Growing in mature economies by developing innovative business models

by
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Most Western groups' business portfolios are structurally stagnant. 80% of their activities are positioned in low-growth segments and geographical markets. Only 20% of their businesses are expanding at more than 10% to 15% annually. As a result, they are unable to achieve overall growth of more than 5% annually.

Achieving strong growth thus requires a major reallocation of human and financial resources at three levels (see table 1): 1) significantly raising the allocation to high-growth segments and geographical markets; 2) enhancing this growth; and 3) accelerating growth in mature economies.

This last challenge is crucial in that one additional point of growth in mature economies raises a group's overall growth figure by 0.8 point. But meeting this challenge requires developing new approaches and implementing innovative business models.

1. Three ways to develop new business models

Simply put, low-growth businesses in mature economies have three ways to develop innovative strong-growth business models:

- re-segmenting and repositioning into strong-growth niches by deaveraging and micro-segmenting the market;
- switching competitiveness levers decisively while investing more than competitors in new levers;
- migrating along the value chain (upstream or downstream).

Re-segmentation

Consumer needs in mature economies are evolving towards greater segmentation, in terms of price, nature of product within a given category, origin of product, and other factors. Sectors like food retailing are developing new growth-driven concepts that meet specific needs in price (hard discounters), proximity (convenience stores), choice (the specialised French retailer Grand Frais), accessibility (e-commerce), and so on.

Markets with weak overall growth rates are actually clusters of niche segments with very uneven growth dynamics. To uncover high-growth niches within those markets, the traditional segmentation framework must be altered.

That first requires looking at the business through a new prism, in terms of both the value that is offered to the customer and how that value is offered. This entails a break with historical practices and in the market set-up.

To capture hidden growth, a business model must be developed that fully responds to niche demand in an economically feasible manner. This, in turn, requires deconstruction (in order to redefine the segments) and reconsolidation (in order to address those segments in a competitive way).

In terms of offer, customers' needs must be deaveraged as much as possible, so that they can be provided with a suitable, specific and differentiated response.

In business terms, customers' needs must be reconsolidated so that an offer can be made in an economically feasible manner.

It is by balancing these two opposing forces that business models succeed. Overly segmented offers make the market weak and the costs of addressing it too high. Overly commoditised offers run the risk of being mostly indistinguishable from existing models.

Take, for example, the strategy of Max Mara in high-end women's clothing (see table 2).

Max Mara has achieved 13%-plus annual growth for more than 20 years using a business model based on micro-segmentation of its offer on a market that, on the whole, grows at just 3% annually. The company has developed about 30 different lines for different customer ages, styles, bust-waist-hip sizes and clothing types.

Max Mara's micro-segmentation strategy has led to lines like Pianoforte di Max Mara (a dressy evening and occasion wear line), Sportmax (mid-range to high-end casual wear for women over 35), Max & Co (mid-range to high-end casual wear for women from 18 to 35), Marina Rinaldi (high-end line for large sizes), Persona (mid-range line for large sizes), etc.

The business model's value and resilience resides in its ability to offer niche lines and brands while pooling costs and expertise in production, distribution and geographical expansion. Most production is located offshore in Central and Eastern Europe, mainly Hungary, Romania and the Ukraine. A distribution network of more than 1,000 company-owned stores or franchises that are required to buy certain quantities of core goods, makes it possible to have large production runs, and, hence, low production costs, while ensuring high quality and good fit.

Max Mara grows by developing new lines (starting in Italy) that closely match changes in customer needs and by expanding the existing lines that are best suited to each geographical market. The objective is to achieve about 20% market share for each country and segment (it would be difficult or even counterproductive to go beyond that).

A major shift in competitiveness levers

A second approach consists in investing in certain competitiveness levers in a way that is very different from competitors. Competitiveness levers can be found in product innovation, investments in marketing or distribution, a significant expansion in marketing presence, etc.

This approach is based on:

- developing a major competitive edge in costs, technology, products, channels, etc.
- aligning competitiveness levers and deciding which ones to focus investment in; room for manoeuvre must be found in some levers, in order to free up resources for investment in others.

This is a fundamental approach, not a marginal one. It requires finding decisive and differentiating competiveness levers.

