Breakthrough Thoughts
by Chuck Lucier and Jan Dyer

The Lake Wobegon Economy

It's a place where revenue growth is two to three times the norm, and shareholder returns are way above average. You'd better move there soon, our newest research shows, if you want to attract investors and talent.

No second chances. No excuses. No kidding. Performance slips, and impatient investors and boards pull the plug. Witness Gillette Company, Lucent Technologies Inc., the Xerox Corporation, Campbell Soup Company, Aetna Inc., Procter & Gamble Company, Mattel Inc., Hercules Inc., Newell Rubbermaid Inc., the Federal-Mogul Corporation, and the Coca-Cola Company. "There's zero forgiveness," Mattel board member and acting CEO William Rollnick told the *Wall Street Journal*, after the toy company fired Chief Executive Jill Barad. "You screw up, and you're dead." The ax falls swiftly. Says Thomas Neff, U.S. chairman of executive recruiting firm Spencer Stuart, "It used to be a couple of years. It has changed dramatically in the last year."

What does it take to fall from grace? Besides unexpected declines in performance, the hurdle is anything less than extraordinary growth in earnings and revenue. Of the companies in the S&P 500 that outperformed the stock market average during the 1990s, the median performer, according to our research, delivered annual revenue growth of 12.9 percent and earnings growth of 19.3 percent. During the same period, the U.S. economy grew by 5.3 percent per year, and the global economy by only 4.0 percent. That means above-average performers in the stock market grew their revenue two to three times as fast as the economy as a whole, and their earnings even faster. In other words, financial performance matters. Just ask the CEOs who failed to deliver.

Of course, below-average stock market performance also matters, even if the CEO doesn't get canned. It matters to companies that are forced by poor results to split apart (like the AT&T Corporation and the FMC Corporation) or that become attractive takeover targets (like Honeywell Inc. and Seagram Company). It matters to managers at all levels, as CEOs who get no forgiveness give none, and demand extraordinary no-excuses performance from each business unit. It matters to employees, because companies unable to grow the top line will (before or after an acquisition) fire large numbers of people in an attempt to achieve rapid

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Exhibit 1: **Performance of S&P 500, 1990–1999**

Quintile of Performance for Shareholders	Annual Returns to Shareholders	Annual Growth in Earnings	Annual Growth in Revenue
Top	34.0%	29.3%	20.6%
Above Average	21.8%	14.6%	8.3%
Average	14.7%	9.8%	5.2%
Below Average	10.0%	4.7%	4.9%
Bottom	3.2%	1.1%	5.2%

earnings increases. And it matters to your prospective employees, because talented people — the key to success in the knowledge economy — flock only to those companies expected to sustain top-tier growth in revenue, earnings, and opportunities. For those are the companies able to offer the most lucrative stock options.

Extraordinary Performance

It's clear, then, that all companies, their leaders, and their people need to move beyond conventional strategies for pursuing growth. Incremental expansion may seem low-risk, but in fact it guarantees failure. At a minimum, companies that want to stay in the game must transcend the average, reaching the place we think of as the "Lake Wobegon Economy," after radio humorist Garrison Keillor's mythical Minnesota town, "where all the women are strong, all the men are good-looking, and all the children are above average."

The table above illustrates companies' extraordinary performance in the 1990s. We've sorted the S&P 500 into quintiles based on companies' total returns to shareholders (stock price appreciation plus dividends) over the decade. For each quintile, we show the median total returns to shareholders and annual rates of growth in earnings and revenue.

These performance standards aren't just part of the recent Internet stock bubble: Companies delivered at these levels well before there was any discussion of a New Economy. For example, during the decade from 1985 to 1994, median performance in the "average" quintile was revenue growth of 8.5 percent and earnings growth of 9.6 percent, and median performance in the "top" quintile was revenue growth of 21.1 percent and earnings growth of 25.9 percent.

