

# A BAD TIME TO BE AVERAGE

By Hans-Paul Bürkner, Martin Reeves, Hen Lotan, and Kevin Whitaker

**W**HEN BELGIAN ASTRONOMER AND mathematician Adolphe Quetelet applied the arithmetic mean to the study of social systems, he put to novel use a valuable tool for summarizing the distributions of different values. But strategy, unlike macroeconomics, has never been about averages. Strategy is about defying the powerful forces of commoditization and reversion to the mean by being exceptional in some way.

The need to think about the world in de-averaged terms and avoid becoming average oneself has never been more urgent than it is today. It's therefore a good time for leaders to remind themselves of the necessity and art of defying averages.

## Strategy Has Never Been About Averages

Over time, markets become commoditized: new competitors appear; standard product designs emerge, making offerings more comparable; and consumers then enjoy more choices and become better educated

in exercising those choices, forcing down prices to marginal cost and returns to the cost of capital.

Traditionally, one way to gain an advantage in such a situation is to be exceptional through scale and costs. In 1968, Bruce Henderson proposed the experience curve to explain how early entrants can accumulate volume and experience faster, thereby becoming the lowest-cost players in their industries. In 1976, Henderson observed that when equilibrium has been achieved in unregulated markets, they can support no more than three profitable significant competitors, which tend to have market shares in the proportions 4:2:1. This remarkable observation, known as the rule of three and four, has since been validated by extensive analysis across all industries.

The other traditional route to avoiding average returns is to be exceptional through differentiation, by creating new products and markets and playing in spaces with structurally low competitive intensity because of barriers to entry. Combining these

two ideas, Michael Porter proposed in 1980 that companies could be competitively advantaged only through cost leadership or differentiation.

As the pace of business accelerated because of global competition and (primarily Japanese) managerial innovation in the 1980s, it became apparent that structural advantage was only temporary, and the idea of being exceptional through speed came to the fore. In 1990, George Stalk and Thomas Hout proposed time-based competition: by having fast, uncluttered end-to-end business processes, companies could be first to market and enjoy higher quality and lower costs, and thus achieve above-average returns.

And as the pace of competition accelerated further, driven mainly by unprecedented innovation in digital technology starting in the 1990s, the notion of serial temporary advantage—for example, in adaptive advantage and the “self-tuning enterprise”—was proposed as a new basis of competition, focused on learning and adapting to changing environments faster than competitors.

Business strategy has thus always been about avoiding average returns by being exceptional with respect to scale, differentiation, speed, or capabilities. While some in-

dustries are significantly more attractive than others, the spread of performance *within* industries is an order of magnitude greater than that *across* industries. How to play (being exceptional relative to your peers) therefore matters much more than where to play, and there is really no such thing as a bad industry. (See Exhibit 1.)

In fact, the spread of company performance is skewed and long-tailed, meaning that the value of being exceptional can be huge.

- On average, large companies generate annual TSR of 7%, but the top 10% generate annual TSR of 37%.
- On average, large companies grow 6% per year, but the top 10% grow 47% annually. (See Exhibit 2.)
- Vitality, the capacity for growth and reinvention, also varies widely across companies: the average vitality score (on a range of 0–100) of the approximately 1,100 largest global companies is 38, while the average and lowest vitality scores of the Fortune Future 50 (the companies identified as having a high capacity for growth and reinvention) are 72 and 61, respectively.
- On average, economic downturns have had a very adverse effect on companies:

EXHIBIT 1 | Performance Varies More Within Sectors Than Across Them



Sources: Compustat and S&P Capital IQ; BCG Henderson Institute.

Note: Based on all US listed public companies with > \$50 million in annual sales. Sectors are based on GICS definitions.

## EXHIBIT 2 | TSR for Top Performers Is More Than Four Times the Average, Revenue Growth More Than Seven Times the Average



Sources: Compustat and S&P Capital IQ; BCG Henderson Institute.

Note: Based on all US listed public companies with > \$50 million in annual sales.

