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# The **granularity** of growth

*A fine-grained approach to growth is essential for making the right choices about where to compete.*

**Mehrdad Baghai, Sven Smit, and S. Patrick Viguerie**

**What are the sources** of corporate growth? If, like many executives, you take an average view of markets, the answers may surprise you: averaging out the different growth rates in an industry's segments and subsegments can produce a misleading view of its growth prospects. Most so-called growth industries, such as high tech, include subindustries or segments that are not growing at all, while relatively mature industries, such as European telecommunications, often have segments that are growing rapidly. Broad terms such as "growth industry" and "mature industry," while time honored and convenient, can prove imprecise or even downright wrong upon closer analysis.

Our research on the revenue growth of large companies suggests that executives should "de-average" their view of markets and develop a granular perspective on trends, future growth rates, and market structures. Insights into subindustries, segments, categories, and micromarkets are the building blocks of portfolio choice. Companies will find this approach to growth indispensable in making the right decisions about where to compete.

These decisions may be a matter of corporate life and death. When we studied the performance of 100 of the largest US corporations in 17 sectors during the two most recent business cycles, a pair of unexpected findings emerged.

**Article at a glance**

*A large company's top-line growth is driven mainly by market growth in the subindustries and product categories where it competes and by the revenues it purchases when it acquires other companies, according to a growth analysis of more than 200 companies around the world.*

*The gain or loss of market share explains only around 20 percent of the difference in the growth performance of companies.*

*Executives should identify and allocate resources to fast-growing segments in which a company has the capabilities and resources to compete successfully.*

*To make the right portfolio choices, executives should benchmark the growth performance of a company and its peers on a segment level.*

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The first was that top-line growth is vital for survival. A company whose revenue increased more slowly than GDP was five times more likely to succumb in the next cycle, usually through acquisition, than a company that expanded more rapidly. The second, suggesting the importance of competing in the right places at the right times, was that many companies with strong revenue growth *and* high shareholder returns appeared to compete in favorable growth environments. In addition, many of these companies were active acquirers.[1]

To probe deeper into the mysteries of what really drives revenue growth, we have since disaggregated, into three main components, the recent growth history of more than 200 large companies around the world. The results indicate that a company's growth is driven largely by market growth in the industry segments where it competes and by the revenues it gains through mergers and acquisitions. These two elements explain nearly 80 percent of the growth differences among the companies we studied. Whether a company gains or loses market share—the third element of corporate growth—explains only some 20 percent of the differences.

At first blush, our findings seem counterintuitive. They demonstrate that although good execution is essential for defending market share in fiercely contested markets, and thus for capitalizing on the corporate portfolio's full-market-growth potential, it is usually not the key differentiator between companies that are growing quickly and those that are growing slowly. These findings suggest that executives ought to complement the traditional focus on execution and market share with more attention to where a company is—and should be—competing.

Going beyond averages to adopt a granular perspective on the markets is essential for any company as it shifts its portfolio in search of strong

[1] Sven Smit, Caroline M. Thompson, and S. Patrick Viguerie, "The do-or-die struggle for growth," *The McKinsey Quarterly*, 2005 Number 3, pp. 34–45.

growth, as this article will explain. It will also argue that a fine-grained knowledge of the drivers of the company's past and present growth, and of how these drivers perform relative to competitors, is a useful basis for developing growth strategies. To that end we will present the findings of two diagnostic tools: one that enables companies to benchmark their growth performance on an apples-to-apples basis with that of their peers, and one that disaggregates growth at a segment level.

## Growth in a granular world

Telecommunications in Europe is often described as a mature industry. But though revenues at ten large European telcos rose by an average of 9.5 percent a year from 1999 to 2005, we found that individual companies expanded by 1 to 25 percent annually. How could this be?

The most important reason is that European telcos make different portfolio choices so that they have varying degrees of exposure to different segments with different rates of growth. Wireless grows faster than fixed line, for example, and the growth rates of each vary widely by country. In addition, these companies have different levels of exposure to fast-growing markets outside Europe.

In industries with higher overall growth, the same kind of variation is apparent. The annual growth rates of a representative set of large high-tech companies, for instance, ranged from –6 to 34 percent from 1999 to 2005.

