracy must be held in check, yet the rush to market should not undermine the cross-functional collaboration, continuous learning cycles, and clear decision pathways that help enable innovation. Are managers with the right knowledge, skills, and experience making the crucial decisions in a timely manner, so that innovation continually moves through an organization in a way that creates and maintains competitive advantage, without exposing a company to unnecessary risk?

Companies also thrive by testing their promising ideas with customers early in the process, before internal forces impose modifications that blur the original value proposition. To end up with the innovation initially envisioned, it’s necessary to knock

down the barriers that stand between a great idea and the end user. Companies need a well-connected manager to take charge of a project and be responsible for the budget, time to market, and key specifications—a person who can say yes rather than no. In addition, the project team needs to be cross-functional in reality, not just on paper. This means locating its members in a single place and ensuring that they give the project a significant amount of their time (at least half) to support a culture that puts the innovation project's success above the success of each function.

Cross-functional collaboration can help ensure end-user involvement throughout the development process. At many companies, marketing's role is to champion the interests of end users as development teams evolve products and to help ensure that the final result is what everyone first envisioned. But this responsibility is honored more often in the breach than in the observance. Other companies, meanwhile, rationalize that consumers don't necessarily know what they want until it becomes available. This may be true, but customers can certainly say what they *don't* like. And the more quickly and frequently a project team gets—and uses—feedback, the more quickly it gets a great end result.

Scale

Some ideas, such as luxury goods and many smartphone apps, are destined for niche markets. Others, like social networks, work at global scale. Explicitly considering the appropriate magnitude and reach of a given idea is important to ensuring that the right resources and risks are involved in pursuing it. The seemingly safer option of scaling up over time can be a death sentence. Resources and capabilities must be marshaled to make sure a new product or service can be delivered quickly at the desired volume and quality. Manufacturing facilities, suppliers, distributors, and others must be prepared to execute a rapid and full rollout.

For example, when TomTom launched its first touch-screen navigational device, in 2004, the product flew off the shelves. By 2006, TomTom's line of portable navigation devices reached sales of about 5 million units a year, and by 2008, yearly volume had jumped to more than 12 million. "That's faster market penetration than mobile phones" had, says Harold Goddijn, TomTom's CEO and

cofounder. While TomTom's initial accomplishment lay in combining a well-defined consumer problem with widely available technology components, rapid scaling was vital to the product's continuing success. "We doubled down on managing our cash, our operations, maintaining quality, all the parts of the iceberg no one sees," Goddijn adds. "We were hugely well organized."

Extend

In the space of only a few years, companies in nearly every sector have conceded that innovation requires external collaborators. Flows of talent and knowledge increasingly transcend company and geographic boundaries. Successful innovators achieve significant multiples for every dollar invested in innovation by accessing the skills and talents of others. In this way, they speed up innovation and uncover new ways to create value for their customers and ecosystem partners.

Smart collaboration with external partners, though, goes beyond merely sourcing new ideas and insights; it can involve sharing costs and finding faster routes to market. Famously, the components of Apple's first iPod were developed almost entirely outside the company; by efficiently managing these external partnerships, Apple was able to move from initial concept to marketable product in only nine months. NASA's Ames Research Center teams up not just with international partners—launching joint satellites with nations as diverse as Lithuania, Saudi Arabia, and Sweden—but also with emerging companies, such as SpaceX.

High-performing innovators work hard to develop the ecosystems that help deliver these benefits. Indeed, they strive to become partners of choice, increasing the likelihood that the best ideas and people will come their way. That requires a systematic approach. First, these companies find out which partners they are already working with; surprisingly few companies know this. Then they decide which networks—say, four or five of them—they ideally need to support their innovation strategies. This step helps them to narrow and focus their collaboration efforts and to manage the flow of possibilities from outside the company. Strong innovators also regularly review their networks, extending and pruning them as appropriate and using sophisticated incentives and contractual

structures to motivate high-performing business partners. Becoming a true partner of choice is, among other things, about clarifying what a partnership can offer the junior member: brand, reach, or access, perhaps. It is also about behavior. Partners of choice are fair and transparent in their dealings.

