CHAPTER 1

The Performance Dilemmas

“To cope with dilemmas is the nature of managerial work.”

—Gerard Kleisterlee, President and CEO, Royal Philips Electronics
The Elusive Targets

A public company anywhere in the world is driven by two goals. First, it wants to be profitable, to record a return on invested capital that exceeds the cost of capital. Second, it wants to grow revenue. In an ideal world, it would sustain both profitability and growth over long periods. Why? Simply put, driving profitable growth enhances value for the firm’s shareholders.

Although the merits of sustaining profitability and growth are obvious, achieving them is elusive. Evidence repeatedly suggests that few firms have been able to show sustained growth or profitability—let alone both simultaneously.

Look at growth. A major consulting firm found that even in the best of times (the boom decade of the 1990s), nine out of ten companies failed to sustain growth.¹ They could not meet even their own growth targets! Only 13 percent were able to grow as fast as gross domestic product (GDP) growth and inflation combined. Another study found that a mere 10 percent of publicly traded firms in the United States had experienced eight or more years of double-digit growth over the same period.²

If sustaining growth is hard, sustaining profitability appears to be equally difficult. A mere 5 percent of the 6,772 public firms surveyed in one academic study showed year after year a return on assets (ROA) that was superior to the average for their industry, on a sustained basis over any ten-year period from 1978 through 1997.³

As is obvious from the studies cited, there is no shared understanding of the benchmarks for profitability and growth and the time horizon over which these have to be sustained.

Some have used double-digit growth and profitability over ten years as a measure of sustained growth or sustained
profitability. The rationale being that 10 percent return on invested capital (ROIC) would be needed at a minimum to cover the cost of capital; and, when corrected for inflation and GDP growth, the firm would need at least 10 percent annual growth to show any real growth in its revenue. There is no particular rationale for a ten-year horizon. It just seems long enough.

However, only a handful of industry subsectors—such as medical equipment, pharmaceuticals, oil and gas, semiconductors, and software—have shown double-digit growth and profitability over the recent ten-year period. Many have not. Because firm growth and profitability depend in part on industry performance, insisting on sustained double-digit growth and profitability for a firm might be too demanding a threshold.

Another approach is to consider the growth and profitability of a firm relative to the average for its industry. This has the merit of setting a more reasonable threshold for measuring sustained profitable growth, although it is hard to designate just one single industry for a diversified firm. At any rate, this is the approach that we have taken for our study.

We looked at the performance over a 15-year period from 1990 through 2004 of nearly 6,000 large public companies from around the world (see Appendix A, “The Empirical Study”). We examined the record of these firms in sustaining not just growth or profitability, but both simultaneously.

The results of our study were striking. Only one firm in four around the world was able to show sustained profitable growth over any consecutive five-year period. Moreover, for those that actually managed to achieve profitable growth, sustaining the two was incredibly challenging. Instead of getting easier, sustaining profitable growth becomes progressively more difficult as the time horizon is stretched. When we extend the time horizon to 10
years, the percentage of firms that sustained profitable growth drops to under 5 percent, and at 15 years it drops further to under 1 percent.

The conclusions are stark. Sustaining profitable growth is incredibly hard. It has proved to be beyond some of the best managers in the world and beyond some of the world’s greatest companies. Nor does it appear to matter which industry sector a firm belongs to, how big the firm is, or which part of the industrialized triad (North America, Western Europe, and Japan) that it is based in. (The appendixes contain summary tables that show this.) This book seeks to answer two questions: Why is profitable growth so elusive? And, what can—and must—executives do better to drive profitable growth?

### Tension Between Profitability and Growth

Looking through our research, there was something else that was eye-catching. When we began, we believed that profitability and growth were mutually supportive, the two elements of the holy grail of business success. But, the research uncovered discomforting tension between profitability and growth. More than 40 percent of the firms that achieved sustained profitability or growth failed to achieve the other (see Table 1.1). Instead of being mutually supportive, for many organizations growth and profitability are rival challenges.
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Table 1.1

Sustained Profitability or Growth without the Other

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<th>Without sustained growth</th>
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<tbody>
<tr>
<td>Sustained profitability</td>
<td>20%</td>
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<tr>
<td>Both sustained profitability and growth</td>
<td>24%</td>
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<tr>
<td>Sustained growth</td>
<td>41%</td>
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<tr>
<td>Without sustained profitability</td>
<td>17%</td>
</tr>
<tr>
<td>Neither sustained profitability nor growth</td>
<td>39%</td>
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Indeed, sustaining growth can actually work against sustaining profitability—and vice versa. Consider the case of the global engineering giant ABB. After five years of losses, the company finally achieved its first full year of profitability in 2005, but at the expense of growth. Revenue had dropped over that period by an average of 0.6 percent each year.