Shifts in customer behaviour and in economic, regulatory or technological dynamics have made new levers increasingly crucial in companies' competitiveness. Incumbent players can shift competitiveness levers only by developing a new outlook and taking a new look at their businesses.

Not only must they find decisive levers, they must remove obstacles to reallocating human and financial resources into those levers and out of others. If resources are reallocated too conservatively, it will not be possible to differentiate approaches clearly. This requires a strong and shared vision and making tough choices.

This is the strategy developed, for example, over the last 15 years by the high-end US leatherwear maker Coach (see table 3).

In 1995, Coach was a mid-sized leatherwear maker offering mostly commoditised US-made products that were of average quality and perceived to be overpriced. Coach's precarious

financial situation kept it from investing in growth. Its Japanese partner forced it to make major changes to its competitiveness levers and to reallocate its investments.

Between 1997 and 2000, Coach completely outsourced and relocated its production to low-cost countries. This cut its production costs by about 40%, which freed up significant resources that it initially reinvested in prices, cutting them by 20%. This, in turn, allowed the brand to reposition itself more in line with its image and to lay the foundations for growth.

In 2001, Coach began investing significantly in marketing, communication and distribution by offering quality products with competitive production costs at lower prices than luxury brands but in a similar environment and based on similar conventions. The brand invested more than 6% of its revenues in marketing and rolled out a large number of well-located company-owned stores in the US and Asia.

Coach's change to its business model added more than 20% to annual growth.

Migration on the value chain

The third approach consists in moving along the value chain, either upstream or downstream, in order to capture as much value as possible.

This must be based on a relevant vision of industry dynamics:

- Value can migrate downstream (e.g., to retailing, to services, or to after-sale service, etc., depending on the company's positioning in the value chain and the nature of the industry) if upstream barriers to entry have dropped, if there are fewer opportunities for differentiation, if competitors use the same technologies, if customers place value on a marketing presence, close relationships and service, and if there are ways to stand out on the basis of price or marketing approach;
- Value can migrate upstream (e.g., to raw materials, production, etc.) if this stage of value becomes critical, i.e., if production is based on scarce resources, essential proprietary technology, etc.

The key is for the company to move out of its normal area of business, where prospects for growth and profitability are weak, and into high-growth adjacent activities.

This is the strategy adopted by IBM in services (see table 4).

In 1992, IBM began to divest its hardware businesses, both domestic equipment (desktop and laptop computers, which it later sold to the Chinese company Lenovo in 2005) and systems. These businesses now account for less than 20% of its revenues, vs. 60% in 1992.

IBM invested heavily in services having 15%-plus annual growth over the last 15 years, mainly in two areas: consultancy in installing IT systems and outsourcing of IT services.

On the whole, this led to an 8%-plus annual increase in operating profits from 1990 to 2008, as these new businesses have been more profitable than IBM's historical businesses.

3. Developing the approach

Our experience has shown that players who have long been in a certain business have a hard time developing innovative new business models. Managers and staff are often unsure of the potential of new segments, the relevancy and differentiating power of a new model, or how to implement that model.

A systematic and structured approach helps determine whether the model has potential, how it can be implemented successfully, and the opportunities it offers to the company. One condition for success is to change the company's outlook and the prisms through which it views its markets.

This requires having a more in-depth understanding than competitors at three levels.

The first level concerns changes in customer needs:

- Nespresso expanded its sales (in spite of its high prices) by meeting a fundamental customer expectation that hitherto had not been satisfied – user-friendliness of products;
- The winemaker Kendall-Jackson addressed a segment of US customers that was seeking quality top-brand wines at moderate prices by developing a business model based on blending wines of even quality and aggressively marketing those wines.

The second level deals with changes in technologies and their applications, major regulatory changes, etc.:

- Teva's expansion in pharmaceuticals was made possible through regulatory changes (i.e., the development of generics);
- Microbreweries have used technological changes to expand rapidly in the US.

The third level concerns economic dynamics in such areas as outsourcing and industrial processes:

- Zara's success is based on an original business model that sets it apart from its competitors;
- Fielmann's growth in optician shops was based on scale in purchasing and marketing. This helped it set its prices about 20% lower than those of traditional chains, offer more generous remuneration to store managers through higher volumes, and generate greater profitability for the chain.

