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Pay Attention to Revenue Growth. But How?

by Paul Leinwand, John Loehr, and Kolinjuwa Shriram

Growth is back on the agenda. It's the increasingly prominent topic of discussion at board meetings, executive sessions, and corporate retreats. Executives recognize that, with cost savings intrinsically limited, long-term financial performance hinges on improving the top line.

But although companies find it more advantageous to pay attention to revenue growth, very few do it well — mostly because they are not confident about what initiatives will drive successful and profitable growth. Many companies find it difficult to deliver and sustain growth in the face of greater competition and commoditization. In fact, in the long term, few companies have outpaced the growth inherent in inflation and population increases. Because of this, they're often driven to seek growth in risky, and usually disappointing, acquisitions.

But what if the problem — the stagnation that leads businesses to attempt desperate measures — was partly a matter of misunderstanding? What if there was a known inherent growth rate for any given portfolio of businesses? If so, then companies could achieve profitability, and outsiders could evaluate companies more accurately, by developing a clearer awareness of a company's real-world potential.

To pursue a successful growth strategy, companies must ask two critical questions:

1. What is the inherent growth rate of our portfolio of businesses? In other words, what is the growth rate that demographics and inflation would predict for our particular set of geographic markets and product categories?

2. Measured against that inherent growth rate, how well does our company perform?

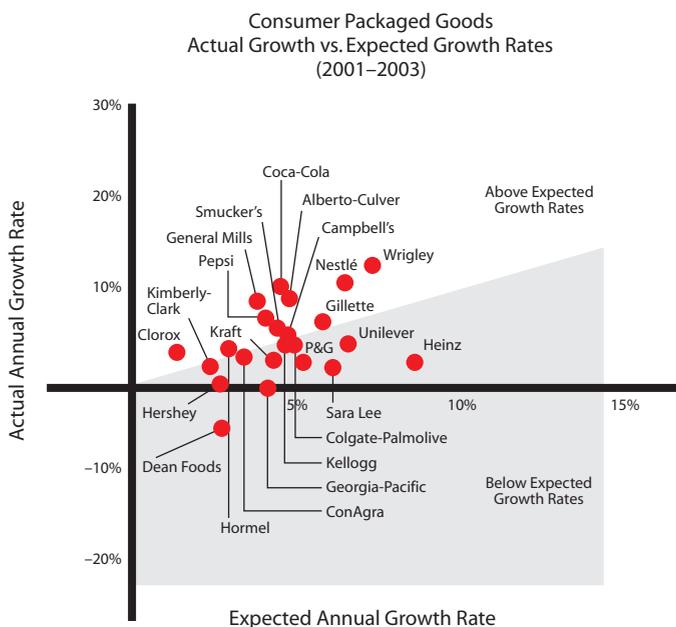
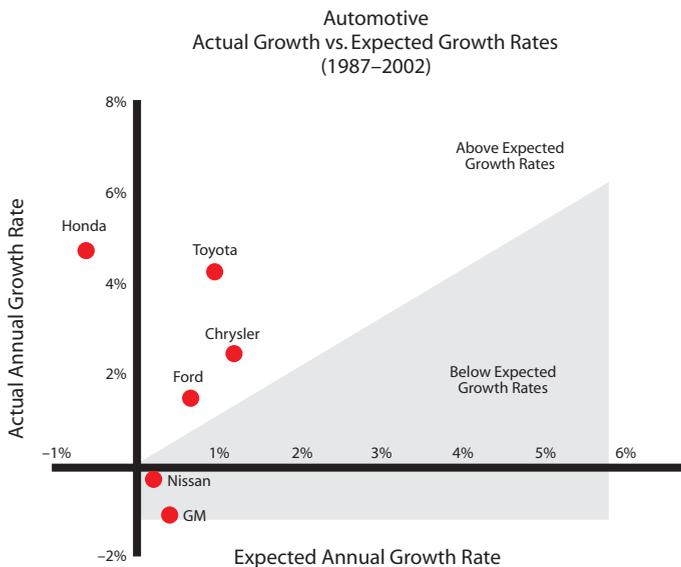
Answering the first question requires an honest and unconditional evaluation of your company's business structure. The goal is to produce accurate forecasts of geographically based growth rates for each market and category you compete in. In other words, understand "the cards you were dealt."

Booz Allen Hamilton ran this analysis for leading companies in the automotive and consumer goods industries. (See Exhibit 1.) Companies that had "positive" inherent portfolios and, thus, high expected growth rates — Chrysler, Toyota, Heinz, and Wrigley — lie to the right on both charts. Those with a potentially weaker growth mix — Honda, Nissan, Clorox, and Kimberly-Clark — are at the left.

