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Growing When Your Industry Doesn't

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BY KASTURI RANGAN AND EVAN HIRSH



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If we had a nickel for every executive who appeared on CNBC and blamed his or her company's inability to grow on a weakness in the market, we'd be richer than Croesus. Of course, there's a reason this explanation for uninspiring performance is so common: It's readily available. At any given time, roughly half of all industries are growing below the level of GDP. And it's only natural to blame something external for one's problems.

The trouble is, a weak market isn't a valid excuse. Plenty of companies that achieve above-average shareholder returns compete in average or below-average industries. Consider Polaris Industries, a maker of snowmobiles, whose revenues and

shares have both surged in a sector (leisure equipment and products) that is not exactly "hot." On average, a dollar invested in Polaris's shares has risen 24 percent per year for the last 10 years, while the average stock in the global leisure segment returned just 9 percent annually. Or think of Tupperware Brands, which achieved a 22.4 percent average annual gain in the last 10 years, versus the 3.6 percent average annual gain of household durables companies worldwide.

There are always some companies that find a formula for growth and success in industries that aren't doing anything special—that are just bumping along with the economy, or underperforming it. If you're an executive in one of these industries, it's your job to ignore the ex-

cuses and figure out how to join the ranks of overachievers.

In our analysis of shareholder returns over the last few decades, we found the phenomenon of superior performance to hold true in every industry, in every part of the world, and over every time period that was long enough to allow the leaders to become apparent. Between 2003 and 2013, for instance, 30 percent of companies with top-quartile shareholder returns (our proxy for success) were in industries growing at or below the rate of GDP. Even industries at the bottom of the heap produced their share of top performers (*see Exhibit, next page*).

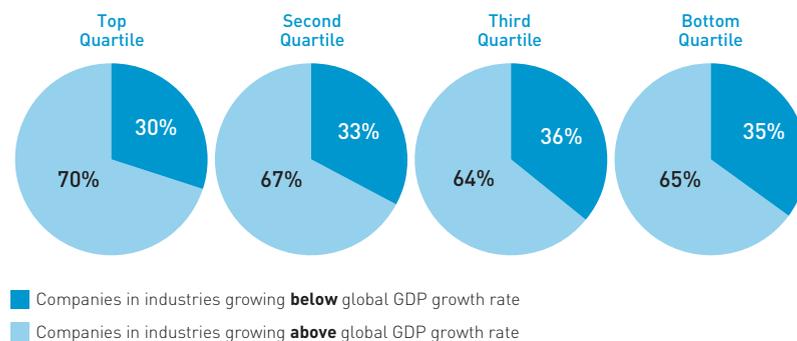
How do the winners in low-growth industries do it? By taking market share from others. And not only do they take market share, but they take it profitably, often without reducing prices. When companies successfully get these two things going together—market share and profitability gains—they in effect create their own growth cycle, one that is independent of the industry cycle. A sort of disequilibrium takes hold, allowing the companies that created it to become dominant in their sectors.

We all know what equilibrium looks like. Equilibrium is the state that exists when a set of companies with fundamentally similar offerings compete within a market, getting similar returns and amassing market shares within a few points of one another. Not to put too fine a point on it, but equilibrium isn't all that interesting. When markets are in equilibrium, competing players (and sometimes there are only a few worth talking about) battle for minuscule amounts of market share. However well developed these companies' operational abilities, or how-

Exhibit: Industry Irrelevance

Between 2003 and 2013, an analysis of 6,984 global firms in 64 industries revealed that slow-growth industries can still produce top performers.

Company Performance by Total Shareholder Returns



Source: CapIQ and Strategy&

ever talented their executives, no one studies them for ideas about how to achieve off-the-charts business success.

Disequilibrium is much more dynamic. The companies that create the conditions for it generally don't follow a template, but discover a particular advantage they can use to tilt the market in their direction and keep it that way. These enterprises often become a source of fascination (and envy) among competitors because they offer proof that in business, true advantage can be created and sustained for years, or even for decades, when companies are especially shrewd—no matter the overall state of the industry.

Creating Disequilibrium

Among the more vivid examples of how a company can introduce disequilibrium into its market—and earn above-market returns as a result—is Blockbuster Video. Blockbuster has now been relegated to the dustbin of business history, but before it came apart in the digital revolution, the company enjoyed a prolonged run of success in which it capitalized on a form of disequilibrium

that it had managed to create.

Blockbuster entered the movie rental industry in the mid-1980s, when there were about 60,000 rental stores already in place. The price of renting a movie was falling rapidly, and within a few years the industry began consolidating. By the late 1980s, if you had asked most movie rental store owners (the large majority of them local, independent businesspeople) how their business was doing, they would have given you a pretty gloomy answer. But not Blockbuster.

In a market that generally consisted of cramped, musty stores, with quirky selections and inventory prone to malfunctioning, Blockbuster stood out. Its retail spaces were well organized, with wide selections that featured hundreds of new titles. It built an extensive customer database that allowed it to optimize the mix of titles in each store—a far cry from local rental places, where “customer intelligence” came down to the owner's intuition or personal taste. And Blockbuster was big enough to gain scale advantages—including in what it paid for its inventory.