4. Bottom line

Aggressively taking on growth dynamics in mature economies and markets is a critical challenge for companies. Redefining mature businesses, deaveraging them or re-segmenting them requires new business models and, thus, significant changes in competitiveness levers.

Companies that have managed to create new segments and to grow are those that have reallocated their investments from one lever to another.

This means making choices – choices that can be made clearer through analysis tools that use a consistent and rational approach to defining the challenges within their proper orders of magnitude, to testing the relevance and resiliency of the approaches adopted, and to assessing the implications in terms of organisation and process. Sources of growth exist in all businesses. They simply must be detected; their potential must be assessed; and ways must be found to tap into them successfully.

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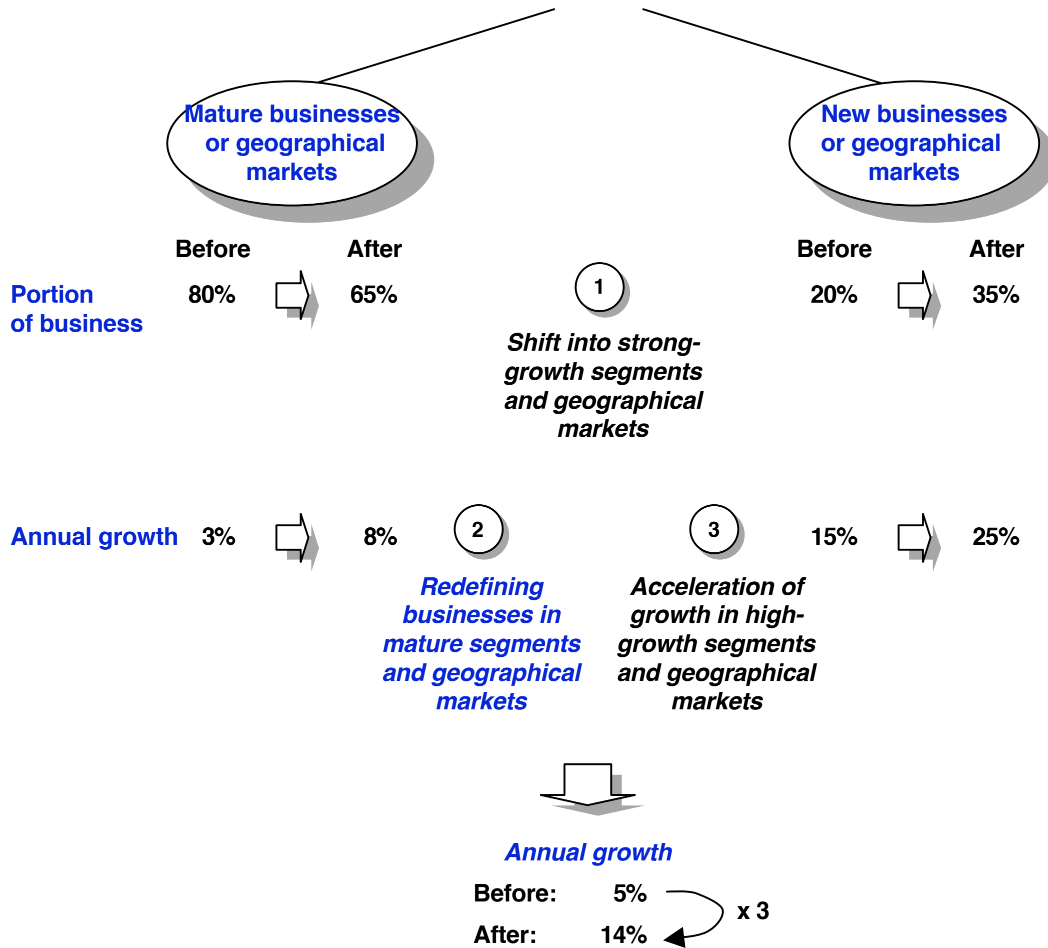
Estin & Co is an international strategy consultancy based in Paris, London, Geneva and Shanghai. The consultancy assists senior management of large European and North American groups in their growth strategies, as well as private equity funds in the analysis and valuation of their investments.

