

# Growing into new businesses

The three logics – business logic, added value logic and capital markets logic – provide three possible reasons for corporate managers to seek to enter new businesses: because the business is attractive, because corporate managers can add value to the business or because the business is undervalued. The ideal situation is one where all three logics are aligned: it is an attractive business, we can add value to it and it is cheap. But, this is rare. Normally one or more of the logics is working against the ambition to enter a new business.

In this chapter, we explain why growing into new businesses is difficult, and why the failure rate is so high. We will look at some examples of success, and we will describe an additional tool – the traffic lights – to help managers decide when to bet on new businesses and when not to. We will also use this chapter to touch on some related topics such as corporate venturing.

## Why is it difficult to grow into new businesses?

The evidence is clear. Whether by acquisition or by green fields investment, the failure rate is high: companies that attempt to enter new businesses mostly fail, even when the new market appears to be close to the company's existing core, such as BA's launch of a low cost airline (GO) or Daimler's acquisition of a mass market car company (Chrysler). Various studies have estimated the failure rate as 90% or above. Also, there is little evidence to suggest that the failure rate is declining. In other words, managers do not seem to be getting better at this difficult challenge.

One of the most insightful studies of the problem was carried out by Clayton Christensen, a professor at Harvard Business School. He noted the high failure rate of existing companies in the face of certain kinds of technological change. In particular, he studied the industry that makes hard drives for computers. He noted that, with each change in technology, which enabled the industry to move to smaller and smaller hard drives, the leading companies with the previous technology failed to succeed with the new technology.

His explanation for this odd reality was that certain kinds of technological change require managers to change their business and operating models. When this happens, managers who have been schooled in the existing business model are at a disadvantage to managers who have not been developed in this way. In other words, existing skills, beliefs and relationships prove to be a disadvantage, causing these managers to be slower to learn the new model and to make more mistakes. Those with less invested in the status quo find it easier to learn the new rules.

It is not just a learning problem. There are also influences from existing stakeholders. Existing customers, for example, are big supporters of the existing business model. If they were not, they would be buying from a different supplier. These customers give negative feedback about the new model and discourage their existing suppliers from investing in it.

The problem, as Christensen discovered, is so common and so difficult to find a way round, that he recommends to companies, such as BA investing in GO or IBM investing in PCs, that they set up a highly independent organisational unit to focus on the new business. The objective is to create a management team that is not burdened with existing managerial mind sets, operating policies or stakeholder influences. However, even for companies that follow this advice, the failure rate is still high.

Another major study was carried out by Robert Burgelman, who tracked the efforts of Intel to grow into new businesses over a twenty-year period. He also observed a high and highly expensive failure rate. Intel tried many new businesses, even investing over \$1 billion in the web server business. Few were successful.

Managers inside Intel, involved in new business projects, referred to the core microprocessor business as the “creosote bush”. This is a desert plant that weeps a substance that kills all other plants within its range. Managers responsible for new businesses felt that the existence of the microprocessor business made their jobs much harder. This was partly because the microprocessor business was highly profitable, making most other businesses seem less important. Also, Intel managers had developed management habits and policies, such as their ‘copy exact’ policy when building new plants and a fanatical approach to safety, that were appropriate for microprocessors but not always appropriate for other businesses.

A third study of relevance was by Andrew Campbell and colleagues at Ashridge Strategic Management Centre. They shadowed 10 companies seeking to develop new businesses and, together with Julian Birkinshaw from London Business School, surveyed more than 100 corporate venturing units. Their explanation for the high failure rate was in line with that of Christensen and Burgelman: existing management habits and practices make it hard for managers to succeed with new business models.

Campbell emphasized the need for more careful selection of which areas to invest in. Christensen, Burgelman and many other authors argue that companies can be successful if they change the way they approach the task of developing new businesses. Campbell and colleagues suggested that the problem appeared to be more about selecting the right opportunities to invest in rather than changing the way the opportunities are nurtured or linked to the main organisation.

Campbell argued that there are often very few, and sometimes zero, significant new businesses that are appropriate for any particular management team, pointing to the very low levels of success in companies like Intel, Microsoft and Macdonald’s. Hence strategies such as investing in a portfolio of initiatives to counteract the high failure rate or setting up new ventures in separate divisions are unlikely to succeed. Companies may be more successful if they are more

selective, and only invest in the occasional new opportunity that fits the company' skills and, hence, has a high probability of success.