Determined not to let the performance pendulum swing from a profit crisis to a growth crisis, Fred Kindle, the company’s president and CEO, focused ABB around four performance measures: growth in orders and revenue; changes in operating margin—measured as earnings before interest and taxes (EBIT) as a percentage of revenue; capital efficiency—measured via both return on capital employed (ROCE) and return on equity (ROE); and the credibility and consistency of ABB’s communications to its investor community. His aim is to
emphasize profitability and growth simultaneously and to manage the expectations of the investor community around both. This is a daunting challenge, but it can be met.

Managing Performance Dilemmas

Webster’s defines a *dilemma* as a choice between two unpleasant alternatives. Business dilemmas, uniquely, offer two equally valued alternatives. The unpleasantness lies in not giving one of the goals the attention that it deserves.

As the experience of ABB illustrates, enhancing value for the firm’s shareholders is not as straightforward as it first appears. It requires the management of twin dilemmas: driving growth and profitability and seeking short- and long-term performance. Driving growth can hurt profitability (and vice versa), and sustaining both over the long term requires investments that can hurt short-term performance. No magic formula yields all four of these performance goals simultaneously. Tensions exist between them. These have to be balanced continuously.

A popular way to address the performance dilemmas is to tolerate periodic imbalances and try to correct them over time. For example, a company may focus on profitability for a period time and then focus on growth after it has accumulated a fair surplus. In our interviews, we often heard the expression “we first have to earn the right to grow” to euphemistically describe a profitability-first and then-growth approach to managing performance dilemmas.

In some contexts, this sequential approach might be unavoidable. For example, when a firm is fighting for its very survival, profitability is a must, whereas growth is merely nice to
That might have been the case, for example, at ABB. When the company had to fight bankruptcy in the recent past, it naturally focused on profitability at the cost of growth. We also encountered a few firms, such as the cleaning company ISS International, where it was growth-first—to build the firm’s market share, followed by a push for profitability.

However, our research shows that a singular pursuit of either profitability or growth makes it difficult to balance the two subsequently.

Pursuing growth requires exploring for new opportunities and competencies. It calls for entrepreneurship and risk taking. Profitability, on the other hand, is helped by exploiting the opportunities and competencies already available to the firm. Systems and processes fine-tuned to maximize profitability cannot nurture entrepreneurship.

Conversely, firms that focus on growth alone have trouble gearing their systems for operational excellence and improved profitability. Best Buy, the leading consumer electronics retailer in the United States, faced this challenge in the mid-1990s. It grew spectacularly with its innovative Concept II strategy, but its profitability was in trouble. It had to bring in outside help to fix its inventory-management and logistics systems. The company has since followed a more balanced approach to growth and profitability.

Moreover, the talent pool required to drive growth is often purged during the firm’s single-minded focus on profitability. When the firm intends to grow later, it might lack the human engine necessary to drive this growth. This is the challenge some oil companies face today. When oil prices were depressed in the 1990s, oil companies laid off trained exploration and production
engineers in their drive to maintain profitability. That very talent is in short supply today as these companies push for growth.

Under normal conditions, firms should strive simultaneously for both profitability and growth. The idea is never to lose the momentum for either growth or profitability, but always to balance the two. Our research shows that a simultaneous focus on growth and profitability builds a healthy momentum toward excelling on both over time.

**Simultaneous Pursuit of Both Growth and Profitability**

When we looked at the history of firms that had sustained both growth and profitability, on average, they achieved higher profitability and higher growth rates than either firms that sustained profitability (at the expense of growth) or sustained growth (at the expense of profitability). In other words, paying balanced attention to profitability and growth can actually enhance both.

