Perspectives

Advantage, Returns, and Growth—in That Order

The Boston Consulting Group

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This article is the first in a series of Perspectives on strategy and value creation.

Short-term market pressures make it tempting for managers to play a game of growing volume, beating plan, or exceeding analysts' estimates for the quarter. But sustained value creation requires disciplined portfolio choices that drive performance along three critical dimensions: competitive advantage, returns (on capital), and growth. The sequence is important: without advantage, returns decrease; and without adequate returns, growth destroys value. Although these principles sound deceptively simple, the wishful funding of me-too strategies and chasing after growth in low-return business positions annually extinguish immense amounts of shareholder value.

Market Valuations: Providing a Feedback Loop on Performance Priorities

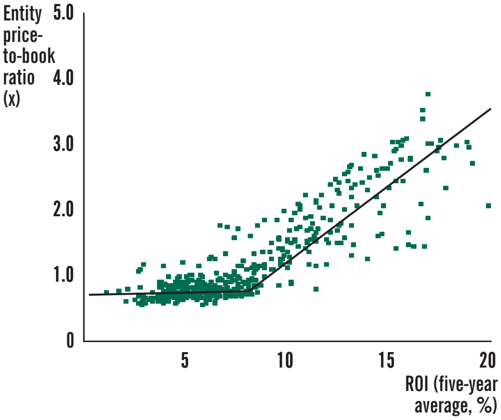
Exhibit 1, on page 4, compares how investors value businesses with different returns on capital. Each dot shows a particular company's valuation multiple, or entity price-to-book ratio, versus the profitability of the business, measured as the five-year-average after-tax return on gross invested capital (ROI), excluding goodwill. The exhibit indicates an overall positive relationship between ROI and the valuation multiple. One dollar of cash flow reinvested in a high-return business creates $1 of new book capital and often $2 or $3 of net present value, while the same dollar reinvested in a low-return business will usually be worth less than $1.

Looking more closely at the left-hand side of the exhibit, we see dots representing 75-cents-on-the-dollar businesses. These businesses earn ROIs of less than 8 percent (roughly at or below the cost of capital), and their valuation multiples cluster between 0.7x and 0.9x. There is a

EXHIBIT 1

INVESTORS PRICE STOCKS BASED IN PART ON DEMONSTRATED ROI PERFORMANCE

Example: Consumer Products and Industrial Goods Companies, 1985–2003



SOURCES: Compustat; BCG ValueScience Center analysis.

small but steady upward drift in the valuation multiple as ROI increases from left to right.

These businesses on the left are usually low-margin and asset intensive, with little competitive advantage. And the market values these low-return companies on the basis of assets (not earnings): the flat slope of the trend line suggests that there is a relatively weak link between valuation and current period profits. These companies consistently trade at a discount to book value because the capital reinvested to sustain the assets doesn't earn back the cost of capital. In other words, each $1 reinvested and on the books is worth only about 75 cents.

As ROI increases above the cost of capital, investors seem to price companies differently. An upward "kink" in the exhibit's trend line indicates that the slope of the relationship between ROI and the valuation multiple becomes much steeper. The story behind this steeper slope is *competitive advantage:* high ROIs reflect competitive advantage, and higher ROIs signal more advantage. Investors, in short, are willing to pay a premium for advantaged assets.

At the same time, however, the goodness of fit seems to decrease for these high-ROI businesses. Turning again to the exhibit, we can see that the vertical scatter in the valuation multiples increases with increasing ROI. Competitive advantage, then, doesn't tell the whole story. A key variable is missing, and that additional variable is growth. High-ROI businesses with more growth potential are above the trend line, and high-ROI businesses with low growth potential are below the trend line.

Portfolio Priorities: Differentiating Goals and Skewing Capital Allocation

So what does all this mean for managing the corporate portfolio?

First, senior managers must frame decisions about portfolio choices at the business level—not just at the project level. That may sound simple, but many companies destroy value through a bottom-up process of funding all "good" projects as they appear or setting one-size-fits-all performance goals across all units (such as increasing volume growth, market share, or operating income margins). Managers of low-return businesses constantly fund incremental investments whose high (forecast) project-level returns fail to raise the business as a whole to attractive levels.

Portfolio choices do not emerge magically from a mechanical review of historical returns. But the business economics are simple: if you don't understand and address the underlying competitive realities that are causing sustained low ROIs, you should expect investments in those businesses to continue to return 75 cents on the reinvested dollar. Often, these value-destroying investments are funded or subsidized with cash flows from higher-ROI sister units. Such cross-subsidies destroy value and are a common cause of the so-called conglomerate discount. Despite the name, such a discount can plague any company that averages reinvestment across a mix of high- and low-return business positions. Even focused companies, such as single-format restaurant chains or retailers, can earn a conglomerate discount by deploying cash flow from their high-ROI legacy locations to fund the opening of marginal new locations.