Campbell agrees with Christensen and Burgelman that the existing core businesses often act as a creosote bush. However, this is a reality, which is hard to avoid (unless of course the parent company decides to exit the existing businesses and change many of the senior team). As a result, companies are better advised to focus on new businesses that are compatible with the existing core businesses. In the language we have been using to explain the added value logic, companies are more likely to be successful in new businesses where the risk of subtracted value by corporate managers is low.

Moreover, companies are advised to focus on new businesses that have the potential to be significant to the company as a whole. If the new opportunity is small and is likely to remain small, it will always be low down the priority list.

These two filters – significant relative to the core and low risk of subtracted value - eliminate most opportunities, and, in some cases, at some points in time, eliminate all opportunities. Hence, Campbell argues, patience is an important part of the management skill needed to enter new businesses.

For example, between 1970 and 1990, Kellogg's managers were looking for new businesses because they anticipated a slow down in the cereal market and they had good cash flow. Over 20 years, they tried many things, with little success. It was not until an unusual confluence of events enabled Kellogg to buy Keebler, a company in related snacks and cookie markets, for a reasonable price that they successfully created a significant new business. The unusual events were mainly about a market imperfection (capital markets logic). Keebler was for sale at a time when all of the likely acquirers were unable to bid for different reasons. As a result the premium Kellogg's had to pay was reasonable given the synergies the company could create.

Another example is McDonald's. Since the mid 1990's McDonald's has been looking for other businesses to enter. Not only is the hamburger market maturing, but there have been health scares related both to meat and to fatty foods. In the late 1990's, McDonald's tried more than forty different new business ideas, but, by 2010 it had exited almost all of these, unable to find a significant new business opportunity it could succeed in.

The problem was particularly tough for both Kellogg's and McDonald's. Both companies are large. This means that there were very few related opportunities that were large enough to be significant. McDonalds has more than 20,000 restaurants. A new restaurant concept would have to have the potential for at least 7000 restaurants to be significant. This rules out nearly all restaurant opportunities.

Also, both companies have been honing their management approaches around their core businesses for more than 50 years. Not surprisingly their

management approach, which may be nearly perfect for their core businesses, may act as a creosote bush for most of the opportunities they explored.

### **How to select new business opportunities**

Despite the large number of failures, there are successes. So it is important that managers have a good way to filter down the lists of new ideas that they generate to the few that have a reasonable probability of success. In the book *Strategy for the Corporate Level*, the authors propose three logics for helping with these decisions – business attractiveness logic, added value logic and capital markets logic.

But Campbell and colleagues developed a different strategic screening tool from their research. The two tools overlap, but there are also small differences. Hence, we will explain Campbell's traffic lights tool first and then link it to the three logics.

Campbell's **traffic lights tool** grades proposed new business ideas along four traffic lights. On each, the choice of grade is red (bad), amber (OK) and green (good). If any one of the lights is red, the tool suggests abandoning the idea or at least looking for a different way of addressing the opportunity to remove the red assessment. If any of the lights are green, without any being red, the tool suggests that the idea warrants investment or at a minimum it warrants the effort required to do a full financial business case. If all of the lights are amber, which is not uncommon, the tool suggests more analysis or more creative thinking, but not any significant investment.

The four traffic lights are:

- the degree of business advantage,
- the attractiveness of the profit pool,
- the relative skills of the managers involved and
- the impact on existing businesses owned by the company.

The first two traffic lights are the dimensions of business attractiveness logic – the degree of business advantage and the attractiveness of the profit pool. But Campbell's tool approaches both axes with some particular analysis. The degree of business advantage is about whether the proposed new business will have **enough** advantage over current and likely future competitors in this market place. So the assessment is looking ahead at the **future** rather than focused on the current situation, and it is asking whether the proposed new business will have enough advantage to warrant the **risks** involved in entering a new area.

The degree of advantage is assessed using an equation. It starts with an estimate of the size of any areas of advantage. Size can be measured by the likely impact on profitability, such as return on sales or return on assets. For example, if the proposal involves using the company's existing brand, and this brand is thought to be an advantage over the brands that other competitors use, then the judgement is about the likely impact on profitability as a result of the brand advantage. Will the brand help increase return on sales by 10% or 50%

compared to competitors? Clearly, this sort of judgement is hard to make with any accuracy. But only an estimate is required.

