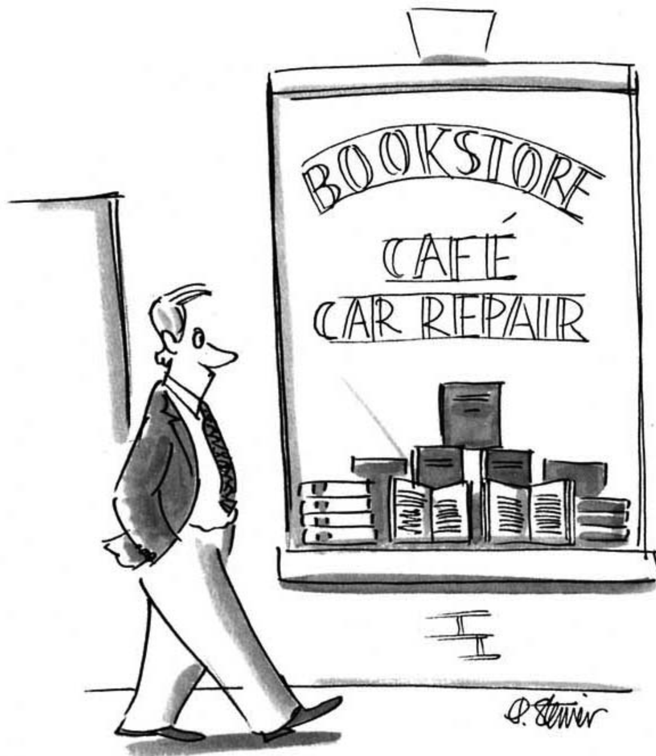

How to make the smartest bets on new business

Growing beyond your core in retail

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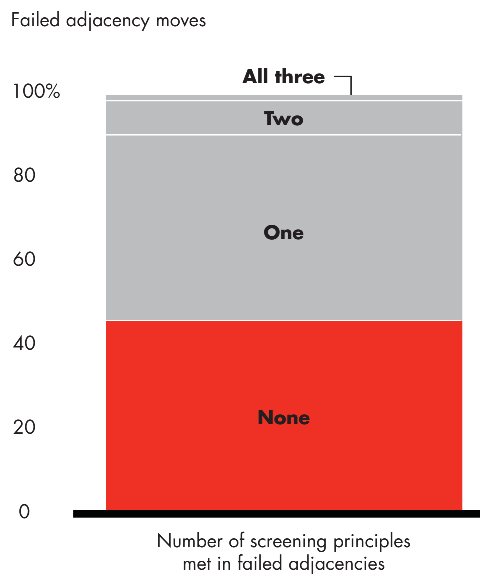
How to make the smartest bets on new business

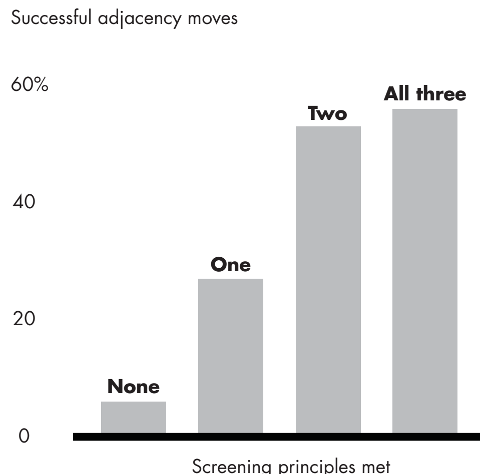
One out of three are long odds. Yet, as retail companies search for growth strategies that will satisfy shareholders, many are making that kind of bet by moving into businesses, geographies or formats outside their core. In Bain & Company's analysis of nearly 300 attempts by more than 60 US retailers to enter adjacent businesses during the period between 1989 and 2004, we found that only 29% of the moves contributed to profitable growth. Moreover, just 15% hit the "jackpot"—moves that not only had a positive net present value but also added more than 5% to revenues and profits.