Moreover, companies that make the most of external networks have a good idea of what's most useful at which stages of the innovation process. In general, they cast a relatively wide net in the early going. But as they come closer to commercializing a new product or service, they become narrower and more specific in their sourcing, since by then the new offering's design is relatively set.

Mobilize

How do leading companies stimulate, encourage, support, and reward innovative behavior and thinking among the right groups of people? The best companies find ways to embed innovation into the fibers of their culture, from the core to the periphery.

They start back where we began: with aspirations that forge tight connections among innovation, strategy, and performance. When a company sets financial targets for innovation and defines market spaces, minds become far more focused. As those aspirations come to life through individual projects across the company, innovation leaders clarify responsibilities using the appropriate incentives and rewards.

The Discovery Group, for example, is upending the medical and life-insurance industries in its native South Africa and also has operations in the United Kingdom, the United States, and China, among other locations. Innovation is a standard measure in the company's semiannual divisional scorecards—a process that helps mobilize the organization and affects roughly 1,000 of the company's business leaders. “They are all required to innovate every year,” Discovery founder and CEO Adrian Gore says of the company's business leaders. “They have no choice.”

Organizational changes may be necessary, not because structural silver bullets exist—we've looked hard for them and don't think they do—but rather to promote collaboration, learning, and experimentation. Companies must help people to share ideas and

knowledge freely, perhaps by locating teams working on different types of innovation in the same place, reviewing the structure of project teams to make sure they always have new blood, ensuring that lessons learned from success and failure are captured and assimilated, and recognizing innovation efforts even when they fall short of success.

Internal collaboration and experimentation can take years to establish, particularly in large, mature companies with strong cultures and ways of working that, in other respects, may have served them well. Some companies set up "innovation garages" where small groups can work on important projects unconstrained by the normal working environment while building new ways of working that can be scaled up and absorbed into the larger organization. NASA, for example, has ten field centers. But the space agency relies on the Ames Research Center, in Silicon Valley, to maintain what its former director, Dr. Pete Worden, calls "the character of rebels" to function as "a laboratory that's part of a much larger organization."

Big companies do not easily reinvent themselves as leading innovators. Too many fixed routines and cultural factors can get in the way. For those that do make the attempt, innovation excellence is often built in a multiyear effort that touches most, if not all, parts of the organization. Our experience and research suggest that any company looking to make this journey will maximize its probability of success by closely studying and appropriately assimilating the leading practices of high-performing innovators. Taken together, these form an essential operating system for innovation within a company's organizational structure and culture.

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The **granularity** of growth

A fine-grained approach to growth is essential for making the right choices about where to compete.

Mehrdad Baghai, Sven Smit, and S. Patrick Viguerie

What are the sources of corporate growth? If, like many executives, you take an average view of markets, the answers may surprise you: averaging out the different growth rates in an industry's segments and subsegments can produce a misleading view of its growth prospects. Most so-called growth industries, such as high tech, include subindustries or segments that are not growing at all, while relatively mature industries, such as European telecommunications, often have segments that are growing rapidly. Broad terms such as "growth industry" and "mature industry," while time honored and convenient, can prove imprecise or even downright wrong upon closer analysis.

Our research on the revenue growth of large companies suggests that executives should "de-average" their view of markets and develop a granular perspective on trends, future growth rates, and market structures. Insights into subindustries, segments, categories, and micromarkets are the building blocks of portfolio choice. Companies will find this approach to growth indispensable in making the right decisions about where to compete.

These decisions may be a matter of corporate life and death. When we studied the performance of 100 of the largest US corporations in 17 sectors during the two most recent business cycles, a pair of unexpected findings emerged.

Article at a glance

A large company's top-line growth is driven mainly by market growth in the subindustries and product categories where it competes and by the revenues it purchases when it acquires other companies, according to a growth analysis of more than 200 companies around the world.

The gain or loss of market share explains only around 20 percent of the difference in the growth performance of companies.

Executives should identify and allocate resources to fast-growing segments in which a company has the capabilities and resources to compete successfully.

To make the right portfolio choices, executives should benchmark the growth performance of a company and its peers on a segment level.