The estimate of the percentage impact on profitability of all the sources of advantage is the starting point: the first term in the equation. Let us suppose that the estimate is a 35% return on sales advantage. In other words, if competitors typically make a net profit of 10% of sales, we would expect to make a net profit of 13.5%. From this estimate, Campbell then deducts three terms:

- the proportion of this advantage that could be turned into cash without investing equity in this business. For example, by licensing a brand to a third party (as Cadbury did with its chocolate brands in the ice cream market). Since this part of the advantage can be “cashed” without getting into the new business, it should be excluded from the assessment of whether the company has **enough** advantage to justify taking on the **risks** of the new business
- any advantages that current or likely future competitors may have that your company does not have. These need to be offset against advantages the company has to arrive at a **net** advantage
- an estimate of the costs of learning how to be successful in this new market. These costs can be significant making it necessary to have extra net advantage to offset the costs.

Sometimes most of the advantage that a company has can be converted into cash without entering the new business. A technology advantage can be licenced to competitors already in the market (as many small pharmaceutical companies do); an advantage from access to raw materials can be traded with companies already in the market; a strong brand can be licensed. These advantages need to be deducted because the company does not need to enter the new business to convert these advantages into cash value. Typically it is advantages that come from managerial know-how that are the hardest to convert into cash value, and hence the main commercial logic for getting into new businesses.

The equation also needs to take account of advantages that other competitors may have that your company is unlikely to have. For example, some competitors may have established relationships with customers, as Unilever had when Mars entered the ice cream market in Europe. Unilever owned many of the freezers that retailers used to store their ice cream. Some competitors may have superior economics due to volume advantages, as GM had when Daimler entered the US mass-market car business with the acquisition of Chrysler. An estimate needs to be made of the impact on profitability of these competitor advantages and deducted from the starting number.

The final term – learning costs – is much harder to convert into a number that can be used in the equation. The term exists because it is common for managers to make business mistakes when they enter new areas. The impact of these mistakes on long-term profitability can be quite severe. Hence this term is only zero if the market is totally familiar. If the market is moderately different from existing markets the learning costs might be 10% of expected profitability, and if the new market is radically different a figure as high as 50% might be

reasonable. For example, when Mars, the confectionery company, entered the ice cream business in Europe, its new product tests were carried out during the two hottest summers for 70 years. Because Mars did not have a long history of data to analyse, managers made errors in estimating the size of the market for its ice cream bars. As a result, the company built a factory that was twice as large as needed, causing the new business to be unprofitable despite some significant sales successes.

The “enough advantage” equation is only green if the advantage, less what can be ‘traded’, less the advantages of competitors, less the learning costs, is significantly positive. Managers need to believe that the equation will give them a net profitability advantage of at least 10%. This traffic light is red if the equation is significantly negative. It is amber in all other situations. In other words, the advantage axis is amber if the equation is somewhere between minus 10% and plus 10%.

The second traffic light examines the profit pool that the new business will be competing for. The focus here is mainly on profitability rather than size. Is this an easy market in which to make money, where even weak competitors will make a reasonable return on investment (green light)? Or is this a difficult market, where even strong competitors find it hard to earn a reasonable return on their investments (red light)? All other situations are normal markets where advantaged competitors do well and disadvantaged competitors do badly (amber light).

Easy markets are ones where growth in demand outstrips supply, such as fibre optic telecoms capacity in the early 1990s, or where there are high barriers to entry and few competitors, such as the market for pharmaceutical drugs protected by patents.

Michael Porter’s five forces framework is helpful in assessing future profitability in a market. The five forces are the intensity of rivalry between competitors, the bargaining power of customers, the bargaining power of suppliers, the barriers to entry or exit and the price threat from substitute products.

If the market already exists, it may be possible to collect the data on past profitability, an important aid to understanding the forces that may affect future profitability.

The third traffic light assesses another dimension of business advantage that is often given two little attention in the business attractiveness matrix - the quality of the managers involved. Competitive advantage is dynamic: it changes as managers react to events. The business with the strongest managers will often develop new sources of advantage. While one with weaker managers may erode their advantage.