- Table 1 -

Growth requires significant changes in business portfolios at three levels

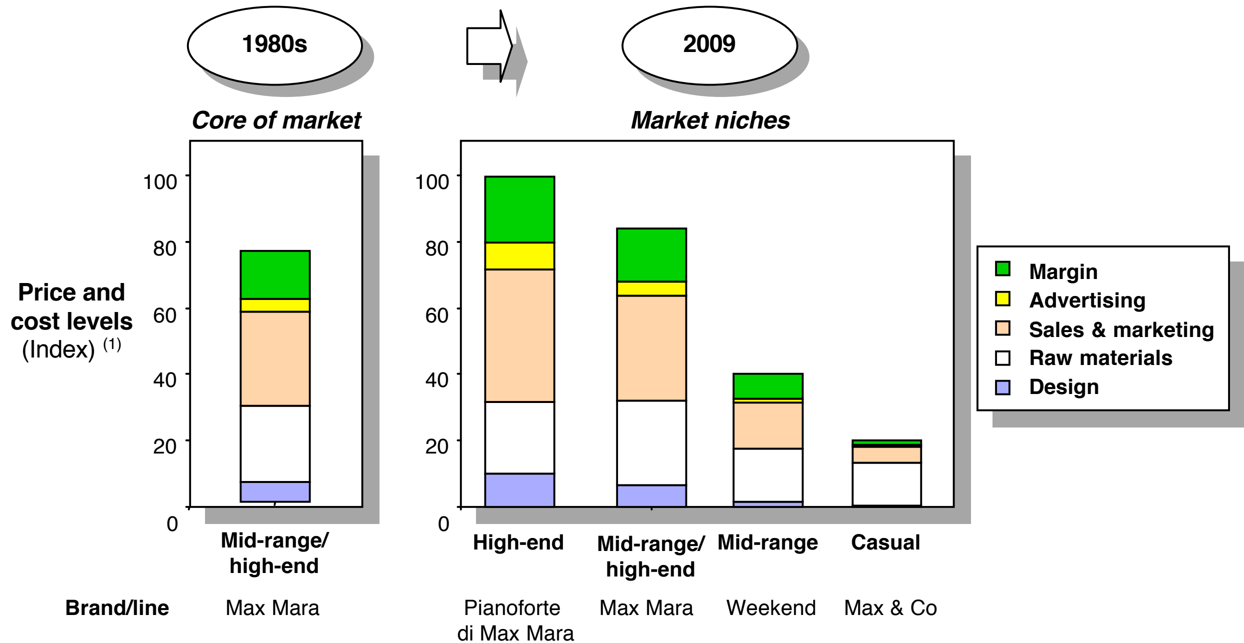


- **Three approaches to developing innovative business models in mature markets:**
  - **Resegmenting and repositioning into strong-growth niches by decommoditising products and micro-segmenting the market**
  - **Switching competitiveness levers decisively while investing more than competitors in new levers**
  - **Migrating along the value chain (upstream or downstream)**

- Table 2 -

Max Mara has developed a business model based on micro-segmenting its offer and on taking a different approach for each segment

(Women's ready-to-wear)



Note: (1) Price, excluding VAT of a pair of casual summer trousers
Source: Estin & Co analyses and estimates

Max Mara has developed about 30 brands that are segmented on the basis of five variables and regrouped into 10 main lines:

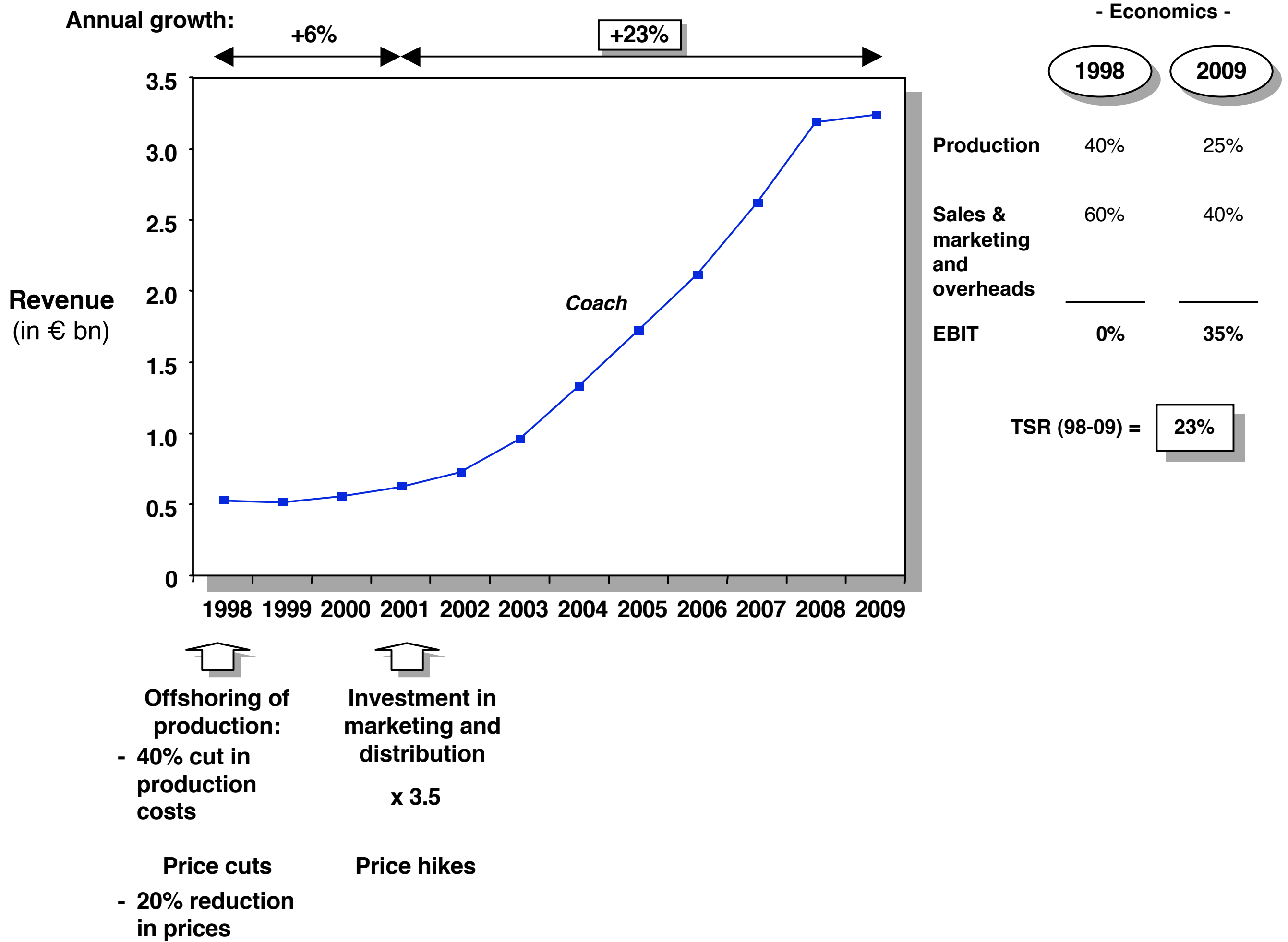
- *Use (eveningwear, work, special occasions, leisurewear, etc.)*
- *Age*
- *Size*
- *Style (classic, trendy, fashionable, etc.)*
- *Range (high-end to casual)*

Pianoforte	*Pianoforte di Max Mara*
Max Mara	*Max Mara Défilé* *Max Mara Basic* *MM*
Sportmax	*Sportmax* *Sportmax Défilé* *Sportmax code* *S de Max Mara*
Weekend	*Weekend by Max Mara*
Max & Co	*Max & Co*
Blues	*I Blues* *Blues Club* *Blue Charm*

Marella	*Marella* *Marella Sport*
Marina Rinaldi	*Marina Rinaldi Basic* *Marina Sport*
Persona	*Persona Basic* *Persona Sport*
Penny Black	*Penny Black* *Pennypull* *Pennyplus*
New Penny	*Newpenny*

