

The full potential of your business

The “full potential” of your business is the level of financial results (net cash flow plus “capital gains”) that the excellent performers among your strategic look-alikes have demonstrated to be feasible. The chances are:

- » our business is now falling short of its potential; but
- » a convincing path toward improvement can be mapped

A major criticism of Western managers is that they focus too much on short-term financial results. Consequently they under-invest in brand building, new products, quality improvement, process improvement and modern technology. PIMS research, looking at long term success measures, leads us to believe that in most businesses value creation falls considerably short of what it might be. In effect, our analysis yields both “bad news” and “good news” for managers:

- » The bad news is, in the words of Robert Hayes and William Abernathy, “a broad managerial failure over time has eroded both the inclination and the capacity of companies to innovate.”
- » The good news is that most businesses have the potential to perform much better than they do, by raising their game to match those of the “good performers” in industry.

CTO, On the negative side, we find that most businesses’ actual performance is far below their potential—typically under 50 % of potential when measured over 5 years. But many businesses—about 10 % in our sample—do achieve their potential. This leads us to the good news: businesses can do much better.

Long-term business performance

In previously published accounts, PIMS research has focused on the links between business strategy and short-term measures of performance such as ROI and cash flow. Though useful, these performance measures have been widely and deservedly criticized as myopic when they are used as the sole indicators of business success. So, we assembled information covering the experiences of 620 businesses over periods of 7 or more years—enough time to see more clearly how strategies affect profitability & competitive position over the long term. With 7 years of data, we can observe the 3-year period from which each business started, then track its actual performance over the subsequent 5 years.

A key concept in our analysis is that of “economic value”, our measure of a business’s total performance or worth. We define the economic value of a business as the sum of its discounted cash flows (DCF) over its planning period plus its discounted “future market value” (DFMV) at the end of the planning period. The first of these is a notion familiar to most managers. It is rare, however, for strategies to be evaluated in terms of their effects on future value —and it is here that businesses fall farthest short of achieving their full potential. Our study lends support to the widespread belief that most managers emphasize short-term financial results at the expense of long-term competitive strength. Beyond simply documenting this, however, we explore some of the reasons why long term value gets neglected.

We used the economic value approach to measure the actual performance of each business unit, in our research, over the last 5 years of the 7 years of business data. We calculated the DCF component of economic value as the net cash generated (or absorbed) by a business during each year, discounted to equivalent values at the beginning of the 5-year period and summed. In the analyses reported here we used a “real” cost of capital of 5 % above inflation.

Calculating the second component of our measure of performance, DFMV, required a new technique. For a publicly listed company, “market value” is perfectly clear: it is the value placed by investors on the equity portion of a firm’s assets. Private equity companies usually also maintain a clear view of the market value of their holdings. The market value of a stock often differs considerably from the book value shown on a company’s balance sheet. Many top managers recognize the importance of how the market values their company, and actively seek to increase their price-to-book ratios relative to peers.

We suggest that this corporate-level logic should be applied in business unit planning, and that explicit estimates should be made of how a strategy will affect a business's future value. But how can a "market value" be determined for a business unit within a corporation, given that it does not issue and sell its own common stock? We estimated what the business's "stock" would have traded for if it had been listed on an exchange and evaluated by investors in the same way as financially similar companies. To do this, we used a statistical model developed by PIMS researchers which explains company price-to-book (P/B) ratios, using actual stock market price data for 600 corporations. The most important determinants of the P/B ratio, as expected, are a company's recent ROI, its growth rate, its R&D spend, its interest coverage and the overall level of the stock market. Because the factors that turn out to have by far the largest influences on P/B are also measurable at the business unit level, we can compute a business unit price/investment multiplier that simulates the market value of a business's investment as though it were a stand-alone company (assuming the overall market stays at an average level).

So, we use business-unit ROI, growth rate, and R&D spend, along with the parent corporation's interest coverage ratio, to assign an investment multiplier to each unit. Multiplying this ratio by the book value of the business unit's investment at the end of the 5-year planning period gives us an imputed "market value" of the business, which we discount to an equivalent value at the beginning of the period.

Thus, our measure of a business's total performance, or economic value, adds the cash flows it earns over a 5-year period to its estimated market value at the end of the period, all discounted to their present values at the outset of the planning period.

Obviously, some businesses are much better positioned than others to realize high rates of profitability, cash flow, and future market value. Those with high market shares, weak competition, low investment intensity, and high labour productivity, for example, can be expected to perform much better than those with opposite characteristics. This leads to the notion of "potential economic value." By this, we mean the greatest possible combination of DCF and DFMV that a specific business

could be expected to achieve, starting from its current strategic position (market share, investment intensity etc.) and given its managers' expectations about market growth and inflation.