So this traffic light assesses the managers of the new business and their corporate sponsors. Are they head and shoulders better than those they are likely to be competing against (green light)? Are the managers and sponsors

clearly inferior in skill or relevant experience to those they are likely to be competing against (red light)? In all other situations, where the managers are not obviously better or worse, the assessment is amber.

Making judgments about managerial ability relative to competitors is difficult. If it is not possible to make a judgement with any confidence, the traffic light is amber. However, if the new business is in oil trading and the managers involved in setting it up are all engineers from an oil exploration business, it is not hard to identify this as a red light: engineers are unlikely to be good traders even in a commodity they understand. Equally, if the new business is on-line banking and the managers involved are among a handful in the industry with both banking skills and on-line business skills, it is not hard to identify this as a green light.

By including corporate sponsors in this assessment of managerial ability, this traffic light is touching on the issue of added value: is the parent company likely to be a better parent to this new business than others. Given the importance of parenting added value, it probably makes sense to separate out the assessment of business-level managers from the assessment of corporate-level sponsors. Possibly even creating a separate traffic light for this dimension.

The final traffic light addresses another aspect of parenting added value. Will the new business have a positive or negative impact on existing businesses? Is the impact significant and positive (green light) or significant and negative (red light)? In all other situations, the light is amber.

This traffic light assesses synergies from the perspective of existing businesses. But there can also be dis-synergies: the new business can sometimes undermine the success of existing businesses in a way that would not happen if the new business was run by a competitor. For example, a company selling through retailers may consider setting up an on-line business. This is likely to anger the retailers, who may be less willing to sell the company's products if the same products are being sold on-line.

Another factor that affects the existing businesses is the redirection of management time to the new business. One of the major regrets of companies that have unsuccessfully invested in new businesses is the opportunity cost of the management time ([reference](#)). New businesses can take up more than their fair share of executive time. They often also attract talent away from existing businesses. This can be true at multiple levels of management. The loss of performance in existing businesses due to the distraction of senior management time can be much larger than any synergy benefits.

The strength of the traffic lights tool is that the red, green and amber lights mostly require only broad judgments. Moreover, the most common judgment is amber. Red and green judgments are unusual and require strong evidence. If there is doubt or disagreement, an amber judgment is appropriate. Hence, judgments can be made at an early stage in the life of a project, making it possible to screen out ideas before much investment has been made, and identify the few ideas that should get most attention. If the traffic lights tool signals a

'go', then a detailed operational and financial proposal can be prepared for investment approval. 'Go' signals that the idea is interesting. It does not necessarily lead to an investment.

In many cases, the idea is 'amber': all four traffic lights are amber. More work can be done on these ideas to test the amber judgments. But this work should not be at the expense of the 'go' proposals. If there are sufficient 'go' proposals, 'amber' proposals can be put on hold, until resources are available to explore them further.

### **Traffic Lights and the three logics**

The traffic lights tool overlaps with the framework of the three logics. A new business proposal that fits the **added value logic** is likely to get 'green' scores for 'business advantage', if the parent company has a significant added value advantage. Alternatively, the business idea might get a green score for 'impact on existing businesses', if the added value comes from significant synergies between the new business and existing businesses. In addition, the business idea may score highly on 'leadership quality' because the managers in the parent company sponsor may have a head-and-shoulders advantage over their rivals. Sometimes all three of these lights will be green as a result of the parent company's ability to add value.

The acquisition of BMI, a European short haul carrier, by BA in 2012 is an example. Lufthansa was selling BMI, and other airlines, such as Virgin, were also interested. As a BA manager explained, "we could extract more value from BMI than Lufthansa or other bidders". This was because BMI's routes were more suitable as feeder routes for BA's long haul flights, BMI had landing slots that BA could convert to more profitable routes and BMI and BA had competing flights on some low profit routes. Not only could BA improve BMI's profitability (green light for business advantage), but BA's long haul business gained significant synergies (green light for impact on existing businesses). While BA might have felt that its managers, who would be sponsoring the new BMI business, were superior, it is unlikely that they were head-and-shoulders better than those at Lufthansa or Virgin (amber score on this part of the 'leadership quality' score).