Blockbuster's superior model allowed the company to wrest existing customers from many smaller stores, and to pull in a fresh set of customers just entering the market. By 1990, the aggregate dollar value of movies rented and watched on home VCRs (the prevailing technology at the time) had essentially reached its market peak and was flattening out. Yet in this slow-growing market, Blockbuster thrived. Its share grew from 10 percent in 1990 to 35 percent in 1995 to 45 percent in 2000.

Blockbuster created disequilibrium in one of the two ways it can be done, through changes on the supply side of the market. *Supply-side changes* that push a market in one company's favor usually involve advantages in quality, functionality, cost/price, service, or selection. Blockbuster had the last three of these in abundance.

The other way to create disequilibrium is through changes that capture demand that didn't previously exist (or that was inaccessible). *Demand-side changes* are typically enabled by some sort of technology shift, such as—ironically—the one that would eventually cause Blockbuster itself to fall to a newcomer named Netflix. (More on this bit of history soon.) But demand-side changes can also be enabled by new regulations, such as those that paved the way for interstate banking in the U.S. in the 1980s. The banks that moved the fastest secured the most new customers, increasing their share of the available revenue and profits and giving themselves a huge advantage, at least temporarily.

Executives who want to create disequilibrium should begin by asking themselves a few questions:

- What do we do that's unique, that customers value?

- Can our competitors match this capability we have?
- Are there any coming technological or regulatory shifts that could transform our market, and if so, do we have a well-thought-out plan for addressing them?

Holding On to an Advantage

Some degree of disequilibrium, created by a company with a clear source of advantage at a given moment, is actually quite common. But usually it doesn't last. Only when market leaders take steps to deepen and extend whatever is working for them can they sustain their advantage. And then companies can sometimes hold on for decades, continuing to grow even when their industry is static or shrinking.

Companies in the lead typically have two important levers available to them. First, they can *manage the ecosystems* of their industry—taking steps to gain favor with important suppliers, thwart competitors, and influence their industry's structure. Second, they can *use pricing strategically*. Of course, pricing is a sensitive area. Like some other competitive tools (including M&A, product bundling, and hiring away a rival's top talent), pricing must be used in a way that doesn't cross a line and open the company up to accusations of anticompetitive behavior. (Microsoft and AT&T, pre-divestiture, are examples of companies that have had their wings clipped by regulators.) The stories of market leaders Netflix and Johnson Controls Inc. (JCI), which we'll come to shortly, help illustrate the power of these tactics.

If the leading company uses its advantages smartly, other companies slip in both market share and profitability. And the effect is cu-

mulative: The less successful companies' weakening position leads to a reduction in investments, further hindering the quality of what these companies can offer to the market. Some of them don't survive, allowing the leader to grow yet more in influence and market power.

"It's like we have a fortress, and our competitors are down below, trying to get over the moat and beat down the fortress door," one executive said to us during a period when his company was reaping the benefits of disequilibrium. "I'm up here pouring boiling oil on their heads."

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Not every executive speaks about the satisfaction of beating rivals so colorfully. But the ones in slow-growing industries all recognize, on some level, that the gains are finite and it's ultimately "us" or "them."

From Leader to Loser

The success of a leading company's business always spurs competition, from the existing rivals and, often, from brand-new entrants. If the competition doesn't offer anything fundamentally new, the leader will hold on to most of its market share or even gain additional share. But if a rival comes up with a superior approach and has the wherewithal to extend that new advantage, the disequilibrium dissolves. And then the fortress the leader has built for itself can become a trap that ensnares it.

Here we can resume the Block-

buster story line: Starting in the mid-1990s, the company's success attracted two new players, Hollywood Video and Movie Gallery, both of which were largely copying Blockbuster's model of running well-organized video stores nationally. The new chains created headaches for Blockbuster and, as viable alternatives for consumers, had an impact on Blockbuster's growth and profitability. But the leader held on to its lead, opening almost 6,100 stores between 1990 and 2000, more than twice the number of the other two chains combined. The

new entrants simply did not offer enough differentiation to overcome the disequilibrium Blockbuster had created.

The real turning point for Blockbuster (and the movie rental industry) came in late 1999, with the emergence of Netflix. With its model of allowing consumers to order DVDs online and receive them by mail a few days later, Netflix tapped into an appetite for online shopping and convenience that was just beginning to take shape. Nothing in Blockbuster's capabilities system was built to serve this need, and for the first time in its history, the company found itself behind a trend instead of initiating one. Things only got worse in 2007, when Netflix began making a library of movies available to its customers via streaming technology. Blockbuster had no answer

to the value proposition of streamed video entertainment. It wasn't long before Blockbuster's greatest assets, its physical spaces, were becoming a huge liability and an unproductive drain on the company's cash and capital. In 2010, having failed to evolve its decades-old business model, Blockbuster filed for bankruptcy. It closed its last stores in January 2014.