Consider Medtronic. It is the global leader in medical technology—alleviating pain, restoring health, and extending life for millions of people around the world. In little more than 50 years, it transformed itself from a two-man garage operation in Minneapolis, Minnesota, to an $11.3 billion global enterprise in 2006, employing 36,000 people in 120 countries. The company’s market capitalization stood at $62 billion in early 2007, representing a compound annual growth rate of 14 percent over the previous ten years. Its revenue in 2006 had grown at an average rate of 15.3 percent over each of the five preceding years. The firm has maintained an average profitability of 16.3 percent
A number of factors have contributed to Medtronic’s success, including its targeting of relatively unpenetrated markets, its distribution and market muscle, its constant drive toward new product innovations, and its select acquisitions of new growth platforms. A major trigger for these strategic initiatives, however, is the company’s discipline in seeking profitable growth in each of its businesses.

Top management expects at least 15 percent growth from each of Medtronic’s businesses—without compromising profitability. Stephen Mahle, president of the company’s oldest and core business, Cardiac Rhythm Disease Management, explained:

*There is clear understanding everywhere in the company that it is in a growth business. This forces us to look at untapped opportunities.*

Indeed, the Cardiac Rhythm Disease Management business has matched the growth of the rest of Medtronic over the past five years.

This focus on profitable growth has percolated down the organization. A middle-level executive reflected on how this goal was monitored within the firm:

*As a manager, you have to make your revenue budgets; that is definitely goal number one. And yes, you must also meet the bottom line. In a tough situation, they will let you have some breathing room, but you have to make the top line and show that you know how to achieve growth. The second thing you must do is to meet your earnings target. The real stars in our system meet their growth and profitability targets with great regularity.*
This simultaneous focus on profitability and growth is at the heart of how Medtronic adds value for its shareholders. It is a simple discipline and yet rarely followed. The obvious question is why.

Wisdom from the Field

To supplement our research into corporate data, we studied the efforts of several management teams around the world as they sought to drive profitable growth. Our work with European companies, including Nestlé, L.M. Ericsson, and Royal Dutch Shell—as well as the U.S. firms Best Buy, Dow Chemical, and Medtronic—has greatly influenced the ideas we present in this book. We have also benefited from the work of our IMD colleagues on companies such as Nokia, Canon, and Sharp.

Nokia, Best Buy, Medtronic, Nestlé, Canon, and Dow have sustained profitable growth in recent years (see Appendix E, “Major Firms in the Field Study”). We have gained insights from these companies. We have also learned from companies that have struggled. In addition, we have discussed our ideas with senior executives from numerous other global firms, in our capacity as researchers, teachers, and consultants.

We have learned a lot from two companies in particular: Nestlé and Best Buy.

Nestlé, headquartered in Vevey, Switzerland, is the world’s largest food and beverage company. A 2004 Stern Stewart survey declared Nestlé to be the top-ranked European company, based on their twin criteria of top line growth between 1983 and 2003 and the market value that was added to the investment of the
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company’s shareholders since its inception. Nestlé had a record year in 2005, with revenue of 91 billion Swiss francs, up from 84.7 billion Swiss francs the previous year. Its earnings before interest, taxes, and amortization of goodwill (EBITA) in 2005, at 11.72 billion Swiss francs, was also up by 8.9 percent over the previous year. Revenue was projected to grow at 9.1 percent for 2006, with profitability also slated to improve further.

Best Buy is the largest consumer electronics retailer in North America, with revenue of $30.85 billion in 2006. The company grew its revenue at an average rate of 17 percent a year from 2002 through 2006, and its profitability averaged 15 percent ROIC over the same period. In 2004, *Forbes* magazine declared Best Buy “America’s Best Managed Company of the Year.” *Forbes* applauded Best Buy’s excellent performance in delivering a five-year annualized return of 26.5 percent to its shareholders.

We have worked closely with the CEOs of both companies and their senior executive colleagues. The accomplishments of the two leadership teams are truly impressive, but they’re not flawless. They have had their own struggles. Sustaining profitable growth requires eternal vigilance and continuous hard work.

We want to abstract from the experiences of these and other companies that we have had the privilege to study and offer ideas for driving profitable growth.
Driving Profitable Growth

Addressing the Underlying Drivers
Consider the challenge that Gerard Kleisterlee, the president of Philips, faced in strengthening the company’s profitability without compromising growth. When he became the president of Philips in April 2001, the company was still recovering from its brush with bankruptcy a decade earlier. Record losses in 2001, combined with a 15-year losing streak in the important United States market, called for a quick fix. Indeed, Kleisterlee took several immediate steps to boost the company’s profitability, including selling nearly 30 noncore businesses with combined annual sales of about $1 billion, outsourcing the unprofitable production of cell phone handsets, and centralizing a number of service functions.