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The first was that top-line growth is vital for survival. A company whose revenue increased more slowly than GDP was five times more likely to succumb in the next cycle, usually through acquisition, than a company that expanded more rapidly. The second, suggesting the importance of competing in the right places at the right times, was that many companies with strong revenue growth *and* high shareholder returns appeared to compete in favorable growth environments. In addition, many of these companies were active acquirers.[1]

To probe deeper into the mysteries of what really drives revenue growth, we have since disaggregated, into three main components, the recent growth history of more than 200 large companies around the world. The results indicate that a company's growth is driven largely by market growth in the industry segments where it competes and by the revenues it gains through mergers and acquisitions. These two elements explain nearly 80 percent of the growth differences among the companies we studied. Whether a company gains or loses market share—the third element of corporate growth—explains only some 20 percent of the differences.

At first blush, our findings seem counterintuitive. They demonstrate that although good execution is essential for defending market share in fiercely contested markets, and thus for capitalizing on the corporate portfolio's full-market-growth potential, it is usually not the key differentiator between companies that are growing quickly and those that are growing slowly. These findings suggest that executives ought to complement the traditional focus on execution and market share with more attention to where a company is—and should be—competing.

Going beyond averages to adopt a granular perspective on the markets is essential for any company as it shifts its portfolio in search of strong

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[1] Sven Smit, Caroline M. Thompson, and S. Patrick Viguerie, "The do-or-die struggle for growth," *The McKinsey Quarterly*, 2005 Number 3, pp. 34–45.

growth, as this article will explain. It will also argue that a fine-grained knowledge of the drivers of the company's past and present growth, and of how these drivers perform relative to competitors, is a useful basis for developing growth strategies. To that end we will present the findings of two diagnostic tools: one that enables companies to benchmark their growth performance on an apples-to-apples basis with that of their peers, and one that disaggregates growth at a segment level.

Growth in a granular world

Telecommunications in Europe is often described as a mature industry. But though revenues at ten large European telcos rose by an average of 9.5 percent a year from 1999 to 2005, we found that individual companies expanded by 1 to 25 percent annually. How could this be?

The most important reason is that European telcos make different portfolio choices so that they have varying degrees of exposure to different segments with different rates of growth. Wireless grows faster than fixed line, for example, and the growth rates of each vary widely by country. In addition, these companies have different levels of exposure to fast-growing markets outside Europe.

In industries with higher overall growth, the same kind of variation is apparent. The annual growth rates of a representative set of large high-tech companies, for instance, ranged from –6 to 34 percent from 1999 to 2005.

In fact, the companies in our 200-strong database that outperformed their peers on top-line growth and shareholder value from 1999 to 2005 compete in industries—construction, consumer goods, energy, financial services, high tech, retailing, and utilities—with different rates of overall growth. No matter which industry they competed in, however, the average market growth of their portfolios outperformed that of their peers. This fact suggests that they tend to outposition their industry competitors in high-growth segments. The portfolios of outperforming utilities, for example, enjoyed growth momentum that was two percentage points higher than the overall industry did. Indeed, when we compared the growth rates of industries with the growth rates of the companies in our database, we could explain why some grew faster than others only by zooming in and taking a granular view of subindustries and product categories by continent, region, and country (see sidebar, "A fine-grained view").

These findings should encourage companies in industries with slow overall growth. Seeking growth is rarely about changing industries—a risky proposition at best for most companies. It is more about focusing time and

A fine-grained view

Which market levels must executives explore when they develop a company's portfolio strategy? To find out, we tested the extent to which industry growth rates correlate with the growth rates of companies at five levels of market granularity, which we call G0 to G4.

G0: the world market. Over the past 20 years, the world economy has grown by roughly 7 percent a year. By 2005, its total output had reached $81.5 trillion. This is the global pie. Global GDP growth is the yardstick used to measure the growth performance of companies.