<sup>1</sup>Based on measurement of preceding five years.

<sup>2</sup>Average of group.

across the last five US downturns, revenue growth declined by 1% on average, compared with 8% annual growth in the three prior years. Similarly, profit margins also declined for the majority of companies. But 14% of companies were able to grow both top and bottom lines during the same periods, thus creating advantage in adversity.

### A Good Time to Be Exceptional

The need to be exceptional is more important than ever. Economic growth is declining globally, both in the short term, driven by cyclical factors, and the long term, driven by demographic shifts—reinforcing the imperative to beat a declining average.

(See Exhibit 3.)

Furthermore, the spread of performance across companies is increasing, because of both declining rewards to low performers and increased rewards to the exceptional. The spread of EBIT margin between the top and bottom quartile nearly doubled over the past three decades, for example. (See Exhibit 4.)

This is in part attributable to the rise of winner-take-all platform-based business

models, which now dominate the list of the largest companies in the world by market capitalization. Ten years ago, those platforms were only beginning to emerge. The rule of three and four is effectively being replaced by a “rule of one” for many platform businesses, where second or third entrants are often unviable.

The difference between the range of individual company performance and the range of industry performance—effectively, the value of not being an average player in your industry—has also increased.<sup>1</sup> And the state of being exceptional, once achieved, is increasingly short-lived and in need of constant renewal. We can see this across various indicators of volatility and dynamism, including:

- Higher turnover in the composition of the Fortune 100 and 500 each year
- Increased competitive volatility
- Acceleration of business life cycles

Moreover, if we look ahead by examining corporate vitality, we can see that growth potential is increasingly tied to technology capabilities. This means that companies that are not exceptional in leveraging tech-

nology to reinvent their business and organizational models are destined to perform poorly. (See Exhibit 5.)

accelerate regression to the mean. How then can companies pursue the extraordinary and eschew the average?

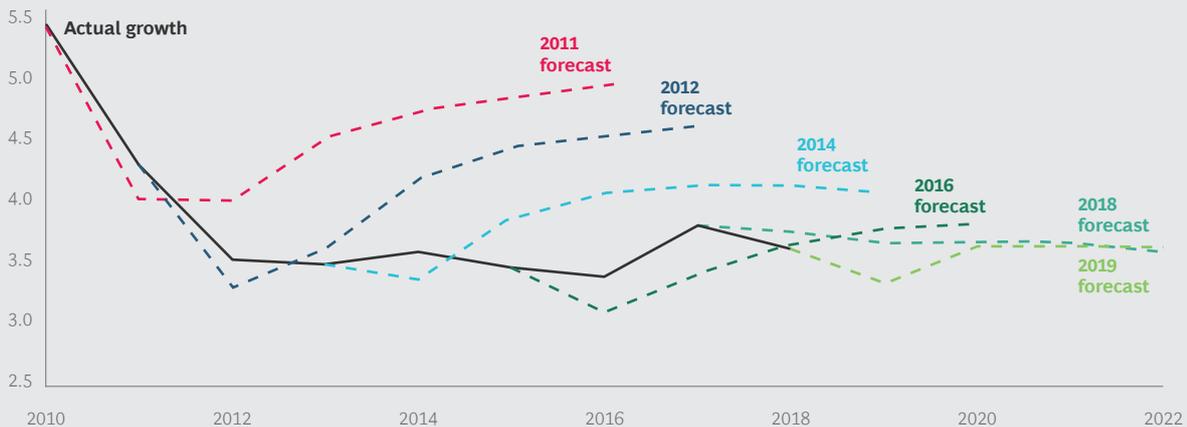
## The Art of Defying Averages

While avoiding being average may sound like obvious advice, a number of common business practices—including benchmarking, best practices, and incremental budgeting—can unwittingly lead to imitation and

**Adopt a uniqueness mindset.** Defying the average begins with a clear articulation of what is unique about a company and the value it can deliver. Look at your purpose, vision statement, and strategy with a skeptical eye and ask yourself whether a reasonable person could identify the

