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The Dangers of Adjacencies Strategy

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"What adjacencies should we enter?" Over the last decade, this question has become synonymous with asking, "How should we grow?" in almost every major company around the world. If growth is an imperative for a business to survive, then entering adjacencies has become the growth strategy *du jour*.

But like any "something"-strategy that finds fame, an adjacencies strategy can be dangerous to a company's health.

Consider big-box retailers such as Walmart and Tesco. Lemming-like, many are pursuing a small-format adjacency strategy. They built enormous businesses by laying down ever-larger stores with an ever-broader range of categories. That path to growth has run its course in their home markets, and now they are rolling out small-store formats to open up pockets of geography that are too little for its big stores.

But here's the deal. I know for a fact that there are myriad growth opportunities sitting inside the large stores and categories they already own. They are hiding in plain sight. Alas, as with many other companies, these retailers seem to be afflicted by "adjacency addiction," a condition contracted when your core business hits a growth pause and you instictively start looking outside its boundaries for new sources of growth.

Adjacency addiction is more common that you might think. For example, it happened with the major airlines, most of which lost sight of how to grow their main business when they fell over themselves piling into car rental agencies and low-fare brand extensions. (Remember Delta's Song or United's Ted? Right, barely.) The same thing happened with integrated steel companies when they decided that construction aggregates would be a good growth avenue, only to watch Nucor turn their industry upside down with its mini-mill invention. Ditto the pharmaceutical makers that pursued growth in personal care and over-the-counter products.

In each of these cases, the primary motivator was slowing growth in the core business—and the move into the adjacent territory was deemed a logical extension for a "travel," "building materials," or "consumer health" company.

But there was an enormous, invisible cost to their adjacency moves: Each move distracted them from finding ways to grow the business they already had. As a result, they missed chances to grow their core businesses and made slow growth a self-fulfilling prophecy.

Missing growth opportunities in your own backyard is one thing, but a second, even bigger, danger of pursuing growth through adjacencies is losing your coherence—that is, loosening the fit between the boundaries and scope of your company and what it's distinctively good at. This is exactly what happened to several

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airline, steel, and pharmaceutical companies. In fact, every one of the big adjacency moves mentioned above had to be reversed. Their promise of growth proved illusory. And the companies had to return to their core business for growth after all, often in a much weaker position than they had occupied before their adjacency moves.

Will the same thing happen to the big-box retailers? Time will tell, but I'm afraid it will. These companies—each in its own way—are distinctively good at supplying and operating large stores with an enormous range and depth of merchandise, and this capability is critical to delivering on the promise each makes to its customers.

But the capabilities required to succeed with a small-format chain are significantly different from big box. Revenue in the smaller format is driven by repeat, small-basket customers looking more for speed of service than rock-bottom prices. The range of merchandise is typically narrower, shallower, and more local. Inventory and supply-chain management involves smaller, more frequent direct-to-store delivery drops, using smaller trucks with partial pallets. Store staff is scheduled to meet rush and lunch-hour peaks (versus more stable hours with shifting coverage in a large store). The financial model is low volume, high margin—the opposite of large stores. And you are dealing with a very different set of competitors.

The danger in trying to be distinctive at operating both small and large stores under one corporate roof is "averaging down"—that is, you may end up competent at both, but you won't be the best at either. In other words, entering the small-store adjacency will very likely dilute a big-box retailer's coherence.

Moreover, the big boxers' ability to purchase goods at a lower cost than other retailers is no longer the advantage it used to be, because competing retailers have gotten bigger and smarter. Their cost advantage now comes primarily from the staffing and other scale economies afforded by the mammoth size of their individual stores, rather than from each company's overall purchasing power. Any by entering the small-store adjacency, its average store size will fall, undermining the powerful advantage from having a single, large-store format.

Thus, what appears to be a logical, close-in adjacency for a highly capable company has two classic dangers: missing growth opportunities in its core business and averaging down its enterprise capabilities and cost advantages. It's not doomed to fail, but I bet it will. Strategies are prone to fashion, and it's currently fashionable for big-box retailers to be rolling out a small-store adjacencies strategy.

Does this mean that all adjacency strategies are bad? No. In fact, a lot can be learned from looking at some of the all-time-great adjacency moves, such as those by Apple (iPod), Berkshire Hathaway (railroads and utilities), and Roche (diagnostics). I'll address these lessons in my next post. +

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