Nor has above-average performance been limited to just a few industries. For example, during the 1990s, the top quintile included retailers (Best Buy, Home Depot, Lowe's, Gap, Staples, and Wal-Mart); financial services institutions (Morgan Stanley Dean Witter, Schwab, Merrill Lynch, and Bank of America); manufacturers (General Electric, Textron, Ford); pharmaceuticals companies (Johnson & Johnson, Amgen, Pfizer, Schering-Plough); consumer products companies (Nike, Colgate-Palmolive, Gillette, Clorox, Wrigley); and energy companies (Enron).

It's true that in recent years —

specifically, in the decades from 1989 to 1998 and from 1990 to 1999 — firms in high-growth industries were slightly more likely to deliver superior performance than those in mature industries. But our hypothesis is that recent history is an anomaly: As traditional companies learn to take full advantage of digital technologies, companies in all industries will be equally likely to create superior value for their shareholders, just as they were in the rolling decades ending in 1982 through 1997. Indeed, since new technologies are creating additional business opportunities for everyone, we believe performance levels won't decline. In the future, they may be even higher.

Certainly the mind-set of managers in mature industries is changing. In high-tech industries, everyone has long known that it's rapid growth or death. However, in mature industries, growth was something many companies hoped for, but didn't depend on. A downturn in the business cycle, they rationalized, would naturally depress revenue and margins. And while intense competition ensured that most productivity programs benefited customers through lower prices, no one expected them actually to increase margins.

Today, however, with investors and the most talented employees demanding growth far greater than the average in these industries, the best companies have been developing growth strategies that are much more aggressive than the add-a-few-customers-here, gain-a-little-market-share-there tradition. And it means that no excuses can be tolerated for not meeting growth targets.

Grow Your Margins

We suggest that all companies focus on simultaneously increasing margins and growing revenues at a rate at least twice that of the economy's growth. Why margins? Notice that during the past decade, earnings grew faster than revenue for both average and above-average performers — that is, their margins increased. Margins remained constant or declined in the underperforming quintiles. Unlike the dot-coms, which hoped vainly that rapid revenue growth alone would leverage their fixed costs and magically increase margins, high-performing S&P 500 companies aggressively delivered margin improvement along with revenue growth.

During the last decade, successful firms demonstrated that there isn't a trade-off between margin growth and revenue growth: You can have it all. In fact, you'd better have it all. It's a bankrupt strategy to grow revenue at the expense of margins (like promotions-crazy packaged-goods companies) or to grow margins at the expense of revenue growth (like the breakfast-cereal manufacturers that raised prices too much). As integrated steel manufacturers and American machine tool manufacturers discovered, fleeing from the most price-sensitive segments in an effort to increase margins is even worse; it not only causes revenue to decline but also creates strategic vulnerability by ceding the fastest growing (and often most innovative) segments to competitors. In contrast, the Intel Corporation demonstrates that when there is sufficient overlap in skills and knowledge with the core business, entering price-competitive adjacent segments can increase the company's total margins and rate of revenue growth.

Some strategies simultaneously increase margins and accelerate growth. For example, well-managed companies in mature industries can make a series of "we bought you" acquisitions. Those are acquisitions in which the acquiring firm quickly

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implements its management systems, rationalizes joint assets, reduces competition, and ruthlessly eliminates jobs — avoiding the protracted efforts to "build on the best of both companies" that used to be popular. As long as the acquiring company's management system is scalable, the risks of "we bought you" acquisitions are minimal, and the opportunities to create value in excess of the purchase premium are great.

Another strategy to increase both margins and revenue growth rates leverages the company's tangible and intangible assets into new revenue streams and businesses. For example, like the IBM Corporation and Hewlett-Packard Company, a company can develop a high-margin service business, such as consulting or training, that takes unique advantage of its knowledge. Or like Johnson Controls Inc., it can "climb the value ladder," assuming greater responsibility for the benefits that customers receive (see "Climbing Up the Value Ladder," *s+b*, Fourth Quarter 2000). Leading marketers like Pfizer Inc. supplement their R&D through in-licensing and co-marketing agreements for potential blockbuster products. It's even possible to develop revenue streams from knowledge that won't be used in the base business: for example, by selling product technology leads to other companies — or venture capitalists — more interested in taking advantage of them.