A business's potential economic value

We estimated the potential economic value of each business in our sample, using the PIMS Report on Look-Alikes, in order to evaluate its actual performance relative to its full potential. For each business unit, we estimated how much improvement in ROI and cash flow might be achieved by improvements in both strategic positioning and operating effectiveness. For the first three years of each business we found strategic look-alikes, starting with similar actual and par performance, in similar growth markets, with similar capital intensity that performed best in creating value. The changes in par ROI, sales, investment, operating effectiveness, and margins could then be modelled to calculate financial results for 5 years to compare to each business's actual performance in the same period.

Unfortunately, we cannot determine how realistic these projections of possible results are. In general the projections tend to be quite optimistic (see the boxed insert). But we believe that the approach is useful as a point of reference, since it takes into account the specific situation of each business unit at the outset of the planning period, and since it employs a systematic, empirically-based procedure.

Potential: opportunities vs. constraints

In estimating potential we have in essence assumed that each business in our sample could successfully pursue every opportunity for improving performance suggested by the experience of other, strategically similar businesses. Each business's full potential is the economic value it would have if it were capable of doing everything its top performing lookalikes did. But for all but a few businesses, our estimates will clearly exceed what they could achieve in practice. In real life there are constraints that limit the attainment of potential. These constraints may appear in many forms: constraints on speed of action, corporate policy or culture, manageability, lead time, employee skills, availability of capital, and so on.

It is possible to estimate how much of its theoretical potential a given business can hope to achieve by combining management’s insights and experience with specially developed PIMS tools. We have started to extend the case-by-case analysis of constraints into more broad-based research, and can draw four conclusions:

- » Only some businesses can achieve their full, theoretical potential. About 10 % of the businesses in our research sample did so.
- » Those that did achieve their full potential did so primarily by improving their relative customer value offering versus competitors, while those that didn’t let value slip. There were corresponding gaps in innovation, marketing, and R&D spend. As a result “winners” generally grew faster than “losers”.
- » The secondary difference between “winners” and “losers” was faster improvement in capital and labour productivity (beyond what we would expect from the growth rate difference).
- » Almost every business can make major improvements. Even if we simulate constraints by halving our estimates of potential, the typical business could still score a 50 % increase in its economic value.

Actual vs. potential performance

As an index of how well each business performed in relation to its own potential, we use the ratio Actual 5-year DCF + DFMV in Year 5 / Potential 5-year DCF + DFMV in Year 5 expressed as a percentage. How well did the businesses in our sample do, judged by this criterion? As shown in the first column of Figure 1, actual “total performance” was typically 36 % of potential. 90 % of the businesses performed below potential, whilst 10 % exceeded their indicated full potentials. Performance could exceed estimated potential for any of several reasons:

- » The potential economic value figures are estimated on the basis of management forecasts of market growth and inflation. If a market actually grew more rapidly, or if patterns of change in costs and

selling prices were more favourable than those forecasted, then actual performance might surpass the maximum as it appeared at the beginning.

- » The estimates of potential performance are also based on each business unit’s competitive position—market share, relative product/service quality, and so on—at the beginning of the period. Unexpected changes, such as the collapse of a significant competitor, could yield “serendipitous” benefits.
- » Our estimates of full potential could, of course, simply be too conservative for some very well managed businesses.

Percentage of full potential	% of businesses	
	DCF+DFMV	DFMV
Under 25%	40%	47%
25% – 50%	22%	29%
50% – 75%	20%	13%
75% – 100%	9%	5%
Over 100%	9%	6%
	100%	100%
Typical (median) performance as % of full potential	36%	27%

Fig. 1: Actual vs. full potential performance

While one-tenth of our sample of business units exceeded their potentials as judged by our standard, a more important conclusion from the data in Figure 1 is that the great majority fell far short of potential. This seems consistent with the criticisms levied by many commentators. The second column of the figure lends further support to the critical viewpoint: if we judge performance by comparing just actual and potential market values in year 5, the record of our sample businesses is even worse. Only one quarter of them (24 %) achieved 50 % or more of potential. The implication is that cash flows during the 5-year period were, in fact, emphasized to the detriment of building higher long-term values.

Market share rank*	% of full potential	% of businesses
1	52%	51%
2	42%	23%
3	33%	13%
4 or worse	29%	12%

* substituting market share or relative market share for market share rank produces similar results

Fig. 2: Actual vs. full potential by initial market position

Potential: opportunities vs. constraints

What kinds of businesses performed best, relative to potential? Comparison of Actual/Potential ratios for different types of businesses within our sample shows that businesses with strong market positions outperformed those with weak positions. As Figure 2 shows, actual performance averaged 52 % of potential for market leaders, versus 42 % for second-ranked businesses and only 29 % for those ranked number 4 or lower.

The finding that weaker businesses typically perform worst may, on the surface, seem obvious: after all, it is well established that market position strongly affects performance. But our calculations of potential DCF and DFMV take position into account, and the figures in Figure 2 relate actual results to potential for a given strategic position, weak or strong. So, our results suggest that not only do weaker businesses suffer from lower profitability, but they are also less likely to realize what potential they do have.