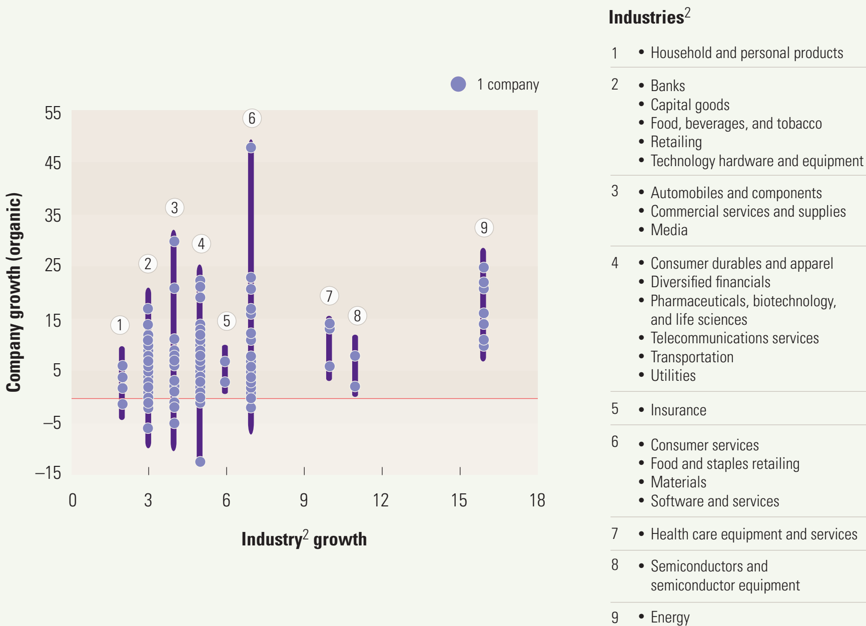
G1: sectors. The Global Industry Classification Standard (GICS) carves up the global economy into sectors, such as energy and capital goods. On average, these groups have a market size of $3.5 trillion. When we plotted the growth of industries and companies, we saw no obvious correlations. This supports our point that talk of "growth industries" is meaningless. The growth rates of different industries vary from approximately 2 to 16 percent—far less than the spread at the company level, which ranges from –13 percent to 48 percent (exhibit).

G2: industries. The GICS breaks down the sectors into 151 industries; the food, beverages, and tobacco sector, for instance, becomes three separate industries. These 151 industries—more granular than the sectors but still huge—have an average size of around $500 billion. At the G2 level, differences in the portfolio exposure of companies explain little more of the variation in organic top-line growth than they did at the G1 level.

EXHIBIT

A greater spread at the company level

Compound annual growth rate (CAGR) for selected companies by industry,[1] 1999–2005, %



[1] 207 representative companies selected from total for readability.
[2] Industry group classifications by Global Industry Classification Standard (GICS), developed by Morgan Stanley Capital International (MSCI) and Standard & Poor's.

Source: Global Insight; Global Vantage; Thomson; McKinsey analysis

G3: subindustries. Now it gets interesting. Our growth database builds on the finest level of data that companies report to the markets, so we can look at subindustries, and sometimes at broad product categories, divided by continents, regions, or, in certain cases, countries. Examples of subindustries within the food industry include frozen foods, savories, edible oils, and dressings. At the G3 level, the world market has thousands of segments ranging in size from $1 billion to $20 billion.

The growth rates of these segments explain nearly 65 percent of a typical company's organic top-line growth; in other words, at this level market selection becomes more important than a company's ability to beat the market. That point supports our finding that the composition of a portfolio is the chief factor in determining why some companies grow faster than others.

G4: categories. In a few cases we have been able to use internal company data to dig deeper and explore categories within subindustries (such as ice cream within frozen packaged foods) or customer segments in a broad product or service category (such as low-calorie snacks). At this level of granularity the world economy has millions of growth pockets that range in value from $50 million to $200 million. Our analysis found that a company's selection of G4 segments often explained its organic growth even better than the G3 segments did. This is the level of granularity on which companies must act when they set their growth priorities—and the level on which they must make the real decisions about resource allocation.

resources on faster-growing segments where companies have the capabilities, assets, and market insights needed for profitable growth.[2]

To make granular choices when selecting markets, management teams must have a deep and similarly granular understanding of what drives the growth of large companies and, in particular, of their own company and its peers. They can use the resulting growth benchmarks when they plan their portfolio moves. One thing they are likely to learn from the benchmarks is to avoid making unrealistic assumptions about a company's chances of consistently gaining market share.

