Growth OR Profit?
A Fool's Choice
By Chuck Papageorgiou

Business owners, whether at the startup or veteran level, often struggle with achieving a balance between growth and profit strategies. This is something we've studied for some time, applying and refining our concepts in several businesses, including ones we've started up and run ourselves.

Before getting into too much detail, some definitions are in order:

- *Value:* The total dollar amount the market is willing to pay for a company at any time
- *Growth:* The increase in revenue and/or market share over time
- *Profit:* Return on invested capital (ROIC) over time

As you might expect, I have a few theories about profit and growth that I've developed and tested over the years:

- The metrics that matter in the long term are a) building a sustainable company and b) creating shareholder value.
- Both growth and profit are important, but at different times. It's a mix that is continually adjusted and requires constant, active management over time.

Finding the balance

Although balancing growth and profit is (or should be) on the business owner's mind all the time, few of us are really doing it. Those who do, are often doing it poorly, but either don't realize that or are sure it will be better next time! Even the people who brag about their successes have often experienced a number of starts and stops, as the benefits of doing it right take time to materialize.

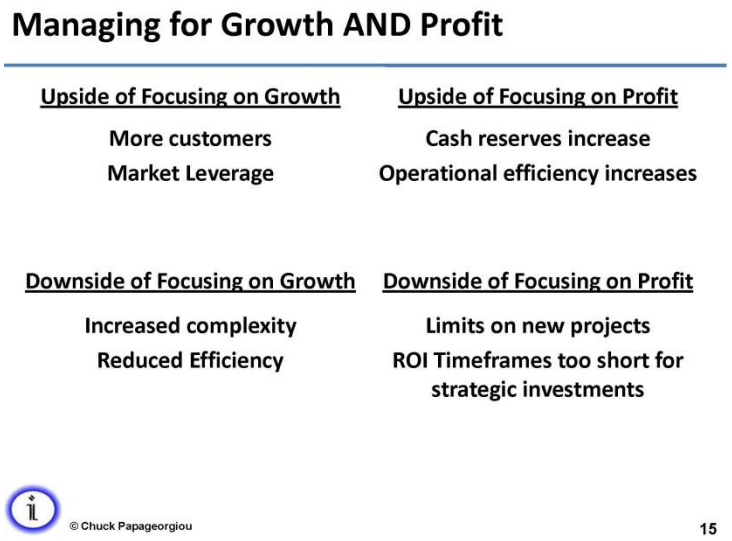
A McKinsey & Company 40-year study of 500 companies concluded that improving ROIC creates more value than growth, except when ROIC is already high. Their analysis showed that ROIC is sustainable over time, but growth inevitably declines – individual companies can sustain a high ROIC but cannot sustain growth.

This is not a theoretical challenge. Being able to shift the focus and continually manage the profit/growth mix is how a company can outperform the market. McKinsey results of an 11-year study (1994-2004) of 20,000 companies provided the data to support my theory that a balanced and managed approach is the most effective. Of the 20,000 companies, only 138 outperformed the market -- 80 percent by revenue or 90 percent by profit -- and of those only 9 outperformed the market in both areas. Market to Book ratios of the 138 demonstrate the significant value differences:

- Market to book ratio value in 2004: Revenue Performers, 1.9X
- Market to book ratio value in 2004: Profit Performers, 3.0X
- Market to book ratio value in 2004: Revenue and Profit Performers 4.1X

Managing for growth and profit
The best way to think of the balance and growth challenge is the "Yin and Yang" model. The symbol is a visual representation that highlights the concept that:

- Profit and growth are interdependent; you need profits to feed growth.
- Profit and growth exist on a continuum, from "modest to insane" profit and "slow to fast" growth.
- Profit and growth can morph into each other - Growth can translate to profitability and vice versa.
- There is profit in growing and growing in profit – or at least there should be!
- If the strategies are disproportionally directed in one area for too long, they eventually create downsides from unintended consequences. Below are general upsides and downsides for both.



Because there is no "right answer" for all time, but rather a continual adjustment between the two strategies, this falls under a set of management problems called Polarities. Proper management of this polarity is important to your success. Here is a basic model for managing polarities:

- Polarities do not have a "solution." Look at it this way: if you only turn left, you'll end where you started. And if your only tool is a hammer, everything looks like a nail. You must have strategies on both sides of the polarity.
- Polarities are in a constant state of transition. The wind always changes, so you must continually adjust your sails. You must have a set of indicators for your business that show you where you are in the cycle.
- Polarities have a natural cycle. Just like nine pregnant women can't deliver a baby in a month, your business or market has its own cycles and you must be aware of them.

Managing this polarity is different between startups and established companies. Let's look first at *self-funded* entities with little or no outside capital. Because of the capital constraints, these

companies should start with a profit focus and continue until the natural cycle of their market, industry or segment becomes clear. Once they become self-sustaining, it's appropriate to shift to growth mode and then adjust afterward based on the natural cycle.

On the other hand, startups with significant *outside capital* can start with strategies that will allow them to reach the growth targets expected by their investors. As long as there is a clear Path to Profitability, they can focus on growth until they reach their targets and then shift to a profit focus to build reserves for funding the next cycle of growth.

And in both cases, the cycles will repeat until maturity.

There is one particular type of a startup that I'd like to discuss. The startup that introduces a new innovation to the market place must be aware of the Innovation Adoption Lifecycle and adjust their shift points according to the place on that cycle, in addition to the market's natural cycles.

- When a company launches a product, their initial customers are the Innovators who generally represent 2.5 percent of the population. At this stage, it's more important to have strategies that focus on delivering a true innovative solution than ones that focus on either profit or growth.
- Once the product is launched and the Early Adopters are the customers, the next 13.5 percent of the population, it critical to be focused on growth rather than profit. The objective is to gather as many early adaptors as possible because of their significance in extending the customer base to the rest of the population.
- Once the product reaches a level of maturity where customers are part of the Early Majority, approximately 34 percent of the population, there should be a clear understanding of the cycle and the company strategies should be focused on growth and profit, with growth being a higher priority.
- At full maturity, when the Late Majority, the other 34 percent of the population, comes on board, the focus is still on both, with profit being a higher priority.
- Once the market penetration is complete and the only remaining customer segment is the Laggards, the last 16 percent, the company focus should shift to profit with the objective of building capital reserves to fund the next innovation that will drive growth in other markets.

So what are the keys to implementing polarity management? I have a few tips. First, see the big picture. Remember the story of the four blind men and the elephant? Each person touched a part of the elephant and formed an opinion of what it was, but no one saw the big picture.

Walk the Talk. Don't just pay lip service to the concepts we've discussed here. This is an active management process.

And you can never go wrong following the K.I.S.S. theory – Keep It Short and Simple! Know where you want to go and don't make it harder than it needs to be. Having good advisors can keep you on the right track as well.

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