This finding may reflect simplistic use of conventional “portfolio planning” approaches, which have been criticized on the ground that they lead managers to neglect all but the “star” divisions and products in their companies. The assumption that businesses worthy of investment and managerial support must have strong market-share positions, and preferably be leaders, may unduly penalize businesses with viable positions as number 2, 3, or even 4 in their markets.

Put another way, businesses with modest shares, even in slowly-growing markets, may represent substantial

untapped resources for their parent companies. Moreover, the potential of these businesses can often be realized relatively inexpensively, since small-share businesses frequently find it easier to gain share than leaders do.

Sleepers

If broad generalizations drawn from conventional portfolio planning are taken too literally and applied simplistically, the result can be a self-fulfilling strategy of minimal support for businesses that don’t qualify as “stars”. Many of these businesses have the underlying strengths, in terms of technology, reputation, and marketing systems that can serve as a basis for renewed growth. For these businesses, we suggest an addition to the lexicon of strategic planning: the “ Sleeper”. A Sleeper, we suggest, is a business unit with a modest market position, in a mature market, or with otherwise unprepossessing credentials, which nevertheless has considerable potential for growth and profitability if adequately supported and effectively managed. Judging by our analysis as shown in Figure 2, many of the businesses in major corporations may be sleepers whose performance potential is unfulfilled. An important problem for managers, then, is to determine which of their businesses are sleepers, and to distinguish them from the “terminally ill” cases that may appear much the same on the surface. Managers need to look beneath the surface, to look at the fundamentals of the business rather than merely at its current financial results. It is highly productive not only to diagnose the business’s strategic position, but also to thoroughly investigate options for improving that position. What have other businesses done from a similar position? How have they done it? Can your business follow their example? This kind of analysis almost always uncovers significant opportunities to awaken sleepers.

The challenge for management

Our research demonstrates, we believe, that most businesses have substantial room for performance improvement. The fact that some of the businesses in our sample performed very well, however, makes us confident that despite the obstacles allegedly imposed by tax laws, high wages, and the cost of government regulation, businesses can perform much better than they have in recent years.

Why does actual performance, on average, fall so far short of potential? Businesses always face constraints, of course, but other factors clearly depress performance too. We have already mentioned one reason cited by many critics. Overemphasis of short-term results can, indeed, lead to shortchanging the future.

Our method for projecting future market value uses forecasts of growth and ROI derived from the PIMS data base. Other approaches could be used to estimate market value. The important point, we think, is that strategy evaluation should take the future condition of a business into account, along with estimates of cash flows during whatever period is used as a planning horizon.

There are other reasons for falling short of potential. Almost all major corporations' management compensation systems reward current profitability. As a result there may be little incentive for an executive to build for the future, especially if doing so requires some sacrifices in the short run.

Obviously, some companies take a longer view, which leads us to believe that obsession with short-term results is not inevitable. Companies that seek to achieve their potentials should give careful attention to the incentives provided by their compensation policies.

Some companies may fall short of potential because they lack the capital to fund aggressive strategies. For many businesses, the capital budgets and marketing programs needed to become "winners" would require substantial upfront investments. If a company does not have adequate resources, or cannot raise additional capital, its only recourse may be to merge with a cash-rich firm. We suspect, however, that lack of resources is usually not a valid explanation of poor performance.

Last, but not least, we believe that many businesses fall short of their potential simply out of ignorance. In some cases poor performers appear to have followed strategies that could have been predicted, on the basis of available evidence, to yield unsatisfactory results. Above and beyond the problems created by emphasis on short-term results, shortages of capital, and aversion to risk, managers of these units seemingly were not aware of

how strategies are linked to economic performance. To put it another way, they were operating with an inferior planning technology, and were obtaining the poor results that normally accrue to businesses operating with inferior technology.

It should be acknowledged that, to the extent that there are real grounds for the charge of strategic ignorance in the business community, a short-run orientation to business policy is entirely rational and perhaps even praiseworthy. If you are driving through a fog, you are wise to drive slowly and to pick your route a few yards at a time. The last thing you should do is to point the car in roughly the right compass direction and step on the accelerator. To become responsibly long-range oriented, you need clear vision and a good map. So, an adequate familiarity with the principles of business strategy is a precondition to aggressive, long-range-focused business planning. As managers come to recognize these principles, it seems reasonable to expect that they can more confidently adopt the kinds of strategies that will, indeed, make their businesses stronger tomorrow.

The PIMS data bank currently contains the strategy experiences, good and bad, of over 3800 product and service businesses. Each experience is documented in terms of the actions taken by the business, the nature of its served market, the kind of competitive environment, and the financial results. In all, over 200 separate characteristics of each business experience are available for study.

PIMS research is incorporated in a series of analytical tools which diagnose the strategic position and prospects of an individual business. The general findings discussed in our publications represent only a part of the research results used in PIMS models. While the findings reported in this letter may offer insights on a specific area of strategic significance to a business, they cannot be used to evaluate a business as a whole. The overall evaluation requires study of the business's specific strategic look-alikes.

(This article is based on original work by Bob Buzzell and Mark Chussil).