- Table 3 -

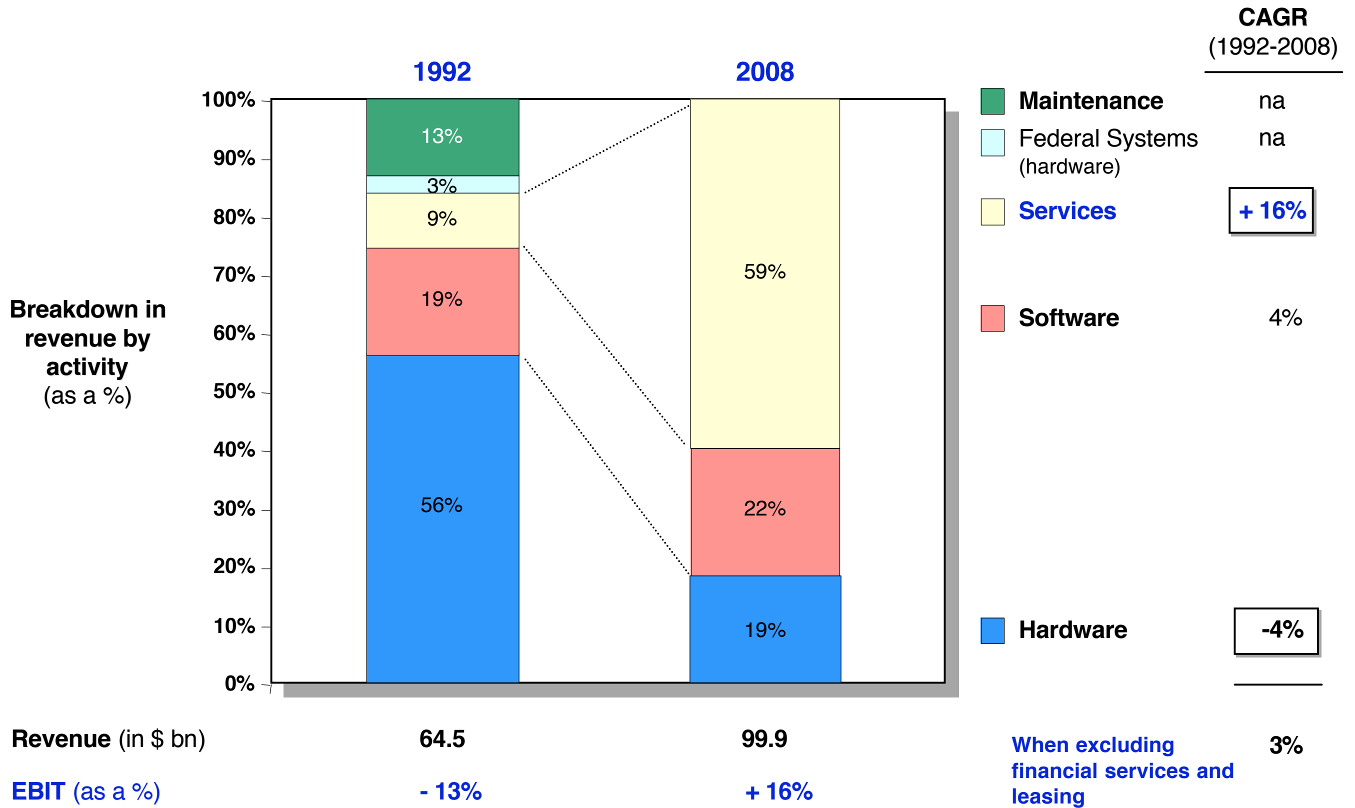
Coach switched its competitiveness levers decisively and has achieved strong growth in the last 10 years



Offshoring of production:	Investment in marketing and distribution
- 40% cut in production costs	x 3.5
Price cuts	Price hikes
- 20% reduction in prices	

- Table 4 -

Over a period of 15 years, IBM migrated from producing hardware to supplying IT services and outsourcing



	1992	2008
Revenue (in $ bn)	64.5	99.9
EBIT (as a %)	- 13%	+ 16%

When excluding financial services and leasing 3%