EXHIBIT 3 | Global Economic Growth Is Trending Down

Five-year forecasts of global GDP growth (%)

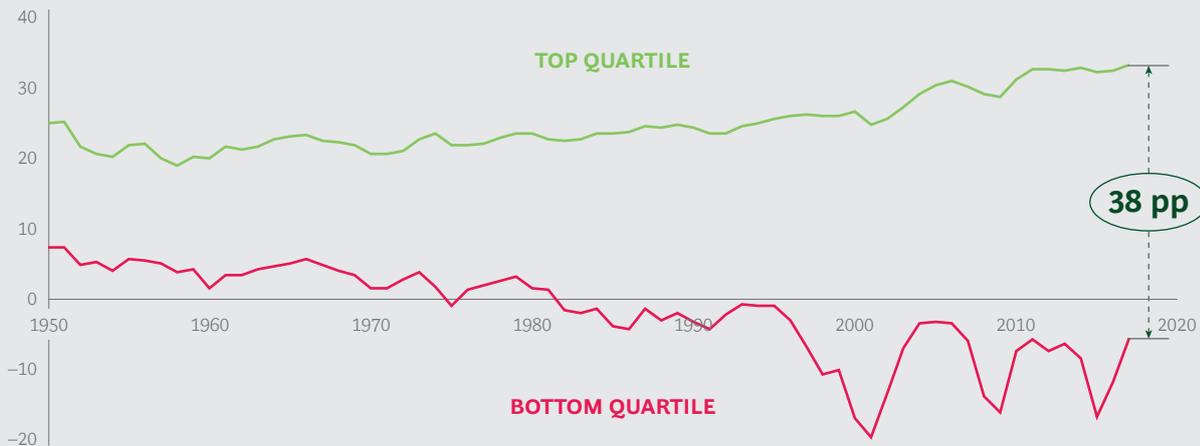


Sources: IMF; BCG Henderson Institute analysis.

Note: Projections from fall IMF outlooks for each year, except 2019, which is from April outlook.

EXHIBIT 4 | The Profitability Spread Between the Top and Bottom Quartiles Nearly Doubled in the Past 30 Years

Average EBIT margin across industries (%)



Sources: Compustat; BCG Henderson Institute analysis.

Note: Based on US listed companies with at least \$50 million in annual revenue; excludes industries that have fewer than ten companies in a given year.

specific industry, let alone the specific company, to which it pertains. By sharpening the articulation of what makes them different, companies can create a better foundation for an attractive strategy.

**Set unreasonable ambitions.** Incremental goal setting can lead to steady, predictable improvements in results—but that’s likely to be exactly what your competitors are doing, too.

Setting unreasonable goals can force imaginative thinking and the identification of new opportunities for being exceptional. It is impossible to stretch one’s strategy without first stretching one’s thinking. Use strategy games, like “destroy your business,” “think like a maverick,” and “friction destroyer” to identify opportunities for creating uniqueness.