Even as Kleisterlee pushed for improved profitability, he had to lay the foundation for sustained growth. He defined four key themes in a technology future that Philips could win: display, storage, connectivity, and digital video processing. However, winning required abandoning the old silo mentality at Philips, and businesses had to cooperate across their divisional boundaries. He started sponsoring “strategic conversations” around each of the key technology themes, a one-day summit for key players regardless of their rank. These conversations led to clear goals, strategies, and road maps for key projects.

Five years into its transformation, Philips has achieved a remarkable turnaround. Its sales have started growing again, up to €30.4 billion in 2005 from a low of €27.9 billion in 2003 (when the noncore businesses were sold off). Its ROIC has grown...
healthfully from –11.7 percent in 2002 to 14.9 percent in 2005. It is beginning to see profitable growth.

For Kleisterlee, seeking profitability and growth meant investing in the core businesses of Philips and developing new businesses for the future (such as health care), driving efficiency and nurturing innovation, and insisting on strict deliverables from each organizational silo even when encouraging them to share freely with each other. Underlying the performance dilemma then was a cluster of other dilemmas that needed to be managed.

Unlike when making decisions, no alternative can be discarded when managing dilemmas. Instead, the two alternatives need to be balanced continuously. This is the balancing act that managers must learn to master if they are to sustain profitable growth. As Kleisterlee astutely puts it, managing dilemmas is the essence of managerial work. Sustaining profitable growth requires managing strategy, organizational, and people dilemmas.

Also, what we find from our field work is that just as in the making of an Oscar-winning motion picture, sustaining profitable growth requires a simultaneous attention to the script, actors, and set (see Figure 1.1). All are important, one no more important than the other. The script for sustaining profitable growth is the firm’s strategy for continuous renewal. The actors are renewal-oriented managers at various levels who can shape and implement four complementary renewal strategies. The set is the firm’s organizational context. It must support (and not hinder) the renewal efforts of its managers.
Continuous Renewal

A persistent dilemma for leaders is to offer a strategy architecture that allows the firm to exploit its existing strengths and opportunities while simultaneously pushing it to explore new opportunities and capabilities that will be needed for competing successfully in the future. It is a tension between ensuring profitable growth today and sustaining profitability and growth over the long run.

Winning today’s competitive battles calls for investments that strengthen the firm’s current capabilities. Invisible assets, such
as customer relations or the network of resources and information
that a firm commands, might not often make the list of a firm’s
core capabilities, but they should. They are important growth
platforms. Resources must also be allocated to initiatives that
exploit these capabilities in geographies, products, value chains,
channels, and customers that are adjacent to the firm’s current
opportunities. But, will such a strategy also serve the firm well in
the future?

Some experts have argued that competing for the future
obliges the firm to risk its present. Insisting on a link between
the firm’s present and its future may distract corporate leaders
from delivering top performance and instead shift their focus to
continuity and survival. Managing for mere survival does not
generate strong long-term performance for the firm’s shareholders.
What the firm needs instead is a process that brings the discipline
of external financial markets inside the firm and forces it to adapt
speedily and radically to the changes in its environment. Leaders
should be prepared to cannibalize the firm’s products, make its
core competencies obsolete, and retire physical capacities and
human resources that are not needed. The firm should launch
creative new products and services that can disrupt the market
position of competitors, even if this means disruptions inside the
firm, too. Some have called this creative destruction.

Senior executives are intrigued by the radical views that the
champions of disruptive growth have to offer. However, it is not
clear what impact these have had on companies. The executives
we have talked to plead that abandoning the present for an
uncertain future is not that easy. After all, the firm’s key
customers, markets, and distinctive competencies are all embedded
in its core businesses. To willingly give up these competitive
advantages for unfamiliar terrain is risky. As an exasperated CEO
put it, “My problem is not the present or the future; it is both.
How can I compete for the future without mortgaging my present?"

We believe that a firm can engage in a dramatic transformation, but through an evolutionary process, not a revolutionary one. The present does not have to be discarded; it can be morphed into the future. It is the preferred way to transform the firm without taking undue risks. We call this continuous renewal.