Next, we plotted actual growth rates. This tells the company how well it has "played its hand." Did actual growth outperform the company's inherent growth expectations? We found that when a company exceeded its forecasts (the dots above the shaded area) or underperformed them (the dots in the shaded area), there was always a logically robust explanation.

For example, Honda had a neg-

Exhibit 1: Actual vs. Expected Growth Rates



Note: Volume-weighted average growth rates

Source: Ward's Communications, Euromonitor Market Research for Consumer Goods, and Standard & Poor's

Many of the potentially weaker companies outperformed their seemingly stronger competitors, with actual growth outpacing their inherent growth rates.

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ative expected growth rate because for most of the 1980s and 1990s, the automaker's portfolio was heavily weighted toward small and mid-sized sedans — which were losing sales industry-wide to minivans and SUVs. Nevertheless, Honda was

able to far outpace its potential by increasing market share in its existing lines through vast improvements in quality and value.

In consumer goods, Wrigley and Alberto-Culver came out winners by adopting new channel

strategies. Wrigley relied on innovation, such as the introduction of sugar-free Orbit in the U.S. and radical new flavorings for aging popular brands like Juicy Fruit, to increase sales in convenience stores. Alberto-Culver drove growth in part through the expansion of its own Sally Beauty retail outlets.

Heinz represents the other end of the spectrum. Despite an excellent product portfolio, led by ketchup and other sauces, the company failed to deliver because of a weak competitive position in Europe; sales of its Ore-Ida frozen potatoes line also slipped badly after private labels precipitated a price war.

In our analysis of the automotive and consumer goods industries, companies that exceeded the inherent growth rates of their portfolio always produced superior returns on equity. Meanwhile, a large majority of companies that underperformed saw their share prices sink.

There are scores of frameworks, tools, transaction models, and organizational structures for evaluating revenue growth, and most of them suffer from the same weakness: They drive companies to pursue random avenues of growth without assessing the inherent growth potential of these new businesses (or the company's existing business line). In our view, that's akin to the blind leading the blind. Only by first identifying actual and inherent growth rates can a company have enough insight to know where and how to grow.

To identify growth rates, start by analyzing the limits to inherent growth for your company's portfolio. What are the individual growth rates for your company's products and services, given the geographies in which you operate? How is the

population expanding (or contracting)? What is the potential impact of inflation or other pricing pressures on the revenues you would expect?

With a more specific and precise analysis, you may discover, as many companies do, that you're actually doing better than you think. That is, you have realized more growth than predicted given your portfolio's limits. Or perhaps you'll discover the opposite — that the relatively high growth you've achieved is not living up to the inherent growth of your business. In either case, understanding how your existing portfolio can be adjusted or better managed is a clear priority

before pursuing more “desperate measures” that might diminish your profitability.

What can the executive team do to improve your company's ability to reach and surpass its potential? Are acquisitions, chancy as they may be, the only answer? Or can you improve your portfolio by reprioritizing, expanding the geographic reach of successful products, improving the performance of lagging brands, or deemphasizing money-losing businesses? These are the questions that must be the focus of a solid growth plan grounded in a better understanding of the true growth potential of your business. +

Developing Diversity: Lessons from Top Teams

by Max Landsberg and
Madelaine Pfau

Who is better equipped to set the corporate agenda: a small and homogeneous top management team of like-minded individuals, or a larger, more heterogeneous team of individuals from a wider variety of backgrounds and perspectives?

There are many opinions on this issue, but very little hard data exists to recommend one approach or the other. As a result, in collaboration with the Center for Effective Organizations (part of the Marshall School of Business at the University of Southern California), we sought to address the issue by analyzing 66 peer-reviewed studies of top management team composition and performance conducted since 1984.

Two findings stand out. We discovered that diversely educated and experienced top management teams give corporations an edge, enhancing their ability to manage globalization and strengthening their financial performance. But there's a catch, and this is our second significant finding: Without the right mix of incentives and an appropriate leadership style, diversity can hinder, not help, performance.

Specifically, we examined correlations between corporate performance and four measures of heterogeneity in the leadership team: breadth of functional expertise, educational background, international experience, and industry experience. We also considered whether corporate performance varied with the size of top management teams — a rough proxy for heterogeneity given

that new team members are commonly added because they bring fresh perspectives resulting from their different experiences.

We found that in rapidly changing industries, such as semi-conductors, natural gas, and medical devices, management team size does matter. On average, companies run by teams of between seven and nine people consistently delivered better top-line and bottom-line performances than companies managed by smaller teams.