In fact, the companies in our 200-strong database that outperformed their peers on top-line growth and shareholder value from 1999 to 2005 compete in industries—construction, consumer goods, energy, financial services, high tech, retailing, and utilities—with different rates of overall growth. No matter which industry they competed in, however, the average market growth of their portfolios outperformed that of their peers. This fact suggests that they tend to outposition their industry competitors in high-growth segments. The portfolios of outperforming utilities, for example, enjoyed growth momentum that was two percentage points higher than the overall industry did. Indeed, when we compared the growth rates of industries with the growth rates of the companies in our database, we could explain why some grew faster than others only by zooming in and taking a granular view of subindustries and product categories by continent, region, and country (see sidebar, "A fine-grained view").

These findings should encourage companies in industries with slow overall growth. Seeking growth is rarely about changing industries—a risky proposition at best for most companies. It is more about focusing time and

## A fine-grained view

Which market levels must executives explore when they develop a company's portfolio strategy? To find out, we tested the extent to which industry growth rates correlate with the growth rates of companies at five levels of market granularity, which we call G0 to G4.

*G0: the world market.* Over the past 20 years, the world economy has grown by roughly 7 percent a year. By 2005, its total output had reached $81.5 trillion. This is the global pie. Global GDP growth is the yardstick used to measure the growth performance of companies.

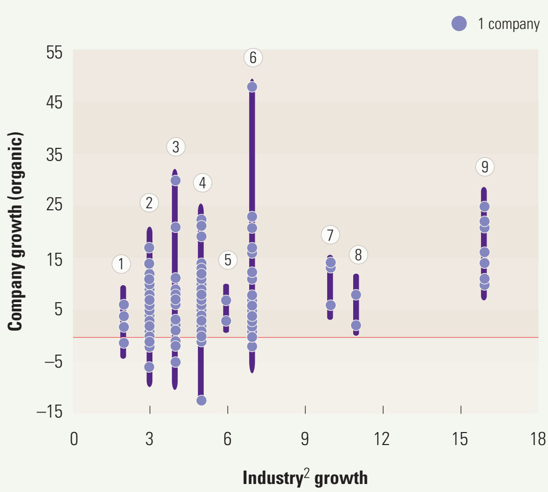
*G1: sectors.* The Global Industry Classification Standard (GICS) carves up the global economy into sectors, such as energy and capital goods. On average, these groups have a market size of $3.5 trillion. When we plotted the growth of industries and companies, we saw no obvious correlations. This supports our point that talk of "growth industries" is meaningless. The growth rates of different industries vary from approximately 2 to 16 percent—far less than the spread at the company level, which ranges from –13 percent to 48 percent (exhibit).

*G2: industries.* The GICS breaks down the sectors into 151 industries; the food, beverages, and tobacco sector, for instance, becomes three separate industries. These 151 industries—more granular than the sectors but still huge—have an average size of around $500 billion. At the G2 level, differences in the portfolio exposure of companies explain little more of the variation in organic top-line growth than they did at the G1 level.

EXHIBIT

### A greater spread at the company level

Compound annual growth rate (CAGR) for selected companies by industry,[1] 1999–2005, %




**Industries**[2]

1
- Household and personal products

2
- Banks
- Capital goods
- Food, beverages, and tobacco
- Retailing
- Technology hardware and equipment

3
- Automobiles and components
- Commercial services and supplies
- Media

4
- Consumer durables and apparel
- Diversified financials
- Pharmaceuticals, biotechnology, and life sciences
- Telecommunications services
- Transportation
- Utilities

5
- Insurance

6
- Consumer services
- Food and staples retailing
- Materials
- Software and services

7
- Health care equipment and services

8
- Semiconductors and semiconductor equipment

9
- Energy

[1] 207 representative companies selected from total for readability.
[2] Industry group classifications by Global Industry Classification Standard (GICS), developed by Morgan Stanley Capital International (MSCI) and Standard & Poor's.

Source: Global Insight; Global Vantage; Thomson; McKinsey analysis

*G3: subindustries.* Now it gets interesting. Our growth database builds on the finest level of data that companies report to the markets, so we can look at subindustries, and sometimes at broad product categories, divided by continents, regions, or, in certain cases, countries. Examples of subindustries within the food industry include frozen foods, savories, edible oils, and dressings. At the G3 level, the world market has thousands of segments ranging in size from $1 billion to $20 billion.

The growth rates of these segments explain nearly 65 percent of a typical company's organic top-line growth; in other words, at this level market selection becomes more important than a company's ability to beat the market. That point supports our finding that the composition of a portfolio is the chief factor in determining why some companies grow faster than others.

