The Myth of Unbounded Growth

Growth is not perpetual and its continued pursuit can be a death knell, especially for large, mature companies.

Jim Mackey and Liisa Välikangas

Imagine the CEO of a growth company telling its shareholders, "Henceforth we will be pursuing no risky new research, acquisitions or new business ventures. We will concentrate on being stewards of our existing business and will simply pay all profits as dividends." This is an unlikely scenario, to say the least. The reality is that markets expect growth. There is a deeply held assumption that neither a company nor its management is viable unless it is able to grow. Growth gives investors a feeling that management is doing its job. Growth is typically perceived as a proactive (rather than a defensive) strategy. Or maybe, as the Red Queen says in Lewis Carroll's *Through the Looking Glass,* "Here it takes all the running you can do to keep in the same place. If you want to get somewhere else, you must run at least twice as fast as that!"

"The only way managers can deliver a return to shareholders that exceeds the market average," Clayton Christensen and Michael Raynor wrote in *The Innovator's Solution,* "is to grow *faster* than shareholders expect," however irrational that may be.[1] Indeed, a recent CSFB HOLT study found that 50% of the valuation of the 20 most valuable companies was based on expected cash flows from future investments.[2] Nevertheless, it has become almost a national sport to suggest that there is a set of visionary, great or otherwise noteworthy companies that can grow indefinitely — only to have those companies, almost invariably, fall from grace shortly thereafter. "The golden company that continually performs better than the markets has never existed. It is a myth," wrote Richard Foster and Sarah Kaplan in *Creative Destruction.*[3] Indeed, of the companies on the original *Forbes* 100 list in 1917, only 18 remained in the top 100 by 1987 and 61 had ceased to exist. Of these highly respected survivors, Foster and Kaplan point to only two companies — General Electric Co. and Eastman Kodak Co. — which outperformed the 7.5% average return on the S&P 500 during this 70-year period, and they beat the average by only 0.3%.

The truth is, companies are successful until they are not.[4] The consistent pattern of stalled or halted growth among the largest U.S. corporations over the last 50 years is eye-opening. Research by the Corporate Strategy Board (CSB) in 1998[5] suggested that there is a "cloud layer" at which growth starts to stall, beginning in the $30 billion range (CPI-adjusted 1996 dollars).[6] Of the 172 companies that have made it to the *Fortune* 50 from 1954 to 1995,[7] only 5% were able to sustain a growth rate above the GDP (and

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half of those have stalled since the study).[8] In addition, once stalled, no U.S. company larger than $15 billion has been able to restart growth that exceeded that of the GDP. In *How To Grow When the Markets Don't,*[9] Adrian Slywotzky, Richard Wise and Karl Weber call this "the Great Divide, moving from a past of strong growth … into a future of low or no growth." The authors say that many companies did so without fully recognizing the change, thereby exacerbating the problem, sometimes fatally. Companies often see a stall as a temporary blip, soon to be overcome with investment and execution of their growth strategy, but in their book *Permanently Failing Organizations,*[10] Marshall Meyer and Lynn Zucker write that many of these companies are merely lingering in a state of decay before they ultimately fail.

As companies increase in size, the variability in growth rate decreases (that is, growth slows down).[11] The classical model of growth — assuming a log-normal distribution of company sizes in a population of companies[12] — fails to explain this phenomenon.[13] Strictly from a numerical perspective, sustaining rapid growth is a massive challenge for a *Fortune* 50 company. For example, to sustain its current 17% growth rate, Merck & Co. Inc. (the 17th largest with revenue of $52 billion) must add $9 billion in revenue this year, $11 billion next year and so on. In five years, Merck's revenues would need to be $114 billion — more than double its current number.

The Cost of the Growth Chase

For a large company, not only are the odds of consistently achieving this kind of growth quite long, but the pursuit of that growth can also be very costly. To pursue billion dollar growth targets quickly, executives feel they must invest billions in the quest.[14] The result is falling profitability often accompanied by huge restructuring charges. Whereas the market cap decline may begin before or after the stall, the eventual fall is dramatic. The CSB study found that 28% of stalled firms lost over 75% of market cap relative to the Dow Jones Industrial Average (DJIA), and 69% lost at least 50%; the average valuation fell by 61%.[15] When this happens, a once great company begins to search for its lost formula, often until the very viability of the company is eventually questioned, as was the case for Sears, Roebuck and Co., IBM Corp., Digital Equipment Corp., Xerox Corp., Motorola Inc., Lucent Technologies and many others. Employees suffer as well. In 53% of the stalls, head count was reduced by over 20%, and morale declined noticeably.

