
merged
acquired
sold
diversified

The do-or-die struggle for **growth**

The largest corporations rarely sustain strong growth unless they compete in the right places at the right times.

Sven Smit, Caroline M. Thompson, and S. Patrick Viguerie

Growth is once again top of mind for business executives. As they turn their attention from improving the operational performance of their companies to making those companies grow again, many of them will follow the standard message: consistently strong, value-creating revenue growth lies within reach of major corporations that pursue best practice in strategy, marketing, operations, and organization.

Or does it? Execution and fundamentals are certainly vital, but growth, particularly for the largest companies, requires more than best practice. At the median annual revenue level of today's Fortune 100—about \$30 billion—a corporation would in effect have to create a \$2 billion company each year to sustain 6 percent top-line growth. Can investors and capital markets reasonably expect that kind of performance? How do some companies achieve it?

To explore the particular challenges of revenue growth in big corporations, we studied the performance of about 100 of the largest ones in the United States, in 17 sectors, over the two most recent business cycles. Almost a third of the companies managed to increase their revenues at a rate faster than the growth of GDP over the second cycle, from 1994 to 2003, while at the same time delivering shareholder returns above those of the

Article at a glance

Large companies with strong revenue growth and high shareholder returns not only execute well but also almost always compete in the right sectors or segments at the right times.

Top-line growth is vital because companies that don't increase their revenues run out of ways to drive their earnings and risk being acquired.

For companies aspiring to grow, where to compete is just as important as how. To choose the right battlegrounds, they must match their distinctive capabilities with sectors where profitable growth is likely to occur.

Companies that have systematically lagged behind the competition should carefully consider their options.

S&P 500 index. The relatively large number of high performers here might indicate that the odds for companies aspiring to grow are decent, if not for a sobering fact: 90 percent of these companies were concentrated in just four sectors—financial services, health care, high tech, and retailing.

It isn't surprising that they are overrepresented. These sectors as a whole, or markets and segments within them, offer favorable growth environments supported by established trends: aging populations, rapid product or format innovation, deregulation, and consolidation. What's striking for large growth-minded corporations is just how crucial it is to have this kind of favorable wind at their backs when they try to achieve strong growth.

Looking across the two economic cycles also revealed the critical role of top-line growth. Large companies that trailed GDP for an entire business cycle were five times more likely to be acquired or otherwise go out of business than were faster growers. Eventually, companies that don't increase their revenues run out of ways to drive earnings and shareholder returns. Even if a company finds a way to create shareholder value, slow-growing companies remain attractive acquisition targets.

These findings have broad implications for management. The first is that large companies need to pay at least as much attention to top-line growth as to increasing the bottom line. While cost improvements can drive earnings and shareholder value in the near term, companies that raise their total returns to shareholders (TRS) without achieving top-line growth have the worst long-term odds of survival. Many companies that struggle to grow do indeed face a "grow-or-go" situation.

Second, where to compete is just as important as how. The choices a large company makes today about its portfolio mix and where to place its bets will shape its growth trajectory over the next five to ten years. Unless the company enjoys the advantages of fast-growing pools of revenues and profits or has ample opportunity to consolidate, growth that just keeps pace with GDP will be difficult to sustain, even if execution is great.

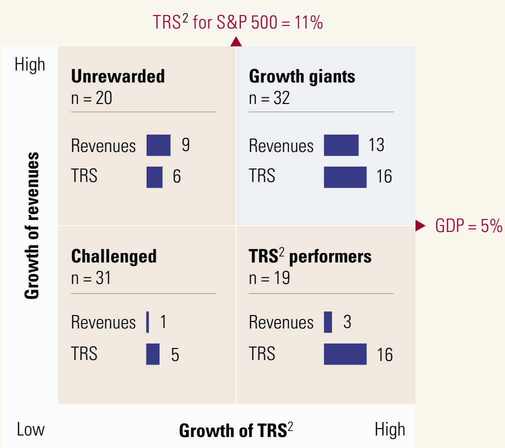
That vital top-line growth

Our research focused on 102 US public companies: the top 75 in 1994 revenues and the top 75 in 1994 market capitalization. We tracked these companies over the 1994–2003 business cycle and segmented their growth performance by revenues (including acquisitions and divestitures) and TRS, which encompasses both share prices and dividends. The median compound annual growth rate (CAGR) for revenues was around 5 percent, corresponding to nominal GDP growth over the period. At 11 percent, the median annual growth rate of TRS was roughly equal to that of TRS for the S&P 500 index.