Disaggregating growth

The growth profiles of companies began to emerge when we broke down their growth into three main organic and inorganic elements that measure positive and negative growth.

- Portfolio momentum is the organic revenue growth that a company achieves through the market growth of the segments represented in its portfolio. The company can influence the momentum of its portfolio

[2] Our analysis suggests that chasing revenue growth for growth's sake alone, at the expense of profitability, generally destroys shareholder value.

in several ways. One is to select acquisitions and divestments, which affect the company's exposure to underlying market growth. Another is to *create* market growth—for instance, by introducing a new product category. Portfolio momentum (including currency effects) is in a sense a measure of strategic performance.

- M&A is the inorganic growth a company achieves when it buys or sells revenues through acquisition or divestment.

- Market share performance is the organic growth a company records by gaining or losing a share of the market. We define market share by the company's weighted-average share of the segments in which it competes.

Beyond the averages

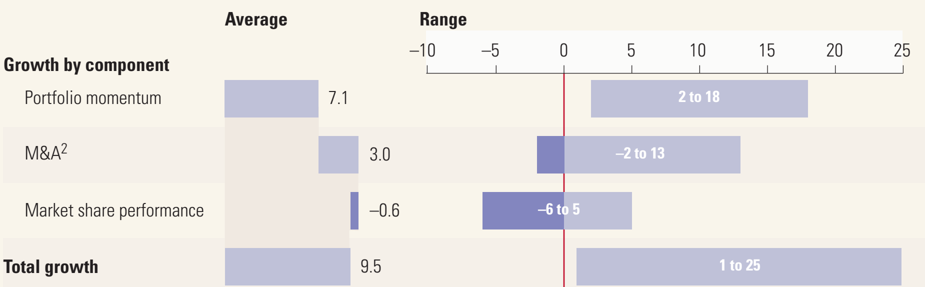
Our growth analysis of ten large European telcos revealed the relative importance of these growth elements for the companies as a group. It also showed how individual companies differed widely in their performance on each element.

Portfolio momentum was by far the biggest growth driver for the group as a whole, followed by M&A. Market share performance made a negative contribution. When we looked beyond the averages, a more nuanced picture emerged. Individually, these companies' range of performance on the three growth drivers was startling: from 2 to 18 percent annual

EXHIBIT 1

A wide range

Compound annual growth rate (CAGR) of revenues for 10 large European telcos,[1] 1999–2005, %



[1] Based on local currency; companies with headquarters in European Union.
[2] Includes impact of changes in revenue base caused by inorganic activity and share gain/loss.

Source: Analyst reports; company reports; Dealogic; Global Insight; Hoover's; McKinsey analysis

growth for portfolio momentum, from –2 to 13 percent for M&A, and from –6 to 5 percent for market share performance. Clearly, companies in the same sector grow not only at different speeds but also in different ways (Exhibit 1).

What about market share?

To probe the sources of growth for the average company in any sector, we took the data on all of the companies in our database and broke down their average performance into the three growth elements. We found that of the overall 8.6 percent top-line annual growth that the average large company achieved from 1999 to 2005, 5.5 percentage points came from the market growth of the segments in its portfolio, 3.0 from M&A activity, and a marginal 0.1 from market share performance.

The negligible role of *average* market share performance—both gains and losses—wouldn't be surprising if markets included only these 200 large companies. But what about the smaller companies that are commonly seen as growing more quickly and gaining share from incumbents?

Perhaps new entrants and other small and midsize companies redefine categories, markets, and businesses rather than capture significant market share from incumbents. There are differences among countries, however. Our analysis suggests that over time the average large company loses a bit of market share in the United States but gains a bit in Europe. Although we haven't analyzed this phenomenon in detail, we believe that the dynamism of the US market allows young companies to challenge incumbents to a greater extent than they can on the other side of the Atlantic.