We discovered three principles that could lift a retailer's success in doubling the industry's overall average. And we found that those retailers that repeatedly attempted moves had a better track record than the rest. The winning approach embraces the following: First, successful movers enter new businesses that are close to their core, with success rates rising sharply for those moves involving adjacencies with few variants in the companies' current cost structures, target consumers or capabilities. Second, successful adjacency movers concentrate efforts on large profit pools, understanding that markets with larger margins are best. Third, they accurately estimate the potential to grow in the market they're entering, ideally targeting markets without an entrenched leader.

Of the unsuccessful attempted adjacency moves we studied, about half didn't follow any of these principles. (See figure 1.) Occasionally, companies that didn't follow the principles managed to succeed nonetheless, but their success rate was a meager 6%, with minimum success defined as "creating some degree of new revenues and profits." When one of these principles was met, the success rate rose to 27%. Meeting two resulted in a 53% success average, and three a slightly higher rate. (See figure 2.)

Figures 1 and 2: Nearly half of unsuccessful adjacencies do not meet any of the screening principles





Note: Top chart includes only those adjacencies classified as clear failures; n=83.
Bottom chart includes both home runs and small successes.
Source: Bain analysis

Let's look more closely at how retail companies can successfully screen their adjacency moves and develop the capabilities to make the right moves repeatedly.

Stay close to the core

Relatedness to your core is the first—and perhaps most critical—principle when generating and screening adjacency opportunities. Such opportunities can include moves to new locations, products or services, customer segments, channels, value chain steps or formats. Understanding your core is key; it comes from analysis about the areas in which you beat the competition, have unusually loyal customers and earn above-average profits relative to your competitors. Key assets in the core could include a unique business model like Dell in computers, a strong brand like American Express in credit cards, or a low-cost position like Tesco in grocery. When we assessed the 293 moves in our study, success was 42% at one step from the core, 23% at two steps out and 18% at three steps. The distance from the core is measured along three dimensions: Does it share the same cost structure as the core? Does it build off the core's existing customer base? Does it leverage existing core capabilities? A company moves farther from its core as more dimensions change.

The classic example of a retailer that lost sight of its core was Kmart, which started in the early 1960s and later served as the benchmark for Wal-Mart's Sam Walton, who called it the "laboratory" that he copied. By the late 1980s, Wal-Mart had caught up with Kmart, and it took the lead throughout the 1990s. Looking for an edge, Kmart began experimenting with multiple adjacencies. But it did so without a well-thought-out plan, purchasing such unrelated businesses as Borders, Office Max, Sports Authority and Builders Square. Each became a major distraction to Kmart management as the company faced off against more focused big-box retailers. The businesses had to be spun off or sold by the time Kmart sank into Chapter 11 protection in early 2002.

> Success rates for adjacency moves rise sharply for those that involve few variants in the company's current cost structures, target consumers or capabilities.

There are other risk factors to adjacency moves as well: The success rate of geographic moves slides steadily downward as cultural dissimilarities grow—from 80% for US companies moving into Canada, to 60% for European expansion, to less than 40% for moves into Asia. However, that historic pattern shouldn't necessarily dissuade companies from entering markets such as China, where adjacencies might require a longer-term investment but where the potential is large. In this case, the three principles become even more important.

Claire's Stores, a leading international specialty retailer offering value-priced costume jewelry, accessories and cosmetics to teens and young adults, found success by focusing on geographic expansion. The US-based firm

has a core business concept that "targets teen girls with accessory styles widely promoted by the media." It didn't necessarily know much about teens overseas, but by serially buying small local entities such as the UK's Bow Bangles in 1996, it acquired the local customer and channel experience it needed. Claire's began a successful European expansion that eventually included Austria, Switzerland, Germany, France and Ireland. Its approach, the company explains, "has been to purchase a retail chain with an existing management infrastructure, local buying expertise and knowledge of local customs. Claire's Stores then converts the acquired stores to the Claire's Stores concept and applies Claire's Stores best practices."