*G4: categories.* In a few cases we have been able to use internal company data to dig deeper and explore categories within subindustries (such as ice cream within frozen packaged foods) or customer segments in a broad product or service category (such as low-calorie snacks). At this level of granularity the world economy has millions of growth pockets that range in value from $50 million to $200 million. Our analysis found that a company's selection of G4 segments often explained its organic growth even better than the G3 segments did. This is the level of granularity on which companies must act when they set their growth priorities—and the level on which they must make the real decisions about resource allocation.

resources on faster-growing segments where companies have the capabilities, assets, and market insights needed for profitable growth.[2]

To make granular choices when selecting markets, management teams must have a deep and similarly granular understanding of what drives the growth of large companies and, in particular, of their own company and its peers. They can use the resulting growth benchmarks when they plan their portfolio moves. One thing they are likely to learn from the benchmarks is to avoid making unrealistic assumptions about a company's chances of consistently gaining market share.

## Disaggregating growth

The growth profiles of companies began to emerge when we broke down their growth into three main organic and inorganic elements that measure positive and negative growth.

- Portfolio momentum is the organic revenue growth that a company achieves through the market growth of the segments represented in its portfolio. The company can influence the momentum of its portfolio

[2] Our analysis suggests that chasing revenue growth for growth's sake alone, at the expense of profitability, generally destroys shareholder value.

in several ways. One is to select acquisitions and divestments, which affect the company's exposure to underlying market growth. Another is to *create* market growth—for instance, by introducing a new product category. Portfolio momentum (including currency effects) is in a sense a measure of strategic performance.

- M&A is the inorganic growth a company achieves when it buys or sells revenues through acquisition or divestment.

- Market share performance is the organic growth a company records by gaining or losing a share of the market. We define market share by the company's weighted-average share of the segments in which it competes.

## Beyond the averages

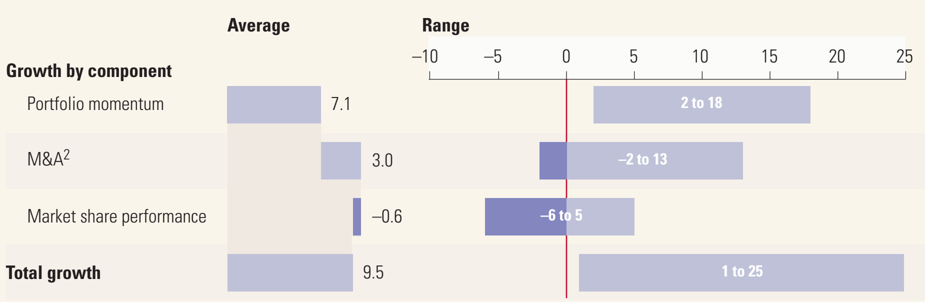
Our growth analysis of ten large European telcos revealed the relative importance of these growth elements for the companies as a group. It also showed how individual companies differed widely in their performance on each element.

Portfolio momentum was by far the biggest growth driver for the group as a whole, followed by M&A. Market share performance made a negative contribution. When we looked beyond the averages, a more nuanced picture emerged. Individually, these companies' range of performance on the three growth drivers was startling: from 2 to 18 percent annual

EXHIBIT 1

**A wide range**

Compound annual growth rate (CAGR) of revenues for 10 large European telcos,[1] 1999–2005, %




[1]Based on local currency; companies with headquarters in European Union.
[2]Includes impact of changes in revenue base caused by inorganic activity and share gain/loss.

Source: Analyst reports; company reports; Dealogic; Global Insight; Hoover's; McKinsey analysis growth for portfolio momentum, from –2 to 13 percent for M&A, and from –6 to 5 percent for market share performance. Clearly, companies in the same sector grow not only at different speeds but also in different ways (Exhibit 1).

## What about market share?

To probe the sources of growth for the average company in any sector, we took the data on all of the companies in our database and broke down their average performance into the three growth elements. We found that of the overall 8.6 percent top-line annual growth that the average large company achieved from 1999 to 2005, 5.5 percentage points came from the market growth of the segments in its portfolio, 3.0 from M&A activity, and a marginal 0.1 from market share performance.

The negligible role of *average* market share performance—both gains and losses—wouldn't be surprising if markets included only these 200 large companies. But what about the smaller companies that are commonly seen as growing more quickly and gaining share from incumbents?

Perhaps new entrants and other small and midsize companies redefine categories, markets, and businesses rather than capture significant market share from incumbents. There are differences among countries, however. Our analysis suggests that over time the average large company loses a bit of market share in the United States but gains a bit in Europe. Although we haven't analyzed this phenomenon in detail, we believe that the dynamism of the US market allows young companies to challenge incumbents to a greater extent than they can on the other side of the Atlantic.

