How can your growth strategy evolve faster than the market?

Strategy realized

The better the question. The better the answer. The better the world works.
Overview

How sure are CEOs that their current growth strategy will achieve a competitive advantage and sustainable value over the next two to three years? Many companies are setting their strategy against a flawed view of the industry and markets in which they compete.

In this article, we look at how to understand a company’s true competitive position, how technology is rapidly making current market assumptions outdated and how companies can use market context to drive sustainable growth.

Embedded in the strategy should be specific approaches to organic and inorganic growth, margin expansion, portfolio optimization, new product development and other tactics. Equally important is having a high level of confidence in being able to deliver on the growth strategy. Companies that have less confidence in their organic growth should pursue M&A as an accelerated pathway to achieving their growth goals.
Understanding market context – competitive position is the strongest indicator of potential performance

EY-Parthenon’s Full Potential Paradigm™ (FPP) framework measures the full potential value of a business. It gives senior management the boundaries to help set strategic goals and actions, including M&A targeting, to deliver long-term value with that high level of confidence. Determining and setting the market context are the foundation of the FPP analysis and critical steps in achieving a successful result.

A market context analysis provides a view of the company’s unique position in scale and profitability compared with its competitors, any adjacent segments and new market entrants. Given today’s competitive dynamics, correctly determining market context is difficult. Properly done, though, it largely answers the following critical questions:

- What are the drivers of growth and profitability for the business and industry?
- Is the industry concentrated or fragmented? Is it consolidating or stable?
- Who are the top competitors? Has there been any turnover at the top, and why?
- Which industry boundaries are under attack?
- What is your market position vs. the leader and runner-up? What are the main sources of relative market share change for your business? How are these factors changing?

A business’s competitive position is the strongest indicator of potential performance. By answering these questions, you can determine from where growth will likely emanate and which M&A targets should be pursued to deliver long-term value.
How to define market context when technology changes everything

Defining market context is part science and part art. It starts with an analysis of how your business is defined, taking into consideration the industry's dynamics.

It is important not to rely on conventional definitions of your industry, such as Standard industrial classification (SIC) codes. Rather, take a more analytical approach. Utilize the four C's: customers, costs, capabilities and competition. But analyze them through the lens of innovation and understand the disruptive drivers, such as technology. This not only increases the complexity, but will also help develop a more useful view of your company and its competitors.

Three areas of technology innovation affecting the four C's are:

1. **Information technology** – The introduction of mass data collection, storage, analysis and distribution has affected many industries. Today, all players have access to increasingly complex information when assessing the market and their own business. For example, a mobile phone company can use data to segment potential customers and target marketing accordingly.

2. **Product technology** – Product development has been an area of profound technological improvements. For example, technology has driven the evolution of the insulin pump market, with improvements such as reduced size, improved battery life and improved effectiveness.

3. **Business model technology** – These technologies are specific to the value chain of the business. Some examples of business model technology include drone technology and the impact on distribution companies, or 3-D printing and its impact on the manufacturing processes.

Understanding how these technologies affect customers, costs, capabilities and competition in your industry makes it possible to better understand your competitive situation. This helps you evaluate what you need to do to gain a competitive advantage that delivers growth.

**Customers**

“Customers” simply refers to a common set of buyers across an industry and geography purchasing a product or service to solve a similar problem. However, competitive dynamics change customer markets, and new technology is often the catalyst for this change. One example is innovation driving product “premiumization” (i.e., the introduction of new, higher-end products).

The mobile phone market is a good example of how customer targeting can impact the market context. It may seem like companies in the market share the same customer set: people who want to buy a mobile phone. But while one company may have a larger share of the market, another may be using product innovation to establish itself as a premium brand, commanding higher margins by focusing on a smaller set of customers.

**Costs**

Understanding cost structures related to a company's production, delivery and servicing landscape can help identify your true competitors. This makes it possible to refine your unique business definition. Generally speaking, companies with similar cost structures that meet similar needs of a set of potential buyers are considered competitors. But disruptive business model technologies can radically shift the value chain and, therefore, the cost structure.