Beyond team size, there was also a strong positive correlation between corporate performance and a broader range of experience (functional, industry, and international) and education.

But although a majority of companies profit from heterogeneity, others are actually hampered by it. The problem is that heterogeneous teams are harder to motivate and manage. Heterogeneity decreases loyalty and increases the probability of conflict.

The results suggest that the critical moment is the point of transition: when a close-knit, like-minded top team evolves into a more heterogeneous group of diverse senior executives. This type of transition is increasingly common in today's globalizing world, and the companies that have navigated it successfully appear to have taken four steps:

1. **Promote openness.** Trust is harder to build and sustain in heterogeneous teams because the bonds that connect people of similar backgrounds are lacking. A secretive culture makes the task harder still. Consequently, for diversity to succeed, internal debate should be encouraged (and never punished) and information should flow freely within the organization.

One of the more interesting recent attempts at openness involved a major health-care company that organized a “fishbowl” at a leadership conference, at which the newly formed heterogeneous nine-member senior team sat in a circle and discussed the changes they had recently seen in their behavior and that of others. The discussion was watched by 75 executives one rung down from the top team, who had been enlisted by the CEO as a sounding board.

2. Focus on goals. Debate is valuable, but it should be explicitly directed toward defining and prioritizing goals. This indicates a more directive role for the CEO. Rather than controlling discussions, the chief executive should play a guiding role, helping participants keep their collective attention focused on topics of shared interest or concern.

3. Get the pay equation right. In heterogeneous teams, cohesion — already in short supply — will be further threatened by significant differences in pay among members (including the CEO). A fair compensation structure, which includes incentives based on objective performance benchmarks aligned with the organization’s core strategy, is essential to maintaining harmony

in a management team.

4. Emphasize training. Teamwork skills vary enormously from individual to individual. Coaching can make the difference. For example, the CEO of a major telecommunications company recognized that the marketing department needed to play a bigger role in the organization. The sales and marketing vice president clearly possessed the functional skills and knowledge for the role, but he was not a natural team player. A former tennis champion, he was more used to going solo. A 360-degree appraisal, which included perspectives from senior and junior colleagues as well as peers, identified the marketing chief’s limitations and convinced him of the need for change. Subsequently, personal coaching helped him collaborate more effectively with his peers. The manager’s personality did not change — at heart, he still preferred singles tennis — but he was able to learn to play a different game.

Adherence to these guidelines cannot guarantee success, but it improves the odds. Chief executive officers who adopt them will be less likely to pay a heavy price for pursuing change for the right reasons in the wrong way. +

tions (the advent of microprocessor-based catalytic controllers) with the creation of new segments — first compact cars and hatchbacks, then minivans, and eventually turbocharged SUVs. Responding to today’s challenges won’t be as simple. In effect, there will not be one next big thing that will allow the entire industry to jump on the same bandwagon. Instead, markets will likely evolve in divergent ways as countries choose their own regulations on emissions and fuel taxes, establishing different sets of incentives for automobile producers in each country and thus driving a variety of options for consumers around the world. Companies that hope to thrive in this environment will need the flexibility to realign themselves with many new sets of vehicle designs, power train alternatives, and primary brands.

Already, thanks to gas prices, the dominance of the large gasoline-powered SUV is over. Vehicle sales in the U.S. have shifted to CUVs (cross utility vehicles); between the first quarter of 2004 and the first quarter of 2005, sales of CUVs increased 1.83 percent, fueled by new model introductions, while sales of SUVs dropped 2.18 percent. The popularity of these smaller, less powerful vehicles, with 29 percent more fuel efficiency than SUVs, indicates that consumers are willing to make trade-offs for better mileage.

Looking forward, other implications of this shift could include the ramping up of alternatives to gasoline power trains. Fuel cells are still far off on the horizon, because of a lack of supporting infrastructure and various other technological constraints. Diesel-powered and hybrid (part electric and part gasoline powered) vehicles will almost cer-

Shifting Gears

by **Bill Jackson, John Loehr, and Natasa Azman**

Consumers in the United States, already squeezed by increasing gas prices in 2005, abandoned hope of relief as hurricanes Rita and Katrina swept down on Gulf Coast oil refineries and pushed gas prices above \$3 per

gallon. For the automotive industry, steady increases in fuel prices, along with regulatory trends and emerging technology, are signaling a moment of intensive change. The automotive industry has historically responded to changes in gas prices, regulatory trends (the tightening of emissions and fuel economy standards), and technological innova-

tainly become widespread sooner than fuel cell-powered vehicles. Diesel has been reasonably successful in Europe because of high taxes on gasoline, but the United States has chosen not to adopt that policy, and diesel penetration remains below 1 percent. However, elevated gas prices could improve opportunities for sales of diesel vehicles in the U.S. High-mileage drivers in particular can realize significant savings with a diesel vehicle. So can drivers of heavy vehicles such as vans, pickup trucks, large cars, minivans, and SUVs. This alone could push diesel penetration in the United States into the 30 percent range within 10 years.