A new business that fits the **business logic** is likely to score green on 'profit pool' or 'business advantage' or both. For example, when Mannesmann, a German engineering company, bid for a mobile phone license in Germany, the logic was driven by the potential attractiveness of the mobile network market. Because the market was growing and only a few licenses were being issued, it was highly probable that companies owning a license would do well. In normal circumstances, some of the other traffic lights, such as 'business advantage' and 'leadership quality' might have been red. But, because the mobile network business was new to Germany, all companies were starting on an equal footing on both dimensions.



As the business evolved, however, there were advantages for companies with international networks. Mannesmann then sold its mobile networks business to Vodafone for a significant profit on its investment.

The traffic lights tool is less good at incorporating **capital markets logic**. There are two solutions to this. One is to add an additional traffic light. The other is to assess the profit pool traffic light with an eye on the cost of getting into the new business. A green light for the profit pool can become red if the cost of acquiring the business means that return on capital invested will be low. A red light for the profit pool can become green if the cost of acquiring the business is low enough to make high returns on invested capital despite having low margins in the business.

Hanson Trust, a British conglomerate in the 1980s and 1990s, was famous for acquiring corporate groups that were out of favour in the capital markets because they were highly diversified. In some of the deals, Hanson Trust was able to buy a company, and recoup the buying price by reselling half of the businesses. The remaining businesses were essentially acquired for nothing demonstrating that the purchase price was cheap. Hanson Trust did exceptionally well because the company also had an added value logic for the businesses it retained – tighter control of management of costs and capital expenditures. But the deals were often justifiable on their own account as a result of the low valuations the market placed on highly diversified companies that did not have a good track record.

So the three logics and the traffic lights are overlapping tools. The strength of the three logics is the simplicity and clarity that they provide. But they do not give as much attention to people. Whether the investment is organic or an acquisition, individuals are critical. Hence, the traffic lights is an additional useful tool. The three logics also give explicit attention to capital markets logic, thinking that is easy to overlook in the traffic lights tool.

The traffic lights does not address added value as a separate category. It can appear under business advantage, impact on existing businesses and leadership quality. This is often less helpful for established businesses than for new organic investments.

In summary, the traffic lights is probably a more useful tool when considering new organic investments and the three logics is probably more useful when considering acquisitions. Trying both is often helpful regardless of the situation.

### **How to grow when the core business is maturing**

As markets mature, most companies reach a point where they become dissatisfied with their rate of growth or they anticipate that their growth will decline to levels below their ambitions. This drove McDonald's to try new businesses, such as Chipotle and Pret-a-Manger. It drove tobacco companies to

try financial services and consumer goods. It drove oil companies to try many businesses from software to mining to electric motors.

Growth is seen to be beneficial, not just because it can drive up the share price, but also because it is easier to attract talent to a growing company. Growth helps build self-confidence and pride. The share price calculation is quite stark. A company with a share price today of 100 can expect to be worth 128 in 5 years time if it is growing at 5%, 140 if it grows at 7% and 161 if it grows at 10% per annum.

But growth also has downsides. Many companies invest in new growth projects only to write down the investment without achieving anything. Many others achieve top line growth but do not advance profits. Some make significant acquisitions that go bad and undermine the survival of the company.

So how should managers approach the growth challenge? First, managers should understand that there is bad growth and good growth. It is better not to grow than to grow badly. **Exhibit xx** illustrates this point. The top right box, where growth is high and returns are above the cost of capital is good growth. The bottom right box is the worst place to be. Growth is high; but, because returns are below the cost of capital, every dollar of growth is destroying wealth rather than creating it. When returns are below the cost of capital, it is better to be in the bottom left box than the bottom right box.

Second, managers need to be aware that many of the frameworks and concepts designed to help them can be misleading. Take three common approaches.

1. Growth is an imperative. The argument is as follows. If you do not move your company out of mature sectors into growing sectors, your company will ultimately become irrelevant. So identify 'industries of the future' and start investing in them now.

This is an attractive argument, but it overlooks some basic realities. Managers schooled in one sector are rarely competitively successful when they invest in a new sector. Moreover, it is often easier for shareholders to invest in new growth sectors than for an existing company to do so. In other words more value can often be created by returning money to shareholders for them to invest in growing businesses rather than using the money to enter new growth industries directly. Unless managers recognise this trade-off, they are unlikely to have a sound growth strategy.

