Profit from the Core

Chris Zook and James Allen
Published by: Harvard Business School Press, 2001

Introduction

Growth is the most important issue faced by all management teams. The key to unlocking hidden sources of growth and profits is not to abandon the core business but to focus on it with renewed vigor and a new level of creativity. Strong core businesses often lose momentum by virtue of premature abandonment, miscalculation, or overreaching in search of new growth.

The foundation of sustained, profitable growth is a clear definition of a company's core business. The authors define the core business as that set of products, capabilities, customers, channels, and geographies that defines the essence of what the company is or aspires to be to grow its revenue sustainably and profitably.

To identify the core business, companies must identify the five following assets:

- The most potentially profitable customers
- The most differentiated and strategic capabilities
- The most critical product offerings
- The most important channels
- Any other critical strategic assets that contribute to the above (such as patents, brands)

The better performing the business, the more likely it is performing below its full potential. The most enduring growth pattern is that of the strong, or dominant core business that benefits from continual reinvestment, constant adaptation to circumstances or business environment, and persistent leveraging to enter new markets or geographies, applications, or channels.

A management team developing, refining, or reexamining its company's growth strategy must: (1) define the business boundaries and core business; (2) identify the sources of differentiation that will continue to create market power and influence over customers, competitors, and industry profit pool; and (3) comb through the core and assess whether it is operating at or near its full economic potential.

The Profitable Core

Companies that have very few, highly focused, core businesses account for most of the sustained growth companies. Most growth strategies force companies to reduce their focus on their core business and thereby to depart from the basis of their real differentiation. Most diversified companies should narrow and focus their activities to create fewer growth platforms, while companies with multiple mediocre business positions should restructure their portfolios to develop a single strong core.

Market share dominance in a well-defined core business often creates superior profitability. But it does not represent a full explanation. It does not explain the success of many strong follower businesses such as American Express versus Visa in credit cards or Canon versus Xerox in copiers. Such an explanation requires a broader way of thinking about what types of market power and influence can achieve leadership. Also, blurred and fuzzy business boundaries make it extremely difficult to determine market share and relevant competitors.

Without a clear understanding of business boundaries, it is difficult to determine the relative importance of differently positioned competitors, or of different growth opportunities. To make the right decisions, it is critical to have a clear definition of the core business, the relevant business adjacencies that surround the core, and the competitive and economic landscape. Errors in defining a business are among the most frequent and most dangerous forms of strategic error. But today defining a business is no easy task. Business boundaries are more difficult to determine and are changing more often than ever before.

Creating market power

The most robust form of market power derives from building a uniquely high and structurally stable level of loyalty in a well-defined customer segment. Customer loyalty can be built as a competitive advantage in an existing customer segment. The other way to build market power and influence through customer segment focus and loyalty is by identifying or even creating a totally new customer segment and dominating its experience of a product or service. Building deep loyalty in a focused customer segment almost always proves economically more valuable than building breadth without loyalty. Establishing leadership in a new or existing channel of product or service distribution is the second most common model of building market power and influence, sometimes from a position of followership. The power of differentiation through superior product development is the rarest form of market power and influence.

The Alexander Problem

Virtually every business has a core and an expanding and complex set of adjacencies. Defining the core is critical. But being extremely diligent about monitoring competitors deemed temporarily to be noncore can be just as important to long-term, sustainable growth. It is the balance between maintaining a strong core and adjusting to threats and opportunities in business adjacencies that is the central issue in a growth strategy.

Moving into new business adjacencies around the core business can trigger either a new burst of profitable growth or lead to distraction and stagnation. Managers are torn between protecting and investing in the core business, on the one hand, and expanding into adjacencies, on the other. The way companies resolve this dilemma often determines the sustainability of their growth.

Adjacency expansion is a company’s continual moves into related segments or businesses that utilize and, usually, reinforce the strength of the profitable core. Over time, these sequenced moves can fundamentally redefine the core business (by adding new capabilities) as well as provide growth in themselves. Indeed, it is through adjacency expansion that a company in a stable industry repositions itself to pursue the most attractive opportunities or to respond to a changed business environment.

Business adjacencies allow a company to extend the boundaries of its core business. What distinguishes an adjacency from another growth opportunity is the extent to which it draws on customer relationships, technologies, or skills in the core business to build competitive advantage in a new, adjacent competitive arena.

The stronger and more dynamic a company's core business, the broader its range of add-on expansion opportunities. Those companies with the strongest cores, and hence the most to sacrifice in losing focus, also suffer the greatest temptation to become distracted. To select new growth initiatives without jeopardizing a strong core, companies must methodically inventory and map out their adjacent opportunities.

