

Adjacent Growth Plays
An unexploited gold mine
or a distraction from core
business?



How CEOs can use their core business to grow sustainable new revenue streams from adjacent and non-core opportunities

Making your current business grow is one strategy. Growing beyond your current business is another. Which one offers greater benefits and how important is the difference?

Deciding to grow a business is the beginning, not the end, of a complex strategic planning process. One of the most important decisions is where to look for growth: in familiar areas that offer quick returns, or in products, services or markets that represent a departure and may take time to cultivate. The answer can determine not only what your business does next, but what it becomes. Should you seek growth opportunities close to the core, or further afield?

This article describes the Deloitte point of view on growth through adjacent plays and how leadership teams can systematically drive this growth through to create the "Business of Tomorrow" for achieving sustainable shareholder value growth.

Shareholders demand growth... but what are the best sources of growth?

It is common cause that all shareholders expect that management teams will diligently apply their minds to growing the business in which they are invested. Increased operational efficiencies, while important, will typically only deliver incremental improvements in margins. What are the other potential sources of growth that could deliver ambitious growth targets and meet the insatiable appetite of shareholders?



A significant part of a company's market capitalisation is driven by the market's expectation of growth achieved through investments yet to be made.

The Innovation Premium™ is a proprietary metric developed by Deloitte and based on a CFROI calculation. It is used for measuring the percentage of a company's market capitalisation that cannot be explained by cash flows from current operations – reflecting the market's expectation and therefore the degree of confidence in management's ability to successfully identify and launch businesses that will create profitable new revenue streams for the company. In other words, despite the fact that these revenue streams have not yet been realised, the market has already given management credit for its ability to deliver this future growth. Whilst the market generally rewards growth, it mercilessly punishes companies with higher Innovation Premiums™ for not meeting consensus analyst expectations.

Every day, investors place their bets on the future performance of companies. Figure 1 below sets out some Innovation Premium™ performances by sector.

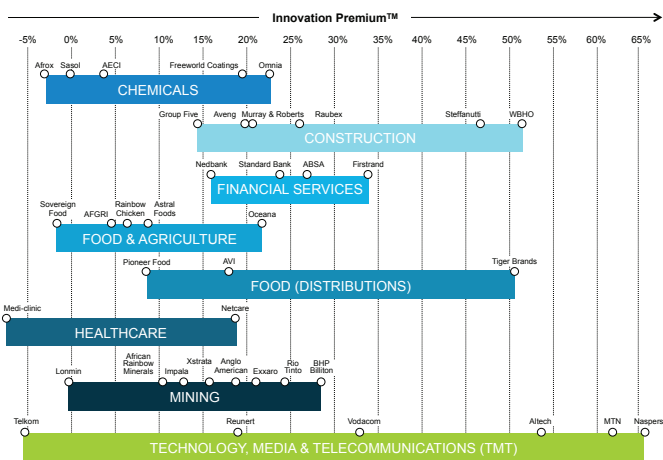


Figure 1: Innovation Premium™ by South African Industry Sector by Company (2011)

It is clear that within each market sector there are companies that continue to delight investors through growth, and there are companies that investors do not expect to grow. The dilemma for companies that have high Innovation Premium™ ratings is that they need to work that much harder to continually find growth opportunities. The opportunity for companies with low Innovation Premium™ ratings is that it does not take much to exceed the market's growth expectation.

Management typically makes investment decisions to either sustain current operations (sustaining innovation) and/or to establish new businesses that will drive revenue growth over the medium to long term (breakthrough innovation).

Market capitalisation and revenue growth move together. Revenue growth is the single biggest factor determining Total Shareholder Returns (TSR), accounting for over 71% of TSR.

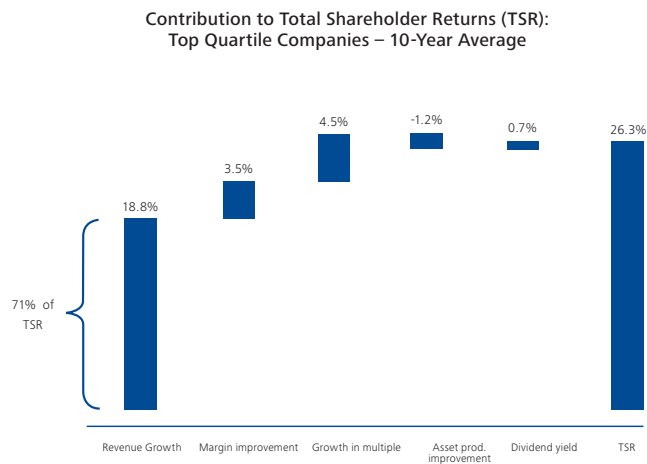


Figure 2: Contributions to Total Shareholder Returns

The challenge lies in identifying sustainable revenue growth. Research conducted by Deloitte in the USA of some 5,000 companies over a 10-year period found that only a small number found sustainable growth over the long term.