We found it more interesting to go beyond the averages and explore the differences in the growth performance of large companies. The results show that portfolio momentum, at 43 percent, and M&A, at 35 percent, explain nearly four-fifths of them; market share is just 22 percent. To put the facts another way, a company's choice of markets and M&A is four times more important than outperforming in its markets. This finding comes as something of a surprise, since many management teams focus on gaining share organically through superior execution and often factor that goal into their business plans.

Not that managers can afford to neglect execution. On the contrary, catching the tailwind of portfolio momentum requires a company to maintain its position in the segment, and this in turn hinges on good or even great execution—particularly in fast-growing segments that tend to attract innovative or low-cost entrants.

The key point is that averages can be deceptive, so we dug deep into our database to see if a more granular story on market share performance would emerge. We did find a number of share gainers and losers, at the corporate (and particularly the segment) level. But we also discovered that few companies achieve significant and sustained share gains and that those few tend to have compelling business model advantages.

A valid question is whether sectors (with their different rates of growth) differ in ways that might affect the importance of market share. We found that market share performance explained 14 to 23 percent of the difference in the growth performance of companies in seven of the eight industries we analyzed. It was significantly more important, at 37 percent, only in the high-tech industry, where short product life cycles and generally higher growth headroom make market share shifts more common.

### Linking growth and shareholder value

The detailed growth and value creation histories in our database let us analyze the growth drivers—portfolio momentum, M&A, and market share performance—and identify correlations between their roles for revenue growth and value creation.[3] Not surprisingly, companies that outperform on the growth drivers increase their revenues faster than the underperformers do,[4] and the more drivers they outperform on, the faster they grow.

It's more intriguing that outperformance on revenue growth is correlated with the superior creation of shareholder value. We defined four levels of performance for benchmarking purposes: exceptional, great, good, and poor. The threshold for differentiated performance appears to be outperforming on one growth driver while not underperforming on more than one. Slightly more than half of the companies in our sample did both and achieved average annual total returns to shareholders (TRS) of 8 percent and revenue growth of 11 percent, which we define as good performance. Companies that outperformed on two dimensions or that outperformed on one at top-decile levels without underperforming on more than one—nearly 15 percent of the sample—did even better, achieving great performance. Only four companies, which chalked up exceptional revenue growth and shareholder returns, outperformed on all three growth drivers. Companies that did not outperform on any driver or underperformed on more than one performed poorly, with TRS of only 0.3 percent.

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[3] Our analysis covers a six-year period that we used to compare detailed segment performance year over year, so we couldn't look at the very long term. However, we can compare revenue growth with at least short- to medium-term trajectories of total returns to shareholders.

[4] We define outperformance as the attainment of a growth rate in the top quartile of the sample for a particular growth driver. We define underperformance as the opposite: performance in the sample's bottom quartile. Quartiles two and three (the middle ones) are neutral—neither outperforming nor underperforming.

Management would do well to step back and assess a company's performance, at the corporate level, on each of these drivers, for they are actionable, and the evidence shows that the more of them companies outperform on, the more those companies have been rewarded. It might also be wise to scrutinize a company's peers to find out which growth drivers, if any, they outperform on, and in which parts of their businesses. Such knowledge can be the starting point of a useful benchmarking discussion about the company's growth performance and potential.