The most common adjacencies in a core business are:

- Interlocking customer and product adjacencies
- Share-of-wallet adjacencies
- Capability adjacencies
- Network adjacencies
- New-to-the-world adjacencies

Perhaps the most common adjacency expansion is moving into new customer and product segments, using each move to reinforce the next. It involves constantly adapting a product to enter a new customer segment and drawing on the knowledge gained about that customer segment to develop new product ideas that can then be applied in still other segments.

A second way for growing beyond the initial boundaries of a core business is moving into "share-of-wallet" adjacencies. By capturing most of the purchases core customers make and then expanding their menu for purchases, it is possible to create a bond with customers that substantially increases their loyalty. Such loyalty allows the cost of serving a customer to be spread across more purchases, increases both the retention rate and the life-cycle value of a customer, establishes a deeper relationship with a customer, creates a more intimate knowledge of each other's businesses and increases switching costs.

Capability adjacencies are based on deep organizational know-how. There are three forms of capability-based expansions. The first is grounded in technology or technical know-how. The second comes from business process know-how and the management model for running businesses. The third is founded on knowledge about to how to store, manage, and obtain value from information, and the peculiar economics of doing so.

The economics of networks in which the addition of a user increases the value of the network to all other users generates increasing returns to scale and therefore large rewards for network-dependent businesses that expand. Increasing returns create situations where incremental scale can be worth more to the leader than to other participants.

Industry turbulence creates new, uninhabited business territory. Such new-to-the-world businesses, can represent an important, opportunistic form of adjacency expansion. As industry structures become less stable, and the life span of a typical strategy grows shorter, adjacency expansions are critical for staking a claim on future market positions as a hedge against uncertainty. The case for making these investments can sometimes be enhanced by going beyond basic net present value calculations and gut instinct to call on frameworks from options theory.

Launching a direct assault on entrenched positions, without a major new angle of attack or differentiation, seldom wins the war. Yet many companies try to move into adjacencies that are, in fact, the well-defended, entrenched positions of others.

Pursuing areas of the market in which a company has relatively low odds of leadership or of building market power and influence can sap resources from the core and actually retard growth in the rest of the business.

The discovery of new, uninhabited market territory frequently brings unexpected players. Lacking familiarity with these competitors, companies tend to underestimate their strength, nature, and angle of attack. Instead, they need to x-ray every new competitor thoroughly to understand the world from the adversary's point of view, economics, and customers.

Narrow boundaries keep "apparent" market shares high, provide psychological comfort and wall out the hard choices that may loom ahead.

The strongest core businesses gravitate to the higher and higher ends of their markets, targeting more sophisticated products with higher margins that can support greater overhead. The danger is that this approach may expose a flank at the low end to attack from new breeds of low-cost competitors.

To evaluate an adjacency investment, companies must ask:

- Does this adjacency strengthen or reinforce the core?
- Does this adjacency add value for our core customers?
- Does this adjacency serve as an insulation against potential competitors intent on attacking the core?
- Is this adjacency positioned in the direction that the industry profit pool (and the core) is likely to shift over time (growing segments, channels, needed capabilities)?
- Do we have a chance of achieving leadership economics in this adjacency through outright leadership, a protected customer position, or shared economics with the original core?

- Does this adjacency hedge against a major strategic uncertainty?
- Does this adjacency lead to other successive moves that, in total, are essential to build or protect the core?
- Does this adjacency move into the backyard of a new competitor? What might the competitor's response be, and how does that play out?
- Does failure to move into this adjacency turn out to render the core vulnerable several moves down the road? To what degree?
- Has the company fully mapped out all the competing adjacencies, or is it acting opportunistically, without fully calibrating the options?

The Redefinition Dilemma

The need to redefine a core business fundamentally is becoming more critical and will become more common, given the increasing frequency of industry turbulence. But successful transformation is quite rare. Only about 5 to 10 percent of profitable and growing companies have transformed or redefined their core business fundamentally in the past decade. Given the deep roots that a company's historic core has, it is no wonder that change of this magnitude is seldom attempted or successful.

Five key controllable variables drive success: (1) time frame and sense of immediacy, (2) clear motivating rationale for the "point of arrival," (3) strong, committed, and visible CEO leadership, (4) strong economic stake in the results for management, and (5) willingness to change or replace management as necessary.

Erosion of the core business

There are five key threats that should be tracked by companies.

Erosion of low-end Product Segments. This turbulence starts, seemingly innocuously, with the washing away of market share of a low-end customer segment that was deemed unprofitable and difficult to serve. This is the "innovator's dilemma" written about by Clayton Christensen. A new, disruptive technology with new, low-cost economics appears on the scene that makes the least profitable and desirable customers of the leader suddenly profitable and interesting to the new follower. By successively ceding low-end market segments, incumbents can find their lunch being eaten by others.