Kodak, as noted, outperformed the S&P 500 for 70 years — from 1917 to 1987 — but today it is the poster child for stalled companies. Its revenue stopped growing faster than the GDP in 1980 when it was No. 29 on the *Fortune* 50 list. Its recent *nominal* market cap is 41% below its 1980 level. When benchmarked against the 10-fold increase in the DJIA since 1980, Kodak's relative market cap has fallen a whopping 94%. Cutting more than 70% of its semiannual dividend, Kodak now seeks to migrate from film[16] and plans to invest $3 billion in digital photography, in which it has been investing since 1972. Kodak also recently announced its $250 million acquisition of Scitex Corp.'s Digital Printing to bolster its entry into the inkjet printer market. Yet film still accounts for about 50% of Kodak's profits.[17] Thus the odds that Kodak can reignite growth are not judged to be good. Kodak's long-term debt is rated triple-B-minus, one notch above speculative, by Standard & Poor's. In an unprecedented revolt, "investors have lost confidence" in Kodak's growth investments and now seek "radically different strategies to maximize shareholder value."[18]

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Given the dismal track record that stalled growth companies have when attempting to return to double-digit internal growth, the massive (and often belated) investments they make in that regard seem analogous to spending the company's life savings on a lottery ticket. The reality for many shareholders is that unless the company is sold while still healthy, the promised payoff never comes, due to low valuation in the sale of nonperforming assets, restructuring charge write-offs, goodwill depreciation and pension- or product-related liabilities. The hard-earned equity evaporates, and assets are sold at near book value in fire sales or in bankruptcy to creditors. *Fortune* 50 bankruptcies are relatively rare,[19] but Enron, WorldCom, PG&E, United AirLines, Kmart, Bethlehem Steel and LTV are recent examples. Others like Lucent, Xerox, Fleming, AMR and Goodyear hover on the brink. Still others are sold for a fraction of their earlier value or at a slight premium to a long-stagnant stock price — for example, Digital, Compaq, Beatrice Foods, Firestone, Uniroyal, American Motors, Armour Food, Gulf Oil, RCA and Union Carbide.

What's a CEO To Do?

It is clear that many strong forces — ranging from natural limitations and managerial complexity to stakeholder harmony and antitrust concerns — make continuous growth very difficult for already-large companies. Rather than continue to seek

growth at any cost, the solution is to seek alternatives to the dilemma — in a sense, to fool the natural limits to growth that large companies face. There are three logical alternatives: Break up the company, create a new corporate form, or make a graceful growth-to-value transition.

Breaking Up the Company IBM spun off Lexmark, HP gave birth to Agilent, AT&T divested itself of Lucent, GM launched Delco, Sears separated from Allstate, and 3M broke off Imation. Such spinoffs generally enhance stockholder value both at the time of the announcement and by about 20% in the subsequent 18 months.[20] J.P. Morgan discovered that smaller breakups performed better.[21] It is important, though, that the post-breakup units be small enough (less than $10 billion) to have significant room for growth. Although not all breakups create successful new companies, they do help bring focus to the parent company. J.P. Morgan also found that "the remaining, slimmer parent does materially better than the market following separation."[22]

Nevertheless there is significant resistance to divestiture because it seems "like a tacit admission of failure, evidence of poor management, or in some corporate cultures even ... treason."[23] The myth of unbounded growth further perpetuates resistance to this seemingly reasonable solution. Indeed, "of the 50 largest divestitures ... more than three-quarters were completed under pressure, most only after long delays when problems became so obvious that action was unavoidable."[24]

Experimenting With a New Corporate Form Whereas attempts at internal independence, including tracking stocks and partial spinoffs, may prove not to offer lasting solutions, evolving new organizational forms and management practices over time can afford a company greater scale and scope.[25] Just as the divisional organization (supported by innovations including the telephone and railroads) extended the management capability beyond that of the functional organization in the early 1900s, perhaps an even more decentralized organization (supported by innovations including the Internet and e-commerce) will enable the next growth leap. Also business models that foster competition between different parts of the organization (for example, GM's Chevrolet vs. Pontiac or HP's Inkjet vs. Laserjet) may offer growth advantages. In addition, internal markets for ideas and talent (such as Shell's GameChanger innovation program) that are open to anyone within the organization with a worthwhile contribution to make may provide new routes to growth.[26]

Take Visa, for example, with an estimated 2003 sales volume of $2.7 trillion. It is technically not a company nor does it appear in the *Fortune* rankings. Yet it has a powerful brand, a strategy for growth, and an integrated business system composed of hundreds of card-issuing financial institutions battling for customers.[27] Similarly, electronics firms today outsource manufacturing, integrate supplier design, engage in software alliances, participate in standards bodies and contribute to and benefit from open-source movements.[28] They are integrated ecosystems that compete for ideas, innovation, people and investment. Here the corporation may no longer be the relevant unit of competitive analysis; the new corporate form is a boundaryless organization.

