Wilson Perumal & Company's

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Growing Profit with Revenue:

4 factors to assess scale potential

Wal-Mart, the company that epitomizes scale and the concept of "bigger is better," was actually most profitable in the mid-1980s. It had fewer than 1,000 stores compared to 11,000 today, and operated almost exclusively in and around its home state of Arkansas. Its much larger size now should allow for more buying power and better leverage of overhead costs. However, with its massive domestic and international growth in the past decades, Wal-Mart is now succumbing to the same issues that once plagued its competitor, Kmart.

As the world has moved out of the Industrial Age, complexity has become the primary driver of profitability—increased efficiencies and profits are no longer achievable simply by growing larger. There is far more at play than size; companies need to understand the characteristics of their businesses that determine if they can grow with scale. The key to achieving scale is obvious, grow revenue faster than costs, but accomplishing that has become far more difficult in a complex world where companies sell more products, through more channels, in more geographies, to customers with more diverse needs.

Increased efficiencies and profits are no longer achievable simply by growing larger. There is far more at play than size; companies need to understand the characteristics of their businesses that determine if they can grow with scale.

Rediscovering Scale

The largest companies in an industry are not always the most profitable. In fact, regardless of size, companies that grow revenue quickly often fail to see a corresponding uplift in profit.

When comparing the revenue compound annual growth rate (CAGR) to the operating income CAGR for the companies of the S&P 500 from 2005 to 2015, almost half of them became less profitable as they grew—they were unable to achieve scale.

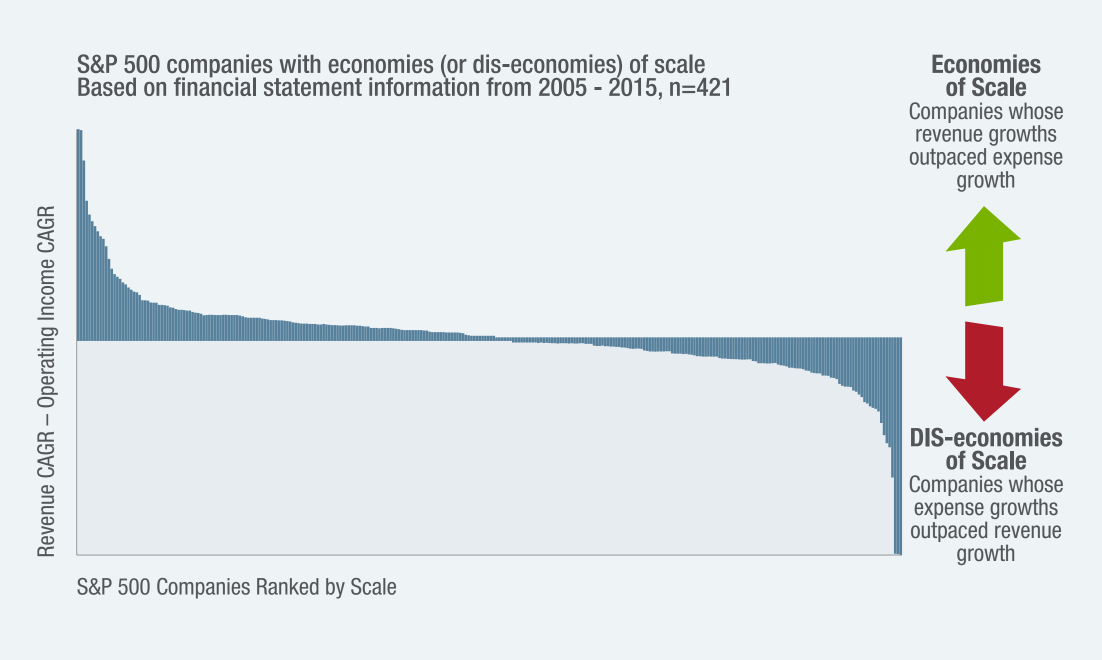

Figure 1: S&P 500 companies with economies and dis-economies of scale. Scale is defined as the difference between the 2005-2015 revenue CAGR and operating income CAGR.

Growing revenue is no longer the primary indicator of whether or not a company will be more profitable. Instead, a company's ability to manage complexity is now the key driver of scalability. Revenue growth is typically driven by creating new products, operating in new geographies, or selling through new channels—actions that increase complexity. Because the costs associated with complexity increase exponentially, adding even small amounts of complexity can drive a disproportionate increase in costs and dramatically erode profitability.