Some strategies can turbocharge either margins or revenue growth. For example, some companies that drive margin growth combine continuous improvements with targeted leaps in performance, applying the best knowledge in the world to achieve dramatic improvements in the efficiency of all their value-added activities. Powerful methodologies such as Six Sigma have enabled even General Electric Company, already a paragon, to continue to reduce costs by more than $1 billion per year. Decision tools and databases enhance the quality of decisions, as well as the efficiency of service activities, such as customer service, and overhead functions, such as credit and marketing. E-business tools will stimulate even more opportunities for cost reduction — far exceeding what pioneers like Cisco Systems Inc., the Dell Computer Corporation, and Charles Schwab & Company have achieved.

The most common strategy to turbocharge revenue growth is to build on the company's greatest strengths, adapting them to new products and services (as the Home Depot Inc. has done), to new geographies (Southwest Airlines Company), to new markets (the Oracle Corporation), or to additional customer segments or buying occasions.

An emerging strategy is to target specific growth dynamics and stimulate managers to create new businesses before competitors do, as the Enron Corporation has done in commodity trading or General Electric and BP in e-business.

Growth in earnings, revenue, and

margins has always been a priority for all companies. What's new is that double-digit revenue growth and even faster earnings growth have to be the priorities. Since simultaneously increasing margins and growing revenue, quarter after quarter, at two to three times the rate of the economy, is so difficult, they have to be a company's primary objectives. Balanced scorecards of multiple measures are fine, but neither shareholders nor the most talented employees tolerate the excuse of success in other measures to explain shortcomings in the rates of revenue and earnings growth. Companies that deliver on those two objectives will create above-average returns for their shareholders and superior opportunities for their employees. (For example, during the 1990s, growth in earnings and revenue explains nearly 60 percent of the variation in returns to shareholders, far more than in previous periods.)

The corollary is that other objectives — even hard, quantitative objectives, such as return on assets and its correlates, return on equity and economic value added — aren't as important as they used to be. Before 1990, the ratio of market value to book value of the S&P 500 fluctuated around one to one: That is, the market expected a return on assets (ROA) approximately equal to the cost of capital. Since raising poor profitability to exceed the cost of capital creates value for shareholders, ROA objectives made sense then. During the 1990s, the average market-to-book ratio of the S&P 500 increased to five to one, reflecting the transition from a capital-intensive to a knowledge-intensive economy.

When ROA is greater than the cost of capital, a focus on increasing ROA further can result in investment decisions that do not maximize value to shareholders. Specifically, setting ROA targets much higher than the cost of capital can choke off the investments necessary to accelerate growth in revenue and earnings. The more important lever, both theoretically and practically, is to accelerate growth by pursuing more and more investments that return more than the cost of capital.

Public and Private

Are our conclusions relevant only to publicly traded companies? It's true that public equity markets demand extraordinary revenue and earnings growth from companies in all industries. But private investors have even higher expectations for performance than the public markets do. Moreover, private investors are even less forgiving: Remember, a decade ago it was leveraged buyout firms that first demonstrated the potential for no-excuses growth in mature industries.

And is this analysis applicable outside the United States, the source of our data about performance? Companies headquartered outside the U.S. face less immediate performance pressure: The public equity markets are less robust, the threat from start-ups less pronounced, and in some countries employees can't be wooed away as easily with stock options. However, we believe that over the medium to long term, even companies headquartered outside the U.S. will have to deliver extraordinary performance. Taking the seductive path of incremental single-digit growth means falling behind U.S.-headquartered companies in both size and capabilities — a gap that will be harder to close when the mobility of capital and talented individuals raises the expectations of performance for all companies to the levels being achieved in the U.S. today.

Successful companies act as if they live in a Lake Wobegon Economy. Regardless of industry, they enjoy beautiful opportunities for growth in revenue and earnings. All can deliver above-average performance by creating extraordinary value for customers and by cannibalizing the weak. Discussions about the old economy and the New Economy miss the point. Technology is an enabler of opportunities but not a panacea. Companies have to make money — lots of it. In the Lake Wobegon Economy, extraordinary performance is the norm. There's room in Lake Wobegon — at least for half of us. Lake Wobegon or bust. +

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