Making a Transition From Growth to Value Using reduced investment to grow earnings can help a company make a graceful transition from a high P/E growth stock to a moderate P/E value stock. Market cap may decline (relative to the DJIA), but this strategy can help avoid the dramatic poststall crash or near bankruptcy that can occur when former growth companies begin delivering neither growth nor profit and are assessed at breakup value. Specific tactics may include increasing earnings stability, balance-sheet strengthening, boosting dividend payout, cost and asset reduction, reductions in marketing and R&D, portfolio adjustments (especially divestitures and spinoffs), and stock repurchase (only if P/E is in single digits). Most companies that survive their growth stall eventually make this transition. It is often delayed, however, due to persistent attempts to recapture growth (for example, IBM in the mid-1980s and early 1990s), or forced after being acquired by a value-oriented firm (for example, Allied Signal's acquisition of Honeywell in 1999). GE, however, shifted focus from growth to profit in the 1950s and transitioned without a crisis. Microsoft's recent decision to begin paying dividends may imply an early recognition of the growth-to-value transition.

This strategy — which requires a shift in corporate culture and investor expectations — may be unpopular because it marks a radical departure from the past. It is thus difficult for any leader to achieve unless precipitated by a crisis. Even when there is a perceived crisis, preliminary case studies indicate that such a transition will take from five to eight years.[29] Denial and short-term incentives create additional barriers because management tends to want to believe they can win the lottery to recapture unbounded growth.

Facing the Liability of Corporate Size

In evaluating their options, the CEO and the board should consider where their company is in its life cycle — growth, stall or poststall. Growth stalls can be anticipated by assessing the natural limits of the company's dominant growth strategy and its pattern of financial performance. Senior managers and board members also have to realistically assess their company's capabilities in innovation and new business creation in order to decide whether their capital and talent would be better spent on core business development than on an increasingly fruitless pursuit of megagrowth. These are not easy decisions to make, especially given the

almost unquestioned culture of growth that continues to exist in today's environment. The biggest challenge and first step toward making those decisions, however, is to overcome denial and acknowledge that unbounded growth is indeed a myth.

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3. S. Kaplan and R. Foster, "Creative Destruction: Why Companies That Are Built To Last Underperform the Market — and How To Successfully Transform Them" (New York: Doubleday/Currency, 2001).

4. G. Hamel and L. Välikangas, "The Quest for Resilience," Harvard Business Review 81 (September 2003): 52-63. See also Kaplan and Foster, "Creative Destruction," 11, 14. Kaplan and Foster note that the turnover rate among *Fortune* 500 companies has accelerated — reaching nearly 10% in 1998 — implying that no more than one-third of today's major corporations will survive in an economically important way over the next 25 years. Further, according to unpublished research done by the Woodside Institute in 2003, the number of S&P 500 companies that have suffered a five-year earnings decline has more than doubled in the last 30 years, suggesting a severe lack of strategic resilience.

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6. The stall range had increased over time slightly faster than inflation (pp. 20-21).

7. This is also true for service companies of equivalent scale.

8. See Corporate Strategy Board, "Stall Points," 13. Wal-Mart, American International Group, Target, and United Parcel Service are still growing; 3M, Hewlett-Packard, PepsiCo and Procter & Gamble now appear to have stalled. In addition, this study by the Corporate Strategy Board cites six companies that stalled but then restarted growth to 1% over GDP. Of those, Chase, Coca-Cola, Fleming and Motorola appear to have stalled again. Only Johnson & Johnson and Merck are still growing. Thus only six out of 172 *Fortune* 50 (3.5%) are still growing relative to the economy.

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14. Christensen and Raynor, "The Innovator's Solution," 236-243. In this passage, including the section titled "The Death Spiral From Inadequate Growth," the authors state that large targets and large investments paradoxically are "likely to condemn innovators to a death march" and that "capital becomes a poison for growth ventures."

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21. Ibid., p. 30.

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29. Refers to ongoing studies of *Fortune* 50 companies conducted by the Billion Dollar Growth Network. The work goes beyond the 50 growth-stall case studies developed jointly with the Corporate Strategy Board in 1997-1998, focusing instead on what happened after the stall — how the companies managed their transition to a lower growth value model. The studies generally examine companies over the past 20-year period, relying on annual reports, Compustat data, secondary sources and follow-up interviews.

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