By focusing on one type of adjacency—geographic growth—and repeating it in a series of small moves, Claire's expansion strategy was a significant success. Between 1989 and 2004, Claire's acquired stores throughout Europe. Its expansion now totals more than 700 outlets, and sales from outside North America contribute 29% of total revenues.

Measure the profit pool

Making sure that adequate money can be made in an adjacent market would seem to be a straightforward matter. But it can be tricky. Unless they're careful, retailers can end up majoring in a minor business. Consider one fashion retailer's foray into the "plus-size" market for women's clothing. Based on demographics and obesity trends, the company bought a chain of stores that focused on this sector, assuming it had entered a growing business. But despite an increasing number of potential customers, several limiting factors emerged: The company belatedly discovered that plus-size shoppers buy clothing far less frequently than slimmer women, and many dislike shopping in stores that single them out as large. The traditional "plus-size" apparel profit pool appeared to be shrinking. By contrast, another retailer decided to scale its sizes, taking into account more mature figures. It helped larger women feel smaller. It also offered higher-fashion materials, designs and accessories for larger women, and put stores next to trendy clothing chains. That retailer effectively used its core business to tap a new and growing profit pool as baby boomers—and their figures—matured.

In another industry, one retailer accurately understood Americans' love affair with their pets. The company saw a huge and growing market that offered a variety of adjacent opportunities and services to its initial pet food business. Pet ownership—rising by 28%, to 69 million households, between 1988 and 2004—made animal food, supplies and services a $34 billion industry. And that was just the beginning. As more and more aging people are buying pets for companionship—and as households with children continue to increase—the sector is growing by 6% a year, providing plenty of room to expand. Over a period of 15 years, this company built or acquired adjacencies in training, grooming and other pet services. It then created an online version of its business—all of which contributed significantly to the company's 25% annual revenue growth.

Determine just how big you can get

A retail market not only has to be big, it should also be open enough so that entrants can gain more than a toehold. Markets with clear and established leaders are difficult to enter without the strongest differentiation in value for customers. But being the leader in one country doesn't necessarily translate into a major share in another locale. The clear leader in US online auctions, eBay, learned that lesson when it arrived in Japan in 2000 to face an entrenched leader. Yahoo Japan, the country's largest portal, already controlled 95% of the online auction market. For the next two years, eBay furthered its difficulties with its pricing and positioning—as a seller of used merchandise, rather than a purveyor of "collectibles" prized in Japan—and wound up exiting the market early in 2002.

While our analysis centered on US retailers, we detected a similar trend in adjacency success rates in Europe, where PPR SA's Fnac, a chain that combines sales of books, CDs, DVDs, software, computers and consumer electronics, has shown great growth potential. Beginning in 1981 —and with increasing speed over the past decade—Fnac has opened 49 stores in eight countries: Greece, Belgium, Spain, Portugal, Brazil, Taiwan, Italy and Switzerland. The chain determines its target countries by size, wealth, general level of education and competitive fragmentation, according to Fnac's CEO, Denis Olivennes. And the stores are run by local management teams that quickly exploit these openings and spread best practices across Fnac's entire chain. In 2005, international sales accounted for nearly 24% of Fnac's revenues, double that of 1995.

Finally, retail adjacency moves are not some kind of other-world territory where every player can be above average. Remember those one-in-three odds? That's the average. But when it comes to hitting the jackpot—growing profitably at more than 5% a year—we found that retailers that repeated a certain type of adjacency won 23% of the time, while novices managed only 5%—a spread of 18 points.

In other words, practice makes perfect. Moreover, by committing to a single type of adjacency expansion as a tool for growth, repeaters move down a learning curve, gaining the ability—like a superior gamesman—to map winning moves far ahead.

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