EXHIBIT 1

Parsing the top US companies

Compound annual growth rate (CAGR) of 102 largest US companies, 1994–2003,[1] %



[1]Top 75 companies by market capitalization and top 75 companies by revenues (some companies were top performers on both metrics).
[2]Total returns to shareholders.

Source: Standard and Poor's; McKinsey analysis

We labeled companies whose top-line growth outpaced GDP and whose TRS outperformed the S&P 500 as *growth giants* and those that achieved above-average TRS growth but trailed in revenues as *TRS performers*. The *unrewarded* companies increased their revenues at a rate faster than the median but weren't rewarded with corresponding TRS growth. The *challenged* companies underperformed on both measures.

Thirty-two companies occupy our growth giants category, and most of them—20 percent of the overall sample—achieved double-digit revenue growth over the period while outperforming the S&P 500 on TRS (Exhibit 1). That accomplishment struck us as particularly impressive, even if more than half of these companies used acquisitions extensively[1] to drive top-line growth.

Although we found a positive relationship between the growth of revenues and of TRS over the ten-year period, exceptions abounded. Companies that increased their revenues at a rate faster than the growth of GDP were 60 percent more likely to outperform the S&P 500 index. But nearly 20 percent outperformed it despite sluggish top-line growth. In fact, the

[1]In our terminology, an extensive acquirer has made acquisitions totaling at least 20 percent of its market capitalization at the end of a given period.

median TRS performer increased its revenue by only 3 percent but, like the growth giants, boasted average TRS growth of 16 percent.

As might be expected, the TRS performers compete mostly in slower-growth industries, such as consumer goods, engineering and construction, and utilities. The keys to their ability to create value were good execution, cost controls, and savvy portfolio management—all of which generated strong earnings growth. Many of these companies sold or exited lower-margin businesses and bought or entered higher-margin ones. Half of the TRS performers increased their earnings at a rate at least twice that of their revenues, and 37 percent pursued major divestiture programs.[2]

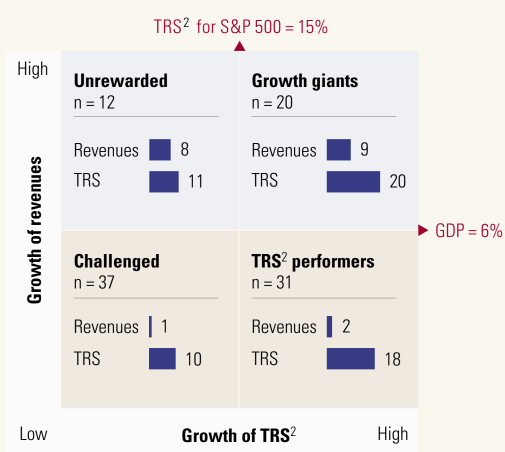
Next we asked what might happen over the longer term. How would the TRS performers and the growth giants cope in a subsequent business cycle? Could they maintain their momentum for an additional five or ten years? And what of the challenged and unrewarded companies—could they turn their TRS around, or did another outcome await them?

EXHIBIT 2

Thriving and surviving

Growth and survival rates of 100 largest US companies, 1984–2003,[1] %

1 1984–93 business cycle
Compound annual growth rate (CAGR), %



2 1994–2003 business cycle
% of companies that no longer existed by end of 2003

Growth giants	5
Unrewarded	8
Challenged	32
TRS performers	32

3 1994–2003 business cycle
% of companies that survived and outperformed S&P 500

Growth giants	65
Unrewarded	58
Challenged	35
TRS performers	10

[1]Top 75 companies by market capitalization and top 75 companies by revenues (some companies were top performers on both metrics).
[2]Total returns to shareholders.