Firms such as Best Buy, Canon, Nestlé, and Medtronic that have sustained profitable growth are masters at continuous renewal. We tell their stories in this book. The first two have relied primarily on organic growth until recently, whereas the latter two have blended organic growth with acquisitions and alliances. Both approaches work. Debates over whether acquisition, alliance, or organic growth is the preferred way to drive profitable growth are meaningless. These are not strategies per se, but are means to implement four renewal strategies that we describe in this book: protect and extend, leverage, build, and transform.

Renewal-Oriented Managers

It is one thing to come up with renewal strategies, but it’s quite another to detail and implement them. Managers who have become good at optimizing performance under today’s business model might be reluctant to try anything new.

One way to address this problem is to insulate new renewal initiatives from a firm’s core businesses and staff these with new hires who can connect more easily with new customers and build new capabilities. The firm will have, in effect, two classes of
managers: one for generating near-term profitability and growth by optimizing the current business model, and the other for sustaining this profitable growth into the future by nurturing new opportunities and building new capabilities.

This segregation makes sense in extremely turbulent business contexts (such as in the technology sector). The firm might have to move away from markets that it dominates and competencies that it is distinctive in merely to survive. Intel’s migration from memory chips to microprocessors is a good example here.

However, not all industries face discontinuous change; and even when they do, there are always pockets of continuity within them. What the firm needs in these situations are managers committed to changing the core, not by insulating themselves from the core, but by building onto and leveraging useful elements in the core. We call them entrepreneur-managers.

These managers differ from the firm’s operating managers in an important way. They are outward focused, aware of the changes to their business environment, and willing to take risks in search of new opportunities and new capabilities.

But entrepreneur-managers are not mavericks. Unlike external entrepreneurs, they do not march to their own drum. Instead, they are true to the corporate vision and values, always keeping their creativity within the bounds of the corporate strategy. Moreover, they also look for ways to connect their initiatives either to existing markets that the firm participates in or the capabilities that it has presently. They take prudent risks.

We will elaborate on the important role that entrepreneur-managers play in implementing renewal. However, their success also depends crucially on the support of senior business executives. We also discuss this important sponsorship role.
The Organizational Context

Having a good script and the right cast of actors is important, but without a proper setting, the actors can find it difficult to act out their script. Organizational context matters for successful execution. Implicit in the term *organizational context*, we include the firm's structure and supporting processes and systems.

We have already alluded to the fact that an organizational context conducive for driving profitability might not be helpful for achieving growth. The context needs to support both. For example, formal planning systems that are well suited to exploiting current opportunities and capabilities might not be conducive for exploring new opportunities or building new capabilities. Critics of formal planning systems, such as Professor Henry Mintzberg, have championed instead a more ad hoc and emergent process. What is required, however, is a balance between these two extremes of everything prescribed by senior management to everything improvised by their subordinates.

Moreover, this balance varies with the renewal strategy that is sought to be supported. One size does not fit all. We discuss the important role that senior executives play in setting a context tailored to each renewal strategy.

Top Management: A Special Kind of Director

To ensure superior performance, top management has to oversee whether the firm has the right renewal strategies, an organizational context supportive of these strategies, and people
resources to execute the strategies well. It is in that sense similar to the role of an Oscar-winning director—mobilizing the right script, set, and cast of actors.

However, imagine having to work within the constraints of the script, set, and pool of actors used to make the previous award-winning movie to now make the next award-winning movie. That is the challenge facing top management. It is constrained by the firm’s past strategies and the inertia of its organizational context. It also cannot start afresh with a new human resource pool at each step in the firm’s renewal journey. And yet, it has to sustain the firm’s superior performance over the long term. There has to be a thread of continuity, but each sequel has to appeal anew to the audience. Balancing continuity and change is a key challenge for top management. We discuss how this challenge can be met.

Renewal also requires a culture of sharing inside the firm. Promoting this culture is another important responsibility of top management.

Finally, to echo again the president and CEO of Royal Philips Electronics, Gerard Kleisterlee, it is the burden of top management to help the organization cope with the many dilemmas it will face in its renewal journey. Top management can use its enormous influence and power to provide the counterbalance when strategy, organization, or people priorities get out of whack.