We found it more interesting to go beyond the averages and explore the differences in the growth performance of large companies. The results show that portfolio momentum, at 43 percent, and M&A, at 35 percent, explain nearly four-fifths of them; market share is just 22 percent. To put the facts another way, a company's choice of markets and M&A is four times more important than outperforming in its markets. This finding comes as something of a surprise, since many management teams focus on gaining share organically through superior execution and often factor that goal into their business plans.

Not that managers can afford to neglect execution. On the contrary, catching the tailwind of portfolio momentum requires a company to maintain its position in the segment, and this in turn hinges on good or even great execution—particularly in fast-growing segments that tend to attract innovative or low-cost entrants.

The key point is that averages can be deceptive, so we dug deep into our database to see if a more granular story on market share performance would emerge. We did find a number of share gainers and losers, at the corporate (and particularly the segment) level. But we also discovered that few companies achieve significant and sustained share gains and that those few tend to have compelling business model advantages.

A valid question is whether sectors (with their different rates of growth) differ in ways that might affect the importance of market share. We found that market share performance explained 14 to 23 percent of the difference in the growth performance of companies in seven of the eight industries we analyzed. It was significantly more important, at 37 percent, only in the high-tech industry, where short product life cycles and generally higher growth headroom make market share shifts more common.

Linking growth and shareholder value

The detailed growth and value creation histories in our database let us analyze the growth drivers—portfolio momentum, M&A, and market share performance—and identify correlations between their roles for revenue growth and value creation.[3] Not surprisingly, companies that outperform on the growth drivers increase their revenues faster than the underperformers do,[4] and the more drivers they outperform on, the faster they grow.

It's more intriguing that outperformance on revenue growth is correlated with the superior creation of shareholder value. We defined four levels of performance for benchmarking purposes: exceptional, great, good, and poor. The threshold for differentiated performance appears to be outperforming on one growth driver while not underperforming on more than one. Slightly more than half of the companies in our sample did both and achieved average annual total returns to shareholders (TRS) of 8 percent and revenue growth of 11 percent, which we define as good performance. Companies that outperformed on two dimensions or that outperformed on one at top-decile levels without underperforming on more than one—nearly 15 percent of the sample—did even better, achieving great performance. Only four companies, which chalked up exceptional revenue growth and shareholder returns, outperformed on all three growth drivers. Companies that did not outperform on any driver or underperformed on more than one performed poorly, with TRS of only 0.3 percent.

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[3] Our analysis covers a six-year period that we used to compare detailed segment performance year over year, so we couldn't look at the very long term. However, we can compare revenue growth with at least short- to medium-term trajectories of total returns to shareholders.

[4] We define outperformance as the attainment of a growth rate in the top quartile of the sample for a particular growth driver. We define underperformance as the opposite: performance in the sample's bottom quartile. Quartiles two and three (the middle ones) are neutral—neither outperforming nor underperforming.

Management would do well to step back and assess a company's performance, at the corporate level, on each of these drivers, for they are actionable, and the evidence shows that the more of them companies outperform on, the more those companies have been rewarded. It might also be wise to scrutinize a company's peers to find out which growth drivers, if any, they outperform on, and in which parts of their businesses. Such knowledge can be the starting point of a useful benchmarking discussion about the company's growth performance and potential.

Scanning for growth opportunities

Getting a detailed sense of the growth performance of a company involves judging how well it is performing on each of the three growth drivers at the segment level. By analyzing this information in the context of the company's market position and capabilities, its management team can develop a perspective on future opportunities for profitable growth.