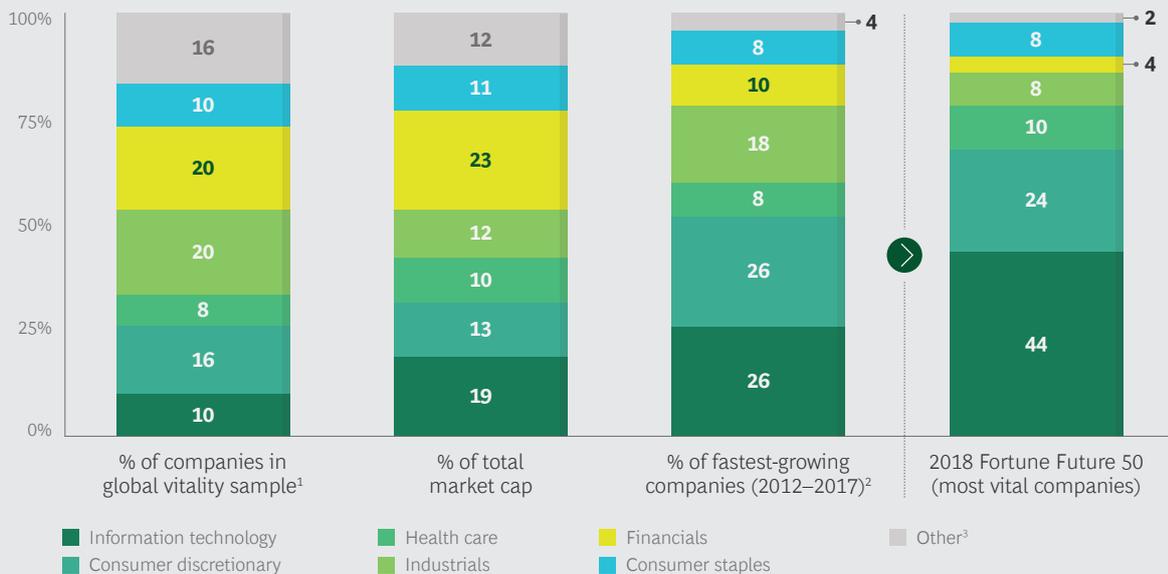
**Segment, prioritize, and balance.** Take a fresh look at your business, geography, product, and customer portfolios to understand where the best opportunities for creating and exploiting advantage lie. Ask yourself if the balance between growth and

cash flow is sustainable, whether you should be investing more in growth, and whether there are positions you should be turning around or exiting. Our analysis of corporate vitality suggests that many established companies are driving short-run performance at the expense of long-term growth, exposing themselves to the risk of stagnation and decline.

**Mass customize.** Digital technology now gives us the ability to microsegment customer needs and personalize an offering for individual customers. Rather than being unique overall, it is now realistic to be unique to each customer on each occasion. Doing so effectively and consistently creates stickiness, which can be difficult to undo.

**Focus less on competitors and best practices.** Business is dominated more and more by digital platforms, which do not respect industry boundaries. You may believe that you are competing with a handful of large companies that make similar products, whereas your customers’ expectations may be shaped by leading digital competitors

EXHIBIT 5 | Technology and Technology-Driven Companies Dominate the Vitality Index



Sources: S&P Capital IQ; BCG Henderson Institute analysis.

<sup>1</sup>All metrics are based on global sample of 1,083 firms (companies with \$10 billion+ in sales or \$20 billion+ market cap as of year-end 2017, excluding energy, metals & mining, and commodity chemicals).

<sup>2</sup>Distribution of 50 companies with highest revenue growth from 2012 to 2017.

<sup>3</sup>Includes real estate, telecom, utilities, materials.

in other industries. By focusing on outperforming your direct competitors and introducing best practices from within your industry, you may be setting your sights too low and making yourself vulnerable to disruption by challengers with more-compelling value propositions.

**Compete on the rate of learning.** The combination of ecosystems, big data, machine learning, and automated decision making is accelerating the rate at which we can learn in technologically enabled enterprises. We believe that in the next decade, enterprises will increasingly compete on the rate of learning. By re-inventing the organization to combine people and technology in new and synergistic ways, you can sustain your edge by learning faster than your competitors about your customers' changing needs.

**Surprise and delight.** Asking your customers what they want, or even measuring accurately what they are buying or browsing, may not be sufficiently forward-looking

to compete with your fiercest rivals. Analyzing and addressing the friction costs in your customers' end-to-end processes, and surprising and delighting them by solving for these before customers can articulate the need, is a bolder and more effective way of looking ahead and maintaining your edge.

**T**HERE HAS NEVER been a worse time to be average. The winners of the 2020s will be the companies that focus on imagining, articulating, creating, and sustaining what helps them escape the mean.

#### NOTE

1. As measured by economic profits (return on equity minus the cost of capital) for US-listed companies.

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