For this to happen, though, diesel engines will have to meet stringent emissions tests. U.S. regulations that took effect in 2004 require that by 2007, diesel engine nitrogen oxide emissions be reduced

omy (in city driving) than non-hybrid versions of comparable gas-powered vehicles, whereas vehicles powered by diesel fuel typically achieve 30 percent better fuel economy (in all conditions) than their gas-powered counterparts. Furthermore, because hybrids are fueled with gasoline and can make use of existing infrastructure, they are more convenient than diesel automobiles, since diesel is available in only about one-third of retail fuel outlets in the United States. Studies have shown that 50 percent of all fuel consumers say that convenience is their primary purchase consideration. And unlike diesels, hybrids do not raise concerns among consumers about cleanliness and noise.

However, hybrids are expensive, selling for at least \$3,000 more than comparable conventionally powered cars. The extra engineering

some European markets, particularly because of the congested, stop-and-go driving in such large cities as Paris, Rome, and London.

Currently, Japanese and European manufacturers are best prepared to meet this changing auto environment. They have the lead on hybrid and diesel power trains; they also have more rapid design cycles and are more capable of rolling out new fuel-efficient designs as needed. Meanwhile, some lesser-known companies could benefit from changes in market demand. For instance, smaller car manufacturers, such as France's PSA Peugeot Citroën, might enter the North American market with diesel technologies and small and medium-sized cars. Market shifts could also allow for the emergence of another creditable set of auto manufacturers from nations like China or India.

Over the next couple of years, automakers and their hundreds of suppliers will make sizable expenditures to meet these expected shifts in vehicle sizes, types, and power trains — whether the shifts are to diesel production and development of hybrid technologies or more exotic alternatives. Manufacturers will need a nimble and rigorous view of the marketplace to make these expenditures pay off.

Often, executive instincts are off the mark during changing times. Executives must shift from a progressive strategic-planning process to a more economically rigorous plan that outlines clear behaviors for anticipating the unexpected, both to seize opportunities and to fend off unforeseen threats. We already see the shift occurring from high gas prices. Are you ready to make the right bets, moment by moment, during this dynamic time? +

In autos, there won't be one "next big thing"; markets will evolve in divergent ways.

by 93 percent and particulate matter emissions be reduced by 90 percent. In addition, the government stipulated that carbon monoxide emissions from diesel vehicles be at the same level as those from gasoline vehicles. Although these standards will increase the cost of making and selling diesel vehicles in the U.S., we believe that the opportunity to tap the large market that has been buffered by high gasoline prices will convince global automakers to refocus their sights on diesel engines.

In some ways, hybrid cars represent an even more attractive alternative than diesel. Hybrids achieve 30 to 60 percent better fuel econ-

required to "hybridize" a regular power train ranges from moderate to gigantic (sophisticated power train controllers, a million lines of software code, and "power electronics" in the black box). The cost of this will only come down with economies of scale. Consequently, even with fuel prices as high as \$3.50 per gallon, only the highest-mileage consumers would be expected to switch to hybrids. This will limit U.S. hybrid penetration to less than 10 percent over the next decade. For the short term, at least, diesels seem to be a better value for most U.S. consumers, whereas hybrids seem to be a better value in

As Patent Laws Weaken, Innovation Suffers

by Robert P. Siegel

Imagine if the only penalty for shoplifting was that you would have to pay for what you took. Implausible as it sounds, that is essentially the consequence faced by those found guilty of patent infringement. Under the current system, if someone (or some company) appropriates a patented idea, the punishment is generally nothing more than the payment of “reasonable royalties.”

In other words, patent infringers are seldom forced to pay out more than they would have if they had licensed the idea from the inventor in the first place. This slap on the wrist is not just some idle quirk in the law. It’s part of a disturbing decrease in the strength of intellectual property rules that may be stoking a growing innovation crisis in the U.S.

Patents were designed to serve as a temporary protective shell around technological seedlings, letting them enter the marketplace shielded for at least a few years from deep-pocketed, established competitors. In recent years, a long-standing legal battle has intensified, threatening to permanently undermine this original intent.