For the better part of the past decade, Netflix has been taking advantage of disequilibrium. Looking at the company's performance, including a subscriber base and revenues that rose by more than 250 percent between 2009 and 2013, you might think that home video rental is a sweet place to be. But for most companies, it isn't. It's just that Netflix built the position and made the investments needed to get a

In low-growth industries, external shocks, whether from technology or regulatory change, are less common. Companies in those industries actually have a better chance than those in high-growth industries of maintaining their advantage and achieving superior total shareholder returns (TSR) for extended periods of time—counterintuitive but true. Companies in low-growth industries can often turn internal operations and process innovations into sources of competitive advantage, continually improving in those areas and upping the ante for rivals.

Consider JCI, and in particular the company's North American energy storage business, known as Power Solutions. Batteries have been a slow-growth industry for decades. In the early 1990s, after losing Sears, its biggest customer, the division

able, over time, to offer better prices and warranties than most of its rivals. This allowed it to build back a sizable U.S. market share. Pretax operating profit in the Power Solutions business unit has grown 17 percent annually for the past decade—a remarkable achievement in a slow-growth industry. Market share increases have been a big contributor to the unit's stellar profit performance. So has the company's low cost basis, which has helped create a situation in which increased customer demand and economic gains usually benefit JCI's bottom line and further strengthen its position.

One can't attribute the whole of JCI's astonishing 20-year TSR run to the performance of its energy storage business, but batteries have certainly played a role in it. Though providing only 15 percent of JCI's revenue, the Power Solutions business unit contributes more than 30 percent of the company's pretax operating profit.

And then there is Polaris, whose present domination in the sports vehicle segment is partly a story about cost and partly a story about micro-segmentation. When Scott Wine joined the Medina, Minn., company as chief executive, in a calamitous 2008, he knew that his first job was to cut costs. But he exempted Polaris's engineering department from the cuts. He had two reasons for doing this. First, he was counting on his engineers to be innovative about removing costs, so that a Polaris side-by-side vehicle (also known as a utility vehicle) would be cheaper to produce than one from Yamaha or Kawasaki. Second, Wine knew that Polaris would need its engineers if it was to increase the commonality of the parts the company used across its product lines, which was a pre-

Netflix's determination to double down and keep getting better at the things that set it apart is a lesson for every company.

good share, then a better share, then a huge share, of a slow-growing business. Netflix's recent talk of raising prices—a possibility introduced in a letter to shareholders earlier this year—shows it understands the power it has and is looking for additional ways to capitalize on it.

Winners' Relentlessness

Netflix's determination to double down and keep getting better at the things that set it apart is a lesson for every company. In fact, it demonstrates a path to winning that's more reliable in low-growth industries.

struggled. The unit's leaders realized they had to make some fundamental changes. They undertook a major restructuring program, stripping out operational complexity and attacking inefficiencies of every type. The resulting 25 percent cost reduction allowed the business to survive, and, gradually, to become stronger.

Through a relentless, disciplined focus on continuous cost improvement and through critical investments in advanced process technology, JCI's battery business transformed itself into the industry front-runner. The company was

requisite to allowing the company to innovate more quickly.

Within a few years, Polaris had one of the lowest cost bases in the industry and a lineup of side-by-side vehicles at multiple price points, with different seating capacities, with different form factors, and running on different types of energy systems, including diesel and electric. “We had created an armada,” Wine told us, remembering the first time he saw the full new side-by-side product line, displayed in a semicircle on a field outside Polaris’s R&D

the cycle that Polaris has begun.

What does all this mean, if you’re a CEO in a slow-growing industry? It means you shouldn’t go looking for a “better” industry, one that’s growing more rapidly than yours. Embrace your own segment. Counterintuitive as it sounds, the opportunity to get great returns for shareholders is probably better where you are than in a market that’s growing by double digits. You can make those better returns come to you by figuring out where you have an advantage, or might gain one, in

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facility in Minnesota. “You weave all of those things together”—that is, Polaris’s cost advantage and the different types and price points of its products—“and you see how we’ve been able to take so much share.”

Polaris’s stock price, around US\$23 when Wine joined the company, is more than five times higher as of this writing. (By contrast, the stock prices of Kawasaki and Honda, the latter being one of Polaris’s big rivals in motorcycles, have stayed more or less steady.) The company’s revenue growth has averaged 27 percent per year in that time, versus 8 percent for Polaris’s peer group. Yet Wine says that what matters is the company’s ability to build on what it has achieved. “The real challenge for me starts now,” he told us, and relates to “what we can do for the next four or five years.” In effect, Wine is talking about perpetuating

terms of cost, service, selection, or a disruptive new product. Make an increase in market share your main measure of winning. And finally, once you’ve got the advantage, keep on doing what you need to do to extend it. The nature of any market is that the opportunity is finite. It’s you or them. +

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