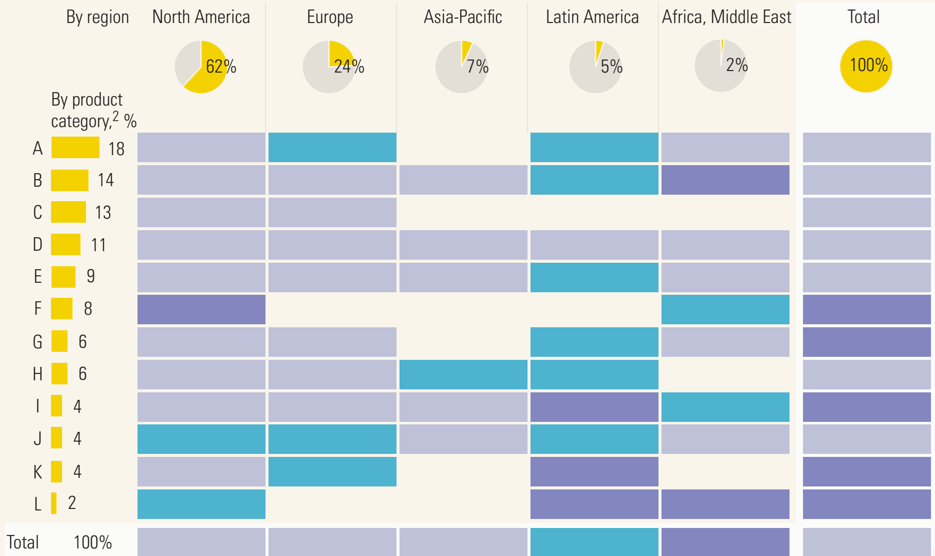
EXHIBIT 2

A detailed picture

Disguised example of growth for GoodsCo, a multinational consumer goods company, 1999–2005

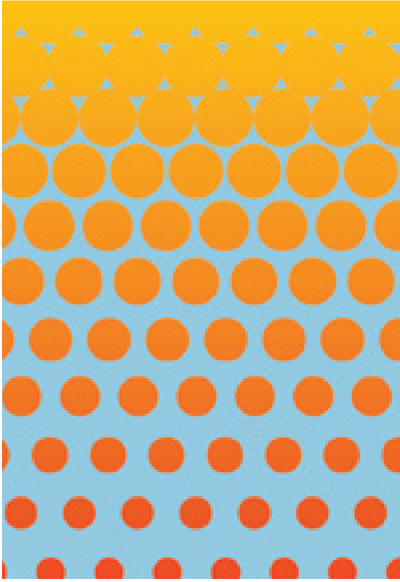
Growth[1]

Revenue share



[1]Exceptional = outperforming on all 3 growth drivers; great = outperforming on 2 growth drivers or outperforming on 1 growth driver at top-decile level without underperforming on more than 1; good = outperforming on 1 growth driver without underperforming on more than 1; poor = underperforming on 2 or more growth drivers or not outperforming on any.

[2]Figures do not sum to 100%, because of rounding.



Consider the disguised case of GoodsCo, a multinational consumer goods corporation. Our disaggregation of its growth at the corporate level revealed that it delivered stable, albeit slow, growth from 1999 to 2005. M&A drove almost all of the company's growth in the United States, however; in Europe positive exchange rates propelled modest growth. Organic revenues rose strongly only in emerging markets, such as Africa, Latin America, and the Middle East. In fact, the North American and European markets that made the largest contribution to the company's revenues were in the bottom quartile for our full sample of companies.

The story gets more precise as we disaggregate the company's performance on the three growth drivers in 12 product categories for five geographic regions. No fewer than 27 of the 47 segments the company competes in register as poor in terms of their performance on our three growth drivers. Unfortunately, these segments represent 87 percent of GoodsCo's sales. On the positive side, 20 segments are good or great, but they make up only the remaining 13 percent of sales. And although a promising growth story is developing in Latin America in most segments, the business is performing poorly in its core ones in Europe and North America. It cannot claim exceptional performance in any segment. GoodsCo has a portfolio problem (Exhibit 2).

Once all the cards are on the table, GoodsCo's managers will be in a better position to make well-informed portfolio choices. The pros and cons of acquiring businesses—or expanding organically by exploiting positive market share performance—in segments where GoodsCo enjoys strong portfolio momentum will probably be high on the top team's agenda. Another issue might be whether to seize divestment opportunities in segments where the company's portfolio momentum is good, though the company is losing market share. A third could be whether to acquire a company (and so build portfolio momentum) in lackluster segments where GoodsCo's management expects market growth to improve significantly.

The growth of segments within industries correlates closely with the differing profiles that emerge when we disaggregate the growth of large companies. This suggests that executives should make granular choices when they approach portfolio decisions and allocate resources toward businesses, countries, customers, and products that have plenty of headroom for growth. Q

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