Source: Standard and Poor's; McKinsey analysis

[2]A company that made extensive divestitures sold assets worth at least 20 percent of its 2003 market capitalization.

To find out, we chose a slightly different sample and a longer time horizon. With the same method we used for our first sample, we identified the 100 largest US public companies in 1984 and then followed their performance over the business cycles of 1984–93 and 1994–2003. When we segmented the performance of these companies during the earlier business cycle, only 20 percent made the grade as growth giants (Exhibit 2, part 1).

We then tracked the companies from each quadrant into the 1994–2003 cycle, examining patterns of survival and TRS performance. The correlation between the future survival of a company and its past revenue growth—but not its TRS—was striking. A company whose revenue increased more slowly than GDP did was five times more likely to succumb, usually through acquisition, than a company that expanded more rapidly (Exhibit 2, part 2). Past TRS performance, by contrast, was a surprisingly poor indicator of corporate survival.

Past revenue growth was also a superior predictor of future TRS performance. Almost half (45 percent) of the growth giants sustained their outperformance in both top-line growth and value creation through the 1994–2003 cycle, and nearly two-thirds continued creating value at a high rate. Even the unrewarded top-line growers from the previous decade had a better than even chance of surviving and outperforming during the 1994–2003 cycle (Exhibit 2, part 3). It was the challenged companies and, above all, the TRS performers that had the worst odds.

The reason is straightforward: most TRS performers from the 1984–93 cycle competed in slower-growth industries, such as utilities and telecommunications, which consolidated during the subsequent one. Most of those that weren't acquired continued to struggle with revenue and earnings growth. Unless these companies embarked on a successful acquisitions program or shifted their business mix, they couldn't capture enough gains from reducing costs or restructuring in their existing businesses to compensate for the lack of top-line growth.

Companies that don't increase the top line eventually hit a TRS wall and often become targets for acquisition. Even the largest companies may therefore find themselves grappling with fundamental grow-or-go decisions.

Where to compete

How does a large company achieve and maintain strong growth? Our analysis of the 32 growth giants in the 1994–2003 sample reveals a sobering reality: good execution is required, but being in the right business at the right time is almost always a prerequisite as well.

The tailwind factor

Four sectors—financial services, health care, high tech, and retailing—collectively accounted for half of all large companies in our sample but for nearly 90 percent of all growth giants in the 1994–2003 cycle (Exhibit 3). The overall economy grew at a rate of 5 percent during those years. Meanwhile, financial services, supported by deregulation, increased borrowing, and the trend toward broader participation in equity markets, grew by 7 percent. So did high tech, propelled by the innovation and information revolution of the 1990s; high-tech services grew even more robustly, at 9 percent.

Health care expenditures grew by 7 percent as a result of innovation and an aging population. Most of the health care growth giants, such as Johnson & Johnson, Eli Lilly, and Pfizer, were concentrated in pharmaceuticals, which expanded even more quickly—by a 12.5 percent CAGR from 1994 to 2003. A similar story unfolded in retailing, which expanded by only 4.5 percent as a whole but much faster in segments where growth giants competed. Wal-Mart Stores' format innovations in the late 1980s, for instance, boosted growth in the overall discount-store segment, to the benefit of followers like Target. In the home-improvement segment, Lowe's, another growth giant, revamped its store format and capitalized on the do-it-yourself craze that The Home Depot created in the 1980s.

*Good execution is needed for strong growth, but so is competing in the **right business** at the right time*

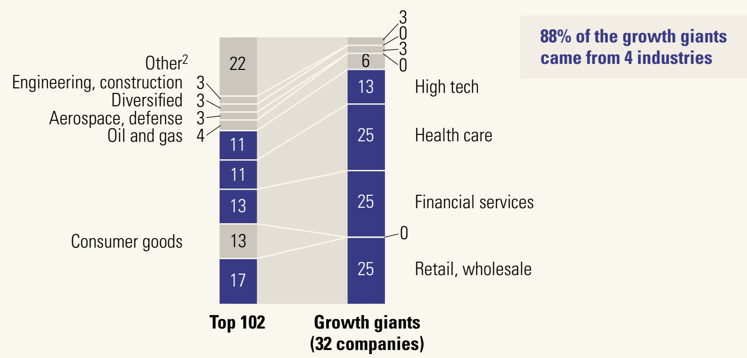
Since most growth giants had the benefit of a favorable growth environment, more than 70 percent of them (23 in all) succeeded in generating impressive financial results by exploiting opportunities in their existing businesses. Most of these companies focused on incremental product innovations or consolidation or on the geographic expansion of a business model or a series of products within the United States. For the 3 growth giants lacking a tailwind, consolidation in the core business was the preferred strategy.[3]