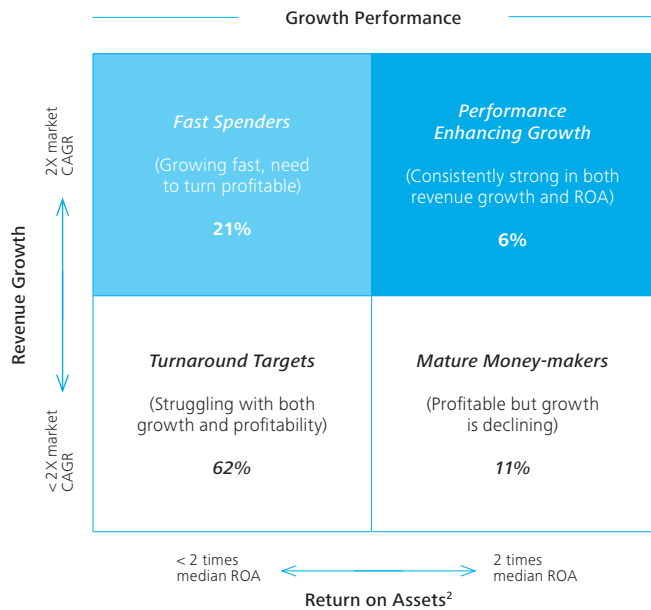
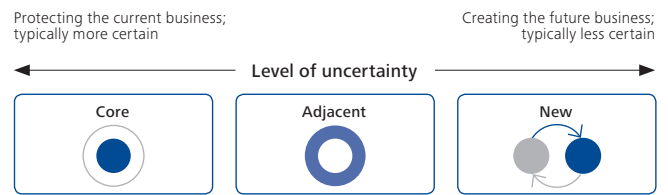


Figure 3: Deloitte USA Company Research Findings

The research found that:

- Companies that attained critical mass (more than \$250M) had a greater chance of surviving.
- Of the companies that survived, only 27% experience high growth that is two times that of market CAGR.
- Among companies analysed, only 6% achieved performance enhancing growth over a long run, i.e. growth that also improves the bottom line and key performance metrics.

In Deloitte’s experience, companies need to adopt a portfolio approach to growth. This means that they must both enhance and protect their existing business while also creating options for emerging businesses to sustain growth over time. There are three sources of growth – core, adjacent and new opportunities.



- **Core:** Maximise profitable growth from the existing set of products, customers, channels and geographic markets.
- **Adjacent:** Utilise existing assets and capabilities to stretch the boundaries of the existing business outward.
- **New:** Develop new assets and capabilities to create new markets, shift the basis of competition or address non-consumption.

Organisations must consider all three when constructing a sustainable growth portfolio.



Case study

How a retailer used its “Business of Today” assets to identify meaningful opportunities for growing revenue streams in adjacent and non-core business sectors

A large South African retailer had shown strong performance over an extended period. The market had recognised this growth trend and the company's shares traded at a premium based on the expectation of continued growth. The business was therefore under pressure to sustainably meet and exceed market expectations.

Key on the executive agenda was to identify an opportunity that would drive growth by leveraging existing assets and capabilities to enter into adjacent and non-core businesses.

The company's executives assembled a team to confirm whether a growth opportunity did in fact exist and, if so, what the best opportunities for growth were.

The corporate venturing approach suggested by Deloitte achieved an executable growth strategy that provided the company with a de-risked market entry strategy that it could confidently pursue in its drive to deliver sustainable shareholder value.

Step 1

Identifying which gaps in the market offered the best opportunity for growth

An in-depth assessment of the market, both globally and within South Africa gave some initial clues as to the market potential. A market sizing exercise indicated that significant opportunity existed, with low penetration compared to other benchmarked countries in most sub-sectors. When penetration levels were mapped to the company's customer base it indicated that significant gaps existed where the business could leverage its “Business of Today” footprint to offer new products and services.