On one side of the legal battle is a new breed of contingency litigators, who file patent infringement suits for inventors who could not otherwise afford an attorney. These so-called patent trolls have recently won visible judgments against some big-name companies. In 2003,

Microsoft was ordered to pay \$560 million to Eolas Technologies Inc. and the University of California for infringing their patent involving functions in Web browsers. (The case was overturned on appeal and will be retried.) And in March 2005, Research in Motion Ltd., which makes the BlackBerry, agreed to pay a little-known inventor \$450 million in a conflict over patents involving wireless e-mail.

On the other side, a number of large corporations — in the automotive, electronics, aerospace, and computer industries, among others — have reacted to these suits by lobbying for weaker patent laws. These big companies, which were often unaware that there were any potential patent claims against them until they came up in court, argue that the inventors take advantage of legal rules to extort big paydays with sometimes frivolous claims on technologies that businesses have used for years. The cure: less stringent protection for inventors.

But by taking this position, U.S. corporations may be hurting themselves in the long run. As former Microsoft Chief Technology Officer Nathan Myhrvold put it: “Small changes in patent law can, as an unintended consequence, have catastrophic effects.”

For years, the U.S. patent system perfectly balanced the interests of the inventor with those of established companies and was considered among the best in the world, responsible for decades of innovation. Between 1929 and 1982, more

than two-thirds of the productivity gains in the U.S. were the result of advances in science and technology, according to George Washington University economist Edward Denison. Now, with global competition at a fever pitch, companies may have picked the wrong time to tinker with these rules and thereby discourage inventors from inventing. The implications affect not just the future of American patent law, but also innovation around the world. Corporations and independent inventors everywhere in a global economy, all with important ideas to protect, require consistently strong patent laws of the sort that America's founders originally designed.

There are already signs that watered-down patent rules are discouraging American invention. Annual U.S. patent growth slowed to about 1 percent in 2002 and 2003, after increasing an average of 4 percent in each of the prior three years, according to U.S. Patent Office data. Moreover, in 2004, U.S. patent output declined by nearly 5 percent, with 75 percent of this drop-off attributable to American inventors.

Prolific and controversial inventor Jerome Lemelson is often cited as the cause for the business community's drive to weaken patent regulations. Mr. Lemelson, who died in 1997, had nearly 600 patents to his name, for innovations involving automation, computers, VCRs, toys, and much more. His patent applications were long, detailed, and so full of ideas that some were eventually divided into as many as 20 distinct patents.

Some of Mr. Lemelson's patents took decades to issue. But when they were finally granted, the inven-

tor gained exclusive rights to such ubiquitous technologies as barcode scanners and automated machine vision systems. From 1989 to 1997, with "submarine patents" — so called because they emerged out of nowhere, long after companies had adopted the technologies — Mr. Lemelson sued Japanese, European, and American automakers and elec-

generated revenue or even been awarded a patent.

And a proposed bill, the Patent Reform Act of 2005, would diminish patent rules further. Under this legislation, patents go to those first to file, rather than first to invent; companies or individuals can avoid paying royalties to inventors by claiming that they previously used

Corporations and inventors everywhere require strong patent laws like those America's founders originally designed.

tronics companies, among others, for patent infringement, ultimately receiving an estimated \$1.5 billion in settlements. In January 2004, a surprise ruling from a Las Vegas district court invalidated his barcode and machine vision patents.

But the damage had been done. In 1995, just as Mr. Lemelson's litigation was at its peak, corporate lobbyists convinced Congress to change the life span of patents to 20 years from the date of application. Previously, it had been 17 years from date of issue. Under the new rules, if a patent took 10 years to be approved, only 10 years would remain on it. This effectively crippled the possibility of a submarine patent, but also broadly weakened patent protection.

A 1999 law restored some protections but added the requirement that most patent applications be published within 18 months of the filing date, eliminating the secrecy that had always been associated with these documents. This exposes inventors when they are most vulnerable, before their ideas have

the idea; and any party, foreign or domestic, can stall a patent indefinitely by asking for a reexamination.

Most observers would agree that companies need a viable way to respond to unjustified sneak attacks on their use of technology, but diluting patent laws is not the solution. A more thoughtful answer would be to give the Patent Office the resources it needs to eliminate harmful delays, and to return to fixed patent terms of 17 years from the date of issue, without prior publication, with one key caveat: If a patent has not been issued after three or four years, and if the delay is caused by the inventor, it should be published promptly. That way, companies will not be blindsided by outliers playing the system.

Perhaps with an approach like this we can return to a time when patents lived up to Abraham Lincoln's lofty praise: In naming the most significant achievements in world history, he cited the "the art of writing and printing, the discovery of America, and the introduction of patent laws." +

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