2. Three horizon planning. McKinsey consultants developed a planning tool that distinguishes between three types of growth: growth coming from existing projects in existing businesses that will deliver in the next year or two (horizon 1); growth from developments that will deliver in the two to five year period and will take the company into adjacent sectors (horizon 2); and growth from wilder ideas and projects that will not deliver for five

years or more and may take the company into significant new areas (horizon 3).

The tool proposes a different management approach for each horizon that reflects the different risks and management challenges. Horizon 1 can be managed through budgets and performance targets. Horizon 2 can be managed through project management techniques. Horizon 3 can be managed as a portfolio, recognising that most projects will achieve little. Stage gates and portfolio management techniques are needed in this third horizon.

This three horizon tool is an idea first developed to help research laboratories manage a portfolio of research projects. It appears to work in this environment, where all projects are part of a single research business model. But, when a company is trying to find growth with new business models in new areas, the tool has less validity. This is because the third horizon is built on a portfolio approach to development. Unfortunately, the failure rate of projects that involve new business models is normally too high to make a portfolio approach economic. So the third horizon tool needs to be supported by a powerful selection process, like the traffic lights, that limits investment to those projects with a high probability of success.

3. Bring Silicon Valley inside. Gary Hamel, the strategy guru, wrote a famous article with this title in the Harvard Business Review. The thesis was that companies needed to develop the skills of venture capitalists (hence the link to Silicon Valley) in order to be able to develop new growth businesses.

There are three problems with this approach, which we will explore in greater depth in the next section. First, most venture capitalists do not earn a good return on investment. Hence, copying what they do is unlikely to be good for shareholders. Second, most management teams do not have the ability to develop the skills of a venture capitalist. Third, if managers did develop the skills of venture capitalists, they would probably do a less good job of managing their existing businesses.

A third guiding thought for managers in search of growth is about patience. Despite needing to grow into new areas, most companies will have periods when there are no new opportunities for them that fit their skills. When this happens they are best advised to do nothing and to wait for appropriate opportunities to emerge. As Steve Jobs pointed out once, when he was asked what new developments he had planned, “we are waiting for the next big thing”.

Patience is tough advise for hyperactive managers who feel that they should be doing something. But it is often the best strategy. Initiating new projects that have low chances of success, consumes resources and saps commitment. Far better to husband the resources and energy until something with real promise comes on the horizon.

The alternative to patience is corporate venturing: set up a small unit to experiment in a number of new areas.

### **Why corporate venturing does not work?**

Over the last 40 years there have been three waves of corporate venturing (late 1970s, late 1980s and late 1990s). In all three periods, the search for growth caused managers to set up special units or departments in their organisations to identify and invest in growth projects. While different management gurus were influential in each of the waves, the broad message was similar to that of 'Silicon Valley inside' and 'three horizon planning': companies need to experiment more, take more risks and try more new things if they are to find the next growth platform.

All three waves of activity have ended in failure. Very few companies found significant growth platforms through a corporate venturing process and many spent large amounts of money. The research project mentioned earlier by Campbell and Birkinshaw, which involved over 100 corporate venturing units mainly from the third wave, found that the costs exceeded the benefits in all but a handful of cases.

This does not mean that the process of corporate venturing – setting up a separate unit and following the processes developed in private equity or venture capital to manage a series of projects – is worthless. It can be a useful management tool, but not for finding new growth platforms.

Campbell and Birkinshaw and co-authors identified five types of corporate venturing of which 'new growth venturing' was only one type.

### **Conclusion**

Growing into new businesses is difficult. Existing managerial skills and relationships get in the way. It can be harder for managers to unlearn what they already know than for new start up companies to build expertise.

Many solutions have been suggested to this problem. Most of them encourage managers to have a portfolio of initiatives and to take more risks. However, there is little evidence that this approach works; and corporate venturing units designed around these ideas on average give poor returns to shareholders.

The alternative is to be more cautious and more selective, and to recognise that giving money back to shareholders in the form of special dividends or share repurchases is a viable alternative in many situations. The traffic lights tool is designed to help managers be more selective by using the rules of good strategy to identify those projects that have a reasonable chance of success.