An analysis of the competitive environment indicated that while the market was dominated by a handful of key players, an opportunity existed for the retailer to enter via certain niche product offerings distributed through direct channels. Studies of international retail peers highlighted the success of this approach as it sought to counter the effects of a maturing core business by leveraging their brand strength and frequent contact with customers to diversify into adjacent opportunities. Several key factors underpinned the success of those retailers that had developed profitable adjacent businesses:

- **Leveraging its brand** to market and sell new products to an existing customer base that identified with the brand
- **Reducing costs** by not initially investing in bricks and mortar but instead using on-line and call centre channels
- **Leveraging its affinity programme** to underpin offerings. Rewards programmes served to entice new customers with the promise of rewards and provide the company with key insights into customer purchasing behaviour relating to the new products
- Entering the market using a **phased approach** whereby the retailer built customer trust in a limited number of products before expanding and increasing the complexity of product offerings
- Developing **targeted and customised offerings** for specific customers or customer segments based on deep insights into purchasing behaviour



Step 2

Identifying the key assets to be leveraged for a growth play

An analysis of the key assets of the company highlighted that it was well aligned with the market opportunity and international peers and was well positioned for an adjacent play:

- The company had been operating in the retail space for a number of years and had created a strong and trusted brand with which customers identified. When considering expansion, trust was a critical determinant of customer purchasing behaviour in the new industry.
- The large and growing geographical footprint of the company's retail stores offered a low-cost, readily available marketing and distribution channel for the introduction of new products and services. The cost of acquiring a customer through existing stores was significantly lower than through other channels, such as media or call centres.
- Aside from retail stores, the existing marketing channels used by the company could be used to reach new and existing customers at nominal additional cost.
- An established call centre could also be leveraged for inbound queries and outbound calling related to the introduction of new products and services.
- The company's large and loyal customer base could form the core target market for the launch of new products and services.
- The company had a strong and established customer affinity programme that touched customers regularly. This "touch point" could be leveraged to introduce and launch new products and services in an innovative manner.
- Its affinity programme also boasted a high rate of redemption. Research had demonstrated that once customers redeem "free offerings", they tend to be more open to spending more with a particular company.
- The affinity programme was also considered a key asset in corporate venturing by virtue of the customer insights it provided. Customer purchasing behaviour could be used to identify specific growth opportunities, inform targeted marketing initiatives and define product ranges.
- Importantly, the company also had strong cash generation capabilities that could be used to fund market entry if required.

Step 3

Identifying specific opportunities to achieve value growth

Conclusions from the market analysis and assessment of the company's key assets were used to generate ideas for growth opportunities within the adjacent industry. These ideas were put through a stage-gate process to sift out those that were not worth pursuing. The parameters used to define the first stage-gate were defined in conjunction with the company executives to ensure strategic alignment.

Step 4

Confirming the opportunities that would deliver the most growth value

The key ideas that emerged from the first stage-gate were developed into Value Propositions (VPs) to inform the next step of executive decision making. Opportunity analysis maps and the stage-gate process were used to de-risk the company's investment decisions. Ideas were excluded when measured against risk parameters, investment size and required return on investment hurdles. The result was a clear set of opportunities that represented the best prospects for growth in the adjacent market. Together these provided the company with a new market entry strategy that it could confidently pursue in its drive to deliver ongoing shareholder value.

Critical Success Factors

Following a structured corporate venturing approach, such as the one described above, systematically de-risks the business development process while providing maximum return on investment. There are, however, several key factors that are important in defining the success of a new business initiative:

- **Executive commitment** to the corporate venturing process is critical. It ensures quicker and more informed strategic decision-making and typically ensures that the delivery team is held to account to ensure that the opportunity is implemented and the benefits derived.
- The key decision-maker (CEO or MD) should be **involved at all times**. In the absence of the support of the key decision-maker, new venture projects tend to drift off the strategic course as "Business of Today" priorities and concerns relegate the new initiatives to a secondary position.
- A **ring-fenced project team** that is independent of the day-to-day running of the business should be appointed to focus on the research and implementation. If this is not the case, "Business of Today" issues take priority and new ventures never get off the ground.
- **Corporate governance** is perhaps the most important of all factors. Selecting the right participants in a steering committee is critical. Similarly, making sure that the "banker" is party to the decisions will save much heartache later in the process.

Conclusions

Companies have growth options in their core business just as they have growth options in adjacent plays. They should invest in both.

Focusing growth on core areas and short-term returns may feel more conservative because it involves familiarity and comfort. But in many cases it may actually be the riskier strategy. Similarly, betting big on brand-new businesses and markets is also fraught with risk and uncertainty.

How then should management balance growth ambition and risk? The answer rests in the duality of growth: deliver and grow the “Business of Today” while simultaneously creating growth for the “Business of Tomorrow”.

Creating growth in this duality requires you to recognise the different needs of the “Business of Today” and the “Business of Tomorrow”. First, you must identify the capabilities you need and either build or obtain them. Exploring uncharted territory requires different skills, experiences and inclinations from driving growth in the core business. Different metrics are required to measure success. While traditional metrics such as growth rate or time-to-market may be appropriate for “Business of Today” initiatives, non-traditional metrics such as growth rate above market or percentage of revenue from first-to-market may be better predictors of success when entering new spaces.

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