Second, senior managers need to segment the portfolio and adopt business-specific goals across competing performance priorities. Each company—each dot in the exhibit—is in fact an aggregation of underlying business positions with different competitive positions and business economics. A one-size-fits-all goal-setting approach treats businesses with different starting positions as if they had the same value-creation priorities. But they don't. In framing the relative merits of investing for growth, focusing on raising returns, or decapitalizing the business, managers need to start with a fact-based review of the long-term return patterns in the peer group of each business unit.

- Are long-term industry returns attractive overall? In other words, are ROIs above the cost of capital?

- Which companies earn high returns and what is their source of competitive advantage? Does that advantage show up in relative cost, relative price (and mix), or relative asset intensity?

- How do your businesses and business subsegments perform relative to industry leaders in terms of ROI level and consistency?

By segmenting the portfolio in this way, you will usually uncover three groups of businesses: those with low returns, those with high returns, and those with erratic returns.

For businesses with sustained low returns and therefore little competitive advantage, you must probe to discover root causes and think as an owner would. "Value" investors who specialize in making money from low-return assets focus their efforts on the restructuring (not growth) implications of low returns:

- If there is a structural problem with the industry—for example, depressed returns for all participants—can you consolidate (either as a seller or as a buyer) to improve industry returns?

- If the strategy is misguided, can you identify the segments and activities that would provide customer value and profits? And can you refocus your efforts, and shrink or exit the remaining segments and activities?

- If the issue is one of bad execution, how quickly can you prioritize the problem areas and close the gaps?

- In all cases, how does the return from selling the business compare with the value, risk, and achievability of the "keep and fix" program?

For businesses with sustained high returns, and therefore meaningful competitive advantage, growth is the obvious priority. Paradoxically, the portfolio management choices can become substantially trickier when you begin from such a strong position:

- An easy choice, if you are lucky enough to be presented with it, is to fund a high-return business facing growth opportunities that reinforce the core business and preserve or raise relative market share.

- A more common—and difficult—challenge is to assess growth investments in a high-return business with few close-in growth opportunities (those to the right and below the trend line in Exhibit 2, on page 10). Growing successful but mature positions often entails taking a leap to new business models or constructing a bridge to "adjacent" markets, where the company's current capabilities and drivers of advantage often apply weakly or not at all. But if the economic linkages between adjacent markets and the core are real, such incremental investment can create significant new businesses, raise the sustainable growth rate, and trigger a positive rerating. (See B➜A in the exhibit.)

- In either case, growing through acquisition can be rewarding but requires the discipline to pay a reasonable price and capture substantial net synergies after the acquisition. You will pay market value (plus a control premium) for the assets, resetting the ROI equation.

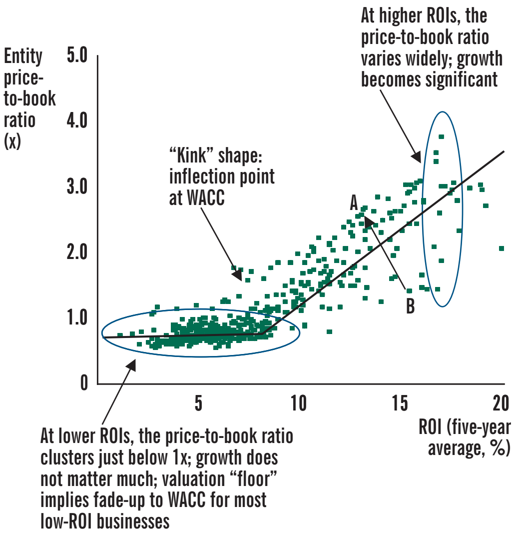
Finally, for businesses with erratic (not just cyclical) returns, one of two things is likely going on:

- There may be a temporary industry instability, usually related to competitive or technological dislocation. In these cases, it's especially use-

EXHIBIT 2

COMPANIES WITH HIGH RETURNS CONFRONT DIFFERENT CHALLENGES THAN THOSE WITH LOW RETURNS

Example: Consumer Products and Industrial Goods Companies, 1985–2003



Sources: Compustat; BCG ValueScience Center analysis.

ful to think creatively about the future—who is likely to win and why.

- The sources of competitive advantage (and returns) may be inherently fleeting or unstable. These businesses are usually not very good candidates as significant portfolio positions for publicly owned companies.

* * *

Portfolio strategy can be a huge lever in driving sustained shareholder value. But managers need to pull up from a purely executional focus and skew their goal setting and capital bets aggressively, finding and funding strategies with competitive advantage and high returns, and fixing or disinvesting disadvantaged businesses. Growth without advantage buys size but creates no value. And beating plan and making the quarter are not enough.

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