Consider the airline industry – there are notorious pricing and profitability pressures to remain competitive, and technology innovation has impacted the industry in many ways on that front. One example is the use of online check-in and self-service baggage check-in kiosks at airports, both of which have lowered operational costs, thereby improving margins and, ultimately, enabling airlines to compete effectively on pricing. Another example showing how technology has impacted the airline industry is the birth of online booking platforms, which have made it easier for customers to compare prices. Not only has this created pricing pressures for the airlines, but it means they now compete for customers not just with other airlines, but also with train and automobile options as well.
How can your growth strategy evolve faster than the market?

Using market context to illuminate profitable M&A growth opportunities

Capabilities

A comprehensive capability analysis makes it possible to identify and evaluate your company’s overall proficiencies. It can also help identify your actual competitors and define relevant adjacencies. There are two types of capabilities to analyze: hard assets — intellectual property, buildings and such — and soft assets — employees and reputation. As with cost, technology disruption in the value chain impacting a company’s or industry’s capabilities can create significant competitive advantage with improvements to either the product or the business model efficiency. For example, shifts in fundamental technologies around capabilities in retail distribution have revolutionized that marketplace. They enable same-day delivery of online orders and help some retailers keep their shelves stocked. Also, consider that Samsung used product technology innovation to capitalize on a leadership position in display technologies to transform itself from an electronic parts supplier to a leading provider of televisions and smartphones. This transformation ultimately shifted its perception of competition and, thus, the market context.

Competition

While all of the analysis thus far helps illuminate positioning vs. the competition, it’s important to take a direct look at the market and assess adjacencies and new entrants. You need to look at your competitive market, understand how that market has changed over time and appreciate how it might potentially change in the future. With technology as the fundamental game changer, we see adjacencies and new entrants joining the competitive mix at an accelerated rate. The need to scan the market for new products and services at the edges of your industry is essential in identifying future threats to the business. The taxi industry is a great example showing how new technology can affect competition. While the industry still provides point-to-point transportation, the emergence of new entrants, such as Uber and Lyft, redefined the business by bringing technological disruption via an app that connects drivers directly to riders.

Using market context to illuminate profitable M&A growth opportunities

Once the market context is set and you have defined your own business and competitive positioning, the next step in the FPP construct is to calculate the relative market share (RMS), one of the best predictors of long-term growth and profit potential. RMS growth drives actual profitability. It is certainly more complex in calculation than standard market share (SMS), because it indexes the end market sales of a company’s competitive set through a geometric mean calculation. It provides additional insight into the competitive market that SMS lacks. Why is this so important? A growth strategy that is solely focused on increasing revenue is not sustainable.

For a properly defined business (based on the market context analysis), profitability is driven by RMS. Companies with high RMS should, with all else being equal, earn more than those with lower RMS. This, in fact, debunks the notion that companies may be “too big to grow.” A high RMS does not limit revenue growth.

To visualize the power of RMS in setting a growth strategy, a diagnostic from our FPP construct is shown on the next page. Here, we set the RMS against the adjusted return on sales (AROS) to help clients establish growth goals around defined margin targets. In addition, we evaluate specific M&A opportunities to reach these goals.

1 RMS indexes a business’s traditional market share by dividing by the share of the leading competitor. RMS for the leading competitor is calculated by dividing its share by that of the next-largest company. In each case, revenues of the end customer are used.
Normative Band Diagnostic – what it says about an industry

Company placement on normative band illustrates profitability

The Normative Band Diagnostic shows the relationship between which company has the strongest competitive position in the market on the x-axis (the RMS calculation) vs. how they are performing from a profitability perspective on the y-axis (adjusted return on sales – AROS). For each industry, there is a unique normative band sloping up across the chart with a lower band of 20th percentile performance and an upper band of 80th percentile performance. Using this normative band, companies can determine whether profitability is on track (at the 80th percentile, e.g., Company A), outperforming (above the 80th percentile, e.g., Company B), underperforming (below the 80th percentile but above the 20th percentile, e.g., Company C) or a potential candidate to exit the industry (below the 20th percentile, e.g., Company D).

Slope = 0.12∗
R² = 0.71∗∗∗

* Illustrative figures.
** Bubble indicates relative size of sales.
*** Proprietary analysis of the performance of companies in 2,000 industries (with an average R² of 0.6 to 0.9) has shown that companies that do sustainably well perform at the 80th percentile.
Normative Band Diagnostic – strategic options underpinning M&A activities

Simple illustration on directionally how companies should evaluate M&A opportunities

This illustrates the multiple options a company can perceive to improve its market position. Company A can move up and gain more profitability or it can move to the right to achieve a greater relative market share, which should allow a later conversion to higher profitability. Using this type of analysis, a company can evaluate which levers it can pull to affect profitability, including M&A. If M&A is the chosen route, it can then better evaluate to what extent specific M&A opportunities meet the deal rationale needed to drive a company’s competitive advantage and deliver profitable growth and long-term value.