Growing with scale necessitates managing costs – COGS, SG&A, R&D, and CapEx – while growing revenue. To do so, companies need to understand their operations and the environments in which they operate to determine if they are in a position to achieve scale. Existing Complexity, Product Adoption, Brand Strength, and Leverageable Assets are the key factors to be examined.

Existing Complexity

How many different products, divisions, facilities, organizations, etc. does the company have? How will growth plans impact complexity?

Product Adoption

How many potential customers are aware of the company's products? How many have already purchased? How many are left? What will drive growth (new customers, products, geographies)?

Brand Strength

Is the company's brand aligned with its strategy? Is the brand consistently executed? Do customers know and understand the brand?

Leverageable Assets

How much unused value chain & organizational capacity does the company have? How much can the company grow without adding assets?

Figure 2: 4 key scale factors.

Scale Factors

Existing Complexity

Complexity can choke a company's ability to achieve scale. Complexity costs grow exponentially; therefore any additional product, process, or organizational complexity added to support sales growth may drive cost increases that outpace revenue gains. To know if a company is poised to grow with scale, it is imperative to understand both the company's existing complexity and any potential complexity that will be added to drive that growth – this could include new products, new sales organizations, and expanded supply chains.

Where Complexity Impacts Costs

Most Impacted Costs			
COGS	**SG&A**	R&D	CapEx

Adding more products means more raw materials, more suppliers, more manufacturing processes, more finished goods inventory, and more manufacturing variability—all leading to higher production costs. Additional products also create scheduling challenges, drive more lost time to changeovers, set-ups, and ramp-up while requiring more training and introducing more variability into demand and production planning. All of this complexity combines to decrease efficiency and increase COGS.

This operational complexity, however, also impacts SG&A costs as these processes require more coordination and management. Entering a new geography or adding a new product not only adds direct SG&A costs, but also incrementally adds to the time corporate staff dedicates to coordinating efforts. The growth in these costs is often hidden because it is so distributed—additional staff scattered through an organization who are needed to coordinate and manage the growing complexity are not easily tied back to specific complexity-increasing decisions.

Companies with lower, well-managed levels of complexity have more opportunity to grow with scale as they can add complexity without dramatically increasing costs. However, scale becomes harder to achieve as complexity increases – additional complexity progressively adds more and more costs. By not understanding that relationship, many companies put themselves in untenable situations with rapidly exploding costs; the Industrial Age adage that "bigger is better" has unfortunately led most companies to adopt too much complexity in their quests for more revenue.

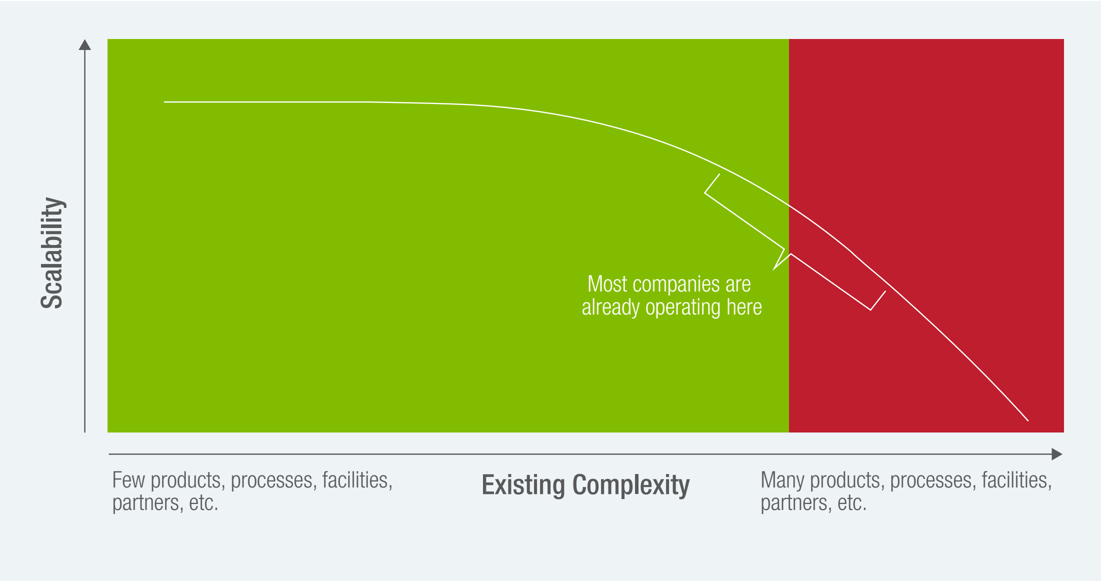

Figure 3: Complexity & Scale. Costs grow exponentially with additional complexity. Companies with low levels of existing complexity are able to scale better as the costs of additional complexity are much lower than companies with high levels of existing complexity.