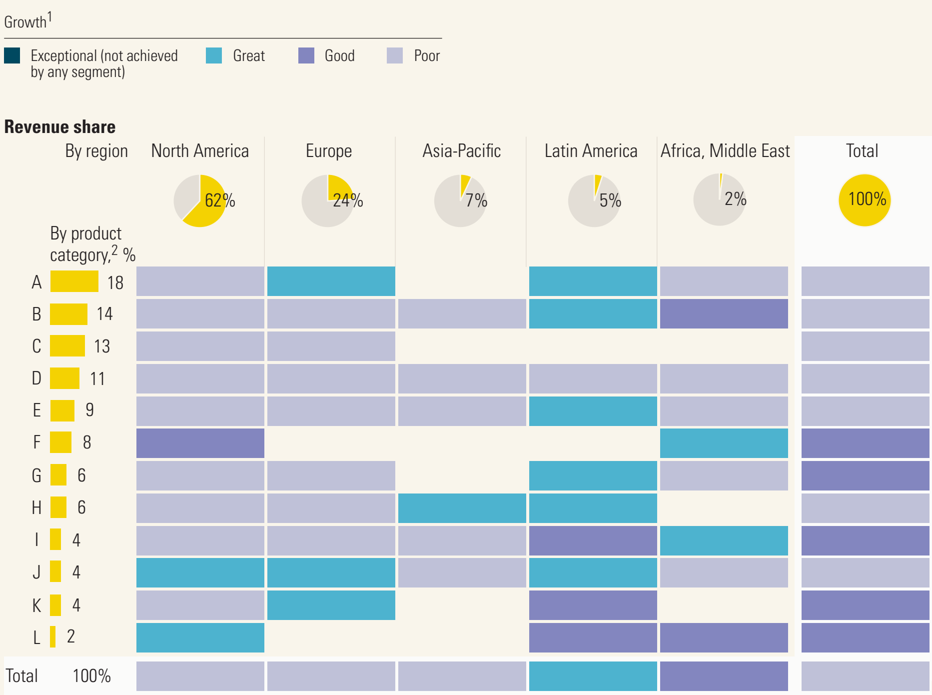
## Scanning for growth opportunities

Getting a detailed sense of the growth performance of a company involves judging how well it is performing on each of the three growth drivers at the segment level. By analyzing this information in the context of the company's market position and capabilities, its management team can develop a perspective on future opportunities for profitable growth.

EXHIBIT 2

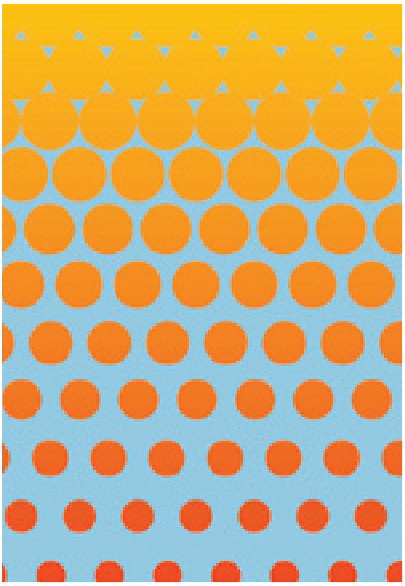
### A detailed picture

Disguised example of growth for GoodsCo, a multinational consumer goods company, 1999–2005




[1]Exceptional = outperforming on all 3 growth drivers; great = outperforming on 2 growth drivers or outperforming on 1 growth driver at top-decile level without underperforming on more than 1; good = outperforming on 1 growth driver without underperforming on more than 1; poor = underperforming on 2 or more growth drivers or not outperforming on any.

[2]Figures do not sum to 100%, because of rounding.



Consider the disguised case of GoodsCo, a multinational consumer goods corporation. Our disaggregation of its growth at the corporate level revealed that it delivered stable, albeit slow, growth from 1999 to 2005. M&A drove almost all of the company's growth in the United States, however; in Europe positive exchange rates propelled modest growth. Organic revenues rose strongly only in emerging markets, such as Africa, Latin America, and the Middle East. In fact, the North American and European markets that made the largest contribution to the company's revenues were in the bottom quartile for our full sample of companies.

The story gets more precise as we disaggregate the company's performance on the three growth drivers in 12 product categories for five geographic regions. No fewer than 27 of the 47 segments the company competes in register as poor in terms of their performance on our three growth drivers. Unfortunately, these segments represent 87 percent of GoodsCo's sales. On the positive side, 20 segments are good or great, but they make up only the remaining 13 percent of sales. And although a promising growth story is developing in Latin America in most segments, the business is performing poorly in its core ones in Europe and North America. It cannot claim exceptional performance in any segment. GoodsCo has a portfolio problem (Exhibit 2).

Once all the cards are on the table, GoodsCo's managers will be in a better position to make well-informed portfolio choices. The pros and cons of acquiring businesses—or expanding organically by exploiting positive market share performance—in segments where GoodsCo enjoys strong portfolio momentum will probably be high on the top team's agenda. Another issue might be whether to seize divestment opportunities in segments where the company's portfolio momentum is good, though the company is losing market share. A third could be whether to acquire a company (and so build portfolio momentum) in lackluster segments where GoodsCo's management expects market growth to improve significantly.

The growth of segments within industries correlates closely with the differing profiles that emerge when we disaggregate the growth of large companies. This suggests that executives should make granular choices when they approach portfolio decisions and allocate resources toward businesses, countries, customers, and products that have plenty of headroom for growth. Q

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