[3] Dow Chemical, Kroger, and Safeway. All were consolidators.

EXHIBIT 3

A select few

102 largest US companies[1] during 1994–2003 business cycle, %



[1]Top 75 companies by market capitalization and top 75 companies by revenues (some companies were top performers on both metrics).
[2]For top 102, includes automotive and assembly, basic materials, media and entertainment, telecom, transport and logistics, utilities, and chemicals; for growth giants (32 companies), includes chemicals.

Source: Standard and Poor's; McKinsey analysis

Breakthrough innovations—new products, retail formats, supply chain models, and so forth that change the competitive game or produce a distinct competitive advantage—were unusual for large companies. We found only four growth giants that developed such innovations during the 1994–2003 cycle and used them as the primary driver of growth. All of them were new products from R&D-intensive industries that experienced a tailwind: technology and health care. None of the growth giants owed their achievements to reinventing the business model. While radical innovations of this kind have propelled companies (such as Dell) from relative obscurity to the Fortune 100, they are rarely pursued or executed successfully after companies become large.

Not all growth giants stuck to their knitting; the other 30 percent (nine in all) extended the scope of their portfolios by building or acquiring new businesses or expanding into global markets.[4] Except for the diversified conglomerate Berkshire Hathaway, all of the growth giants entered adjacent customer or product markets or focused on internationalizing a successful business model or series of products. Seven of the nine companies used acquisitions to enter new markets.

But success in building businesses was about more than acquisitions or customer and product strategies. The companies that excelled at it had

[4]We considered new businesses or geographies to be significant if they accounted for less than 5 percent of a company's revenue at the start of the period and for at least 15 percent by its end.

either truly distinctive capabilities or operational assets that created a real competitive advantage in the new arena. Johnson & Johnson and Medtronic, for example, use acquisitions to enter new product spaces but drive organic growth by leveraging excellent product development and commercialization capabilities and superior relationships with doctors, hospitals, and other customers. Of the nine business builders, eight took advantage of industry momentum by building or acquiring new operations in health care, financial services, or technology.

Only one growth giant built a big new business without the backdrop of a rapidly growing market: Wal-Mart, which used its network of stores, its brand, its supply chain expertise, and a format innovation to enter the relatively slow-growing US market for perishable grocery products. The other business builders may or may not have been looking for the next favorable business environment. Creating a new business, however, not only gave them opportunities to behave and grow like an attacker but also provided moderate diversification if the prevailing favorable winds were to shift in the core business.[5]

The experience of the large companies that we followed across the 1984–93 and 1994–2003 business cycles shows how difficult it is to grow without a tailwind. Although almost half of these companies maintained their status as growth giants through the two cycles, all except Wal-Mart had or built new businesses in health care or financial services—sectors that were hot in both cycles. Similarly, most companies in the challenged category from 1984 to 1993 lumbered along in industries that were then growing slowly: automotive, defense, oil, and utilities. Twenty percent of the challenged companies (7 of 37) managed to become growth giants during the next cycle, but a favorable environment was important: five of the seven growth turnarounds took place in industries whose conditions improved dramatically. Only 2 companies moved from our challenged category to become growth giants without substantial growth in demand. Both were grocery chains that relied heavily on consolidation, investing at least 80 percent of their 2003 market cap in acquisitions over the period.

>>> *How did Wal-Mart drive format and other innovations in the retail sector? See "Retail: The Wal-Mart effect" (www.mckinseyquarterly.com/links/17918).*

[5] Neil W. C. Harper and S. Patrick Viguerie, "Are you *too* focused?" *The McKinsey Quarterly*, 2002 special edition: Risk and resilience, pp. 28–37 (www.mckinseyquarterly.com/links/17809).