Option 1: Move up to increase profitability

Option 2: Move right to increase RMS

Option 3: Move up and to the right for optimal benefits

* Illustrative figures.
** Bubble indicates relative size of sales.
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Slope = 0.12
$R^2 = 0.71$
Normative Band Diagnostic – sample industry

Simple illustration on directionally how companies should evaluate M&A opportunities

Figure 3 looks at a sample industry and the companies within it. Each company has a unique perspective and, therefore, a unique set of options it can pursue to achieve profitable growth.

- **Company A:** If it is content with its current market position, leadership can adjust internally to target 80% performance at the current RMS to achieve optimal profitability (moving the center of the bubble up so that it aligns with the 80th percentile).

- **Company B:** It has the highest RMS, and perhaps achieved this by dropping prices. This can be risky, as profitability will drop in the short term to gain this additional market share. The company must make sure it takes full advantage of its RMS to help regain profitability.

- **Company C:** It could gain RMS by acquiring a near or direct competitor, such as Company D, in hopes of both increasing RMS and taking advantage of Company D's high profitability.

- **Company D:** If the above happens, diligence is important as Company D could be highly profitable at the fault of letting its R&D program wither, thus halting innovation. Or, it could have great leadership that manages profitability well. In turn, this could introduce a mindset and culture of efficiency that, if integrated properly, could boost the profitability of Company C.

Each of these scenarios in Figure 3 addresses the need to gain more relative market share or improve AROS. In this example, Company C and Company D could use the analysis to identify specific M&A targets to accelerate the path to increased RMS and profitability.

It is essential for executives to determine where their own company fits on the normative band in relation to its competitors in order to make thoughtful strategic growth decisions.

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eBay: using M&A to expand market and capabilities

eBay, with a rich history of more than 60 acquisitions, illustrates how M&A can underpin a successful growth strategy in a transformative market. eBay launched its online auction and trading company in 1995, connecting buyers and sellers. At the time, it was focused on the US collectible market (specifically Pez dispensers). It now has annual revenue of more than $10b and is a market leader in e-commerce worldwide.

Increasing its addressable market has been a primary strategy to deliver growth. First, it expanded collectibles to the mass market. Then, it transitioned and expanded from online auction sales to fixed-price sales. Acquisitions such as StubHub and Motors.co.uk have accelerated this market and geographic expansion.

eBay has also brought new capabilities to the firm, such as by purchasing PayPal in 2002. This has enhanced its customer experience to seamlessly deliver an end-to-end online purchasing process, attracting more customers and likely reducing costs. Eventually, PayPal developed into a stand-alone adjacency and, subsequently, was spun off in 2015.

The acquisition of new capabilities to drive a competitive advantage, like eBay’s purchase of PayPal, is the number one motivation behind most M&A activity today. It accounts for 33% of deals globally and 41% in the Americas specifically. These transactions are centered around leveraging the value chain while improving a company’s hard capabilities, such as plant and equipment, or soft capabilities in areas such as technology, talent, intellectual property (IP) and, research and development (R&D).
Aligning M&A with strategy can help deliver long-term value

With disruption front and center across most industries, it is difficult to pinpoint growth goals with confidence. Organic growth, while an important factor, is often not enough to make a timely and significant business impact. M&A is required to help make up the difference. Understanding market context is critical in evaluating where market power lies in your industry, and how that impacts your business and acquisition opportunities to deliver long-term, profitable growth.

Click here to learn more about EY-Parthenon’s strategy capabilities and our Full Potential Paradigm™ construct.
The Stress Test Every Business Needs

In our EY book, *The Stress Test Every Business Needs: A Capital Agenda for confidently facing digital disruption, difficult investors, recessions and geopolitical threats*, the authors extend the banking stress-test concept to a company’s “Capital Agenda” – managing capital, executing transactions and applying corporate finance tools to strategic and operational decisions.

See Chapter 15 to learn more about the Full Potential Paradigm.

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