Erosion of Customer Segments. This is reflected in increased customer defections.

Erosion of Microsegments. A new competitor may emerge who that can attack underserved microsegments of a customer base with a targeted and superior model. This danger is hard to detect and can signal a fundamental shift in the nature of competition.

Erosion of Traditional Business Boundaries. Perhaps the most obvious, but also the most often denied, sign of change is the sudden erosion of traditional business boundaries, in effect increasing significantly the number of competitors vying for a space.

New Intermediaries and New Control Points. Some of the most profitable businesses over time have been those that were able to control a position in a larger system that others needed to pass through, pass over, or use in some manner.

Getting the timing right

Companies must guage when it is time to decide whether a major redefinition of the core is in order. Prematurely abandoning the core or constantly creating false crises can be destabilizing to an organization. The following litmus tests can be used for determining when a serious consideration of redefinition may be in order:

- Are top-tier venture capitalists funding businesses with the avowed intent of attacking a segment of the company's core business?
- Are sophisticated recruits in interview discussions elsewhere in the industry asking tougher and tougher questions about the company's fundamental business model?
- Is a new competitor beginning to gain surprisingly rapid market share in a marginal segment of the business that the company once controlled?
- Are steps in the value chain that was once considered core being unbundled and controlled by specialists?
- Are there fast-growing adjacent customer segments that the company might once have been able to serve but that cannot now compete for without adding a new capability?
- Are there potential legal or regulatory changes that could undermine the company's competitive position in its ability to compete for the next set of logical business adjacencies in the growth plan?

The issues in redefinition

Redefining a core business while still running it profitably poses several dilemmas that are especially acute with many Internet-driven redefinitions:

- *Pricing:* To make the new model fully competitive, requires developing different pricing strategies. But what does that do to the core business?
- *Staffing;* The new model of the core requires excellent managers to execute a difficult start-up and ensure that the company competes effectively. But the best managers are needed to run the original core, where all the profits come from historically.
- *Rewards:* The reward structure may need to be different in the newly redefined model. But how can all employees be motivated equitably?
- *Channels:* Selling a product in a way that competes with historic channel relationships is disorienting. Can they be managed internally?

What is the best way, to begin to reshape, or redefine, the core quickly while still making money in the original business in its original form?

First, the company must identify which of three basic situations it is in. The first is where a core business, serving a core set of known customers, is confronted with a radically improved business model for serving the needs of its current core customers. The second situation is where the original boundaries and structure of the core business are changing in complicated ways. The third situation is where turbulence could remove the need for the core.

When the new business is strongly related to the core, but will never replace the original business, the best decision will depend on the answers to various questions:

- Is the new business better able to attract the talent it needs as an integrated entity or as an autonomous unit?

- Would the new business model receive a high valuation from the external stock market? Is such currency required to buy talent and invest in the business?

- Would separating the new business from the old foster the competition necessary to define customer boundaries where one model is superior to the other?

New businesses that draw heavily on the core, but will not cannibalize the core to a great degree, are often best set up in separate units. Whether these units should be outside the corporate structure and with outside ownership, depends on the answers to the following questions:

?? Can the right talent be attracted inside? Is an initial public offering required to attract this talent?
?? Is separation required for strategic reasons, such as the need for neutrality or the need to avoid creating conflict with customers in the core business?
?? Would separation provide a source of public financing, because of high stock valuations, for making critical strategic acquisitions or investments?

Concluding Notes

The lessons of the book can be summarized as follows:

- Very few companies actually grow profitably and sustainably, though all plan to do so.
- Building unique strength in a core business, no matter how small or narrowly focused, is the key to subsequent growth.
- Most management teams underestimate the growth potential of their core and fail to mine all of its hidden value growth. In fact, the best core businesses are often the greatest underperformers relative to their true potential.
- Most successful companies achieve most of their growth by expanding into logical adjacencies that have shared economics and reinforce the core business, not from unrelated diversifications or moves into “hot” markets.

- Many of the most damaging mistakes in strategy result from the tension between investing in the core and growing into adjacencies as well as in the specific choice of adjacencies.
- A visionary leader redefines his or her company's core business at a time when it appears at the height of its power.
- Achieving growth is hard because most organizations protect the status quo, and growth requires change.

Managers should be constantly vigilant in tracking the three most dangerous long-term patterns. The first is premature abandonment of the core in favour of new adjacencies. The second is excessive mining of a core business, failing to put in place large enough new growth vehicles soon enough. If more earnings growth is consistently coming from these operating and cost-cutting initiatives than from core growth, there is clear danger. The third pattern is failure to anticipate the need for core redefinition. By the time competitors with new business models are taking away customers, the company has probably waited too long to react.