Catch the wind

When large companies face slow-growing markets and have few options for consolidation in their existing businesses, opportunities to change the growth trajectory are limited. The best approach is to reposition the portfolio of businesses, customers, products, and geographies to create a mix with a higher potential for growth.

In 1994, for example, ITT Industries was a diversified conglomerate with holdings ranging from hotels to defense electronics. It then decided to concentrate on two segments—defense electronics and fluid technologies (pumps, mixers, and valves)—that seemed likely to grow and were well aligned with ITT's capabilities. The rest of the portfolio was spun off, and these divestitures not only created substantial value for shareholders but also gave the remaining parts of ITT a strong operational focus in segments with favorable growth conditions. In 2003, the company's revenue had reached only 70 percent of its 1994 level, so ITT wasn't a growth giant by our criteria. It did, however, increase its annual TRS by 18 percent during this portfolio transition, and the remaining businesses are growing rapidly, by an average of 18 percent over the past three years.

IBM's turnaround strategy also focused on the portfolio, although the company did less pruning and put greater emphasis on building new businesses. Management believed that IBM's brand, customer relationships, and engineering skills could propel growth in the emerging IT services market. From 1994 to 2003, the company's largely organic growth in services ranged from 15 to 20 percent, and the proportion of its corporate revenue from services, starting out at 25 percent, rose to almost 50 percent.[6] These strong growth prospects have been a major driver of the company's TRS—almost 22 percent a year during the sample period.

Viewed over the course of ten years, the top-line growth performance of ITT, IBM, and other companies that transformed their portfolios was characterized by divestitures or strategic decisions to exit businesses with relatively low growth potential. These transformations created considerable shareholder value and gave such companies a better position to increase their revenues and TRS in the next cycle.

[6] Excluding maintenance and software.

Grow or go?

When a large company faces a headwind in its existing businesses, consolidation and efforts to transform the portfolio are its most plausible ways to grow. Even so, these are not without risk.

Consolidation strategies have a better chance for success when a company can show that it has "earned the right to buy." Do its operating margins and returns on invested capital (ROIC) compare favorably with those of its industry peers? Has it created value through mergers and acquisitions in the past? The answers to these questions—as well as the industry's readiness for consolidation—have a direct bearing on whether buying makes more sense than selling.

M&A skills and sound operations are part of the picture for any company that considers transforming its portfolio. But it is even more important to place the right bets on where to compete. A company must not only figure out which markets are likely to be attractive but also have a realistic view of its own capabilities. Are any of them powerful enough to confer a competitive advantage in a new geography, product, or customer segment—or even a different sector? The importance of having a real competitive advantage holds whether an entry strategy calls for organic growth or acquisitions.

The bar for distinctive capabilities is high. A company may believe that it has them in logistics or the supply chain, for example. But are they so strong that customers of other companies will switch? Will these capabilities support a price premium or allow the company to maintain operating margins that competitors can't match? If the answer to all of these questions is no, the capabilities don't provide a true competitive advantage; they are merely things the company does well.

For companies struggling to increase their revenues, a high bar to investments in new capabilities, markets, and growth seems particularly well justified. One-third of the 37 challenged companies from the 1980s chose to sell before 2003. As a group, the sellers performed well, realizing median compound annual TRS growth of 19 percent from 1994 to the time of sale, as compared with only 11 percent for the median survivor in the challenged category. In other words, unless your company has a reasonable chance of turning itself around, don't dismiss the "sell" option too quickly.

As a company becomes larger, the question of where it should compete becomes more critical. Choosing the right battlegrounds means matching its distinctive capabilities to the businesses, customers, products, and geographies where profitable growth is most likely to occur and acting on those insights before it's too late. A company that struggles with growth may have few distinctive capabilities. Building or acquiring new ones that can stimulate growth surely ought to be explored—as should the possibility of selling.

Sven Smit is a director in McKinsey's Amsterdam office;
Caroline Thompson is a consultant and **Patrick Viguerie** is a director in the Atlanta office.