Managing Complexity to Achieve Scale

McDonald's has had its ups and downs in the last decade as it has sought continued sales growth. Some efforts have been very successful, while others have resulted in higher costs, slower service, angry franchisees, and frustrated customers. The addition of McWraps to the menu was responsible for significant growth in sales in the early 2000s. However, these wraps required new ingredients and new preparation and assembly processes—this was on top of an already diverse and complex menu. The tortillas took 20 seconds alone to be steamed, which slowed preparation times, drove costs higher, and diminished service levels. McDonald's fueled growth by adding more complexity to an already complex organization, and this failed. McWraps have now been scaled back.

By contrast, McDonald's recent decision to offer certain breakfast items all day has been extremely successful. Expanding breakfast service times added little complexity to restaurant operations and none to product complexity while driving significant sales growth. They have been able to achieve scale by leveraging existing products and processes to increase sales.

Product Adoption

The number of customers a company has already reached and the number still available to reach play a critical role in determining costs needed to drive growth. New products follow a fairly standard life cycle of adoption. Product adoption naturally starts low after introduction when consumers are first learning about the company or product. It will eventually grow to a point of maturation when few, if any, potential new customers exist. As companies consider their path to growth, it is important to understand current adoption rates as there are situations of both low and high adoption that will drive costs higher and inhibit scale.

Where Product Adoption Impacts Costs

Most Impacted Costs

COGS	**SG&A**	**R&D**	CapEx

In addition to R&D spending, new product launches require significant upfront SG&A costs that inhibit a company's ability to achieve scale. New sales channels have to be developed and a salesforce needs to be hired. A heavy investment in marketing is necessary to raise awareness and trigger demand. While traditional back-office functions such as human resources, finance, and facilities management have to add additional staff to handle expansion. All of these costs will drive up SG&A spending at a faster rate than the initial corresponding revenue growth.

At the other end of the spectrum, when a market is nearly saturated, there may be dramatic growth in R&D and SG&A spending to reach the remaining customers. Once the customers who readily adopted a product have purchased it, reaching new customers requires different, potentially expensive, means—this might include product improvements/enhancements, more marketing spend, increased service levels, and/or lower prices. There is a point when the cost of reaching the last additional customers is far more expensive than the revenue lift they represent.

How Product Adoption Impacts Scale

When a company first establishes a new brand or product, they start with low product adoption and low scalability. That is because it requires high upfront costs to launch the new product, build out sales/distribution, and educate customers. Companies have to invest heavily in R&D to develop a new product and SG&A to build the market and support it—these investments may not be quickly recouped.

As sales grow, these costs are spread over larger sales volumes with minimal additional investment. Companies are in a "sweet spot" for achieving scale as they are able to leverage existing resources, such as existing physical store locations and employees, to produce more sales.

Then, as they penetrate the market, additional scale benefits become more difficult to attain. New customers are harder to reach or more resistant to buying. Companies fight to reach the last set of customers with more marketing and/or R&D spending while potentially offering customers more value, e.g., lower prices, more service, etc.

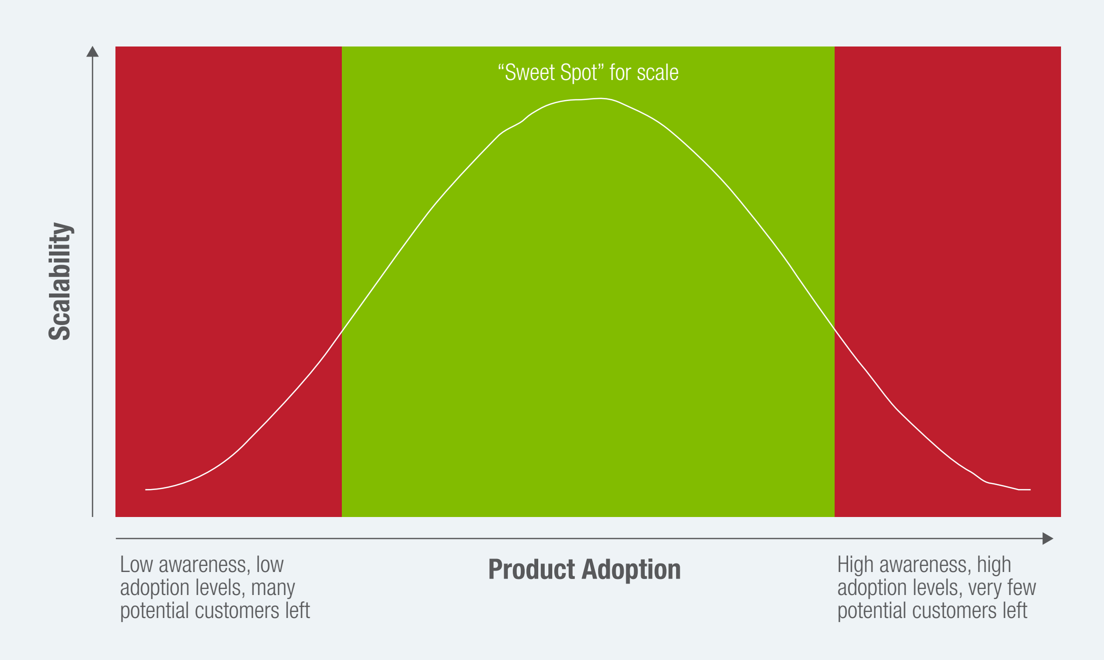

Figure 4: Product Adoption & Scale. When adoption is low, high upfront costs and low revenue prevent scale, but scale is achieved as sales grow and investments are spread over larger volumes. Then, when adoption is high, additional investments in marketing, R&D, and/or discounts will be needed to grow sales and scale is not achieved.

Brand strength is a combination of how clearly and consistently a company's brand is defined (internal) and how well that brand is understood in the marketplace (external). It is not a measure of how "good" a brand is perceived to be, but rather if the company is internally aligned around its brand promise and if customers know what to expect from the brand.

How to Manage the Implications of Product Adoption

When Toyota launched its Lexus brand of luxury vehicles in the late 1980s it was entering a market dominated by European brands like BMW, Mercedes-Benz, and Jaguar. Breaking into this market required designing a brand new vehicle, establishing a new dealer network, educating consumers, and convincing consumers to try something new. This initial investment meant that in the short-term Lexus would not be a profitable venture for Toyota—scale was simply not a possibility. However, they were able to grow sales quickly and began contributing substantial profits to their parent company in less than a decade by leveraging the infrastructure and brand awareness built during launch.

Now that the luxury market is saturated with brands from around the world, Lexus, like most other brands, is expanding its product portfolio dramatically. Between SUVs and crossovers of all sizes, luxury sedans, sports cars, hybrids, and low-volume specialty vehicles, Lexus has gone from a portfolio of a handful of products in the 1990s to more than a dozen today. This was done to reach more of the market—they have to reach new customers with niche products to grow sales. Sales may be growing with the addition of these new products, but profit growth is slowed by the additional development spending needed to support these new vehicles. Though, Lexus is able to overcome some of this resistance to scale by leveraging the same platform to build multiple vehicles, its existing dealer network, and brand awareness.

Brand Strength

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Where Brand Strength Impacts Costs

Most Impacted Costs			
COGS	**SG&A**	R&D	CapEx

Brand strength is a key enabler of scale—when a company has a clear brand proposition and customers understand that brand, it will be able to leverage its familiarity in the market along with its existing internal processes to grow without seeing dramatic growth in costs. COGS and SG&A are the two areas where brand weakness can lead to high-cost growth and prevent scale.

If a company is not focused on what it offers, it may expand into different, unrelated, or inconsistent products to chase revenue growth. This not only introduces additional complexity into the organization and drives the corresponding costs, but it likely means the company will be unable to make use of and leverage current facilities, suppliers, raw materials, staff, and processes. As a result, COGS will be higher for the new products. Additionally, the less focused a company's brand is in the market, the harder it is for customers to understand what to expect from the company. Companies that do not have brand strength will have to spend more to promote their products and will see dramatically higher SG&A costs.

The stronger a company's brand, both internally and externally, the more easily they will be able to leverage existing familiarity to grow with minimal investments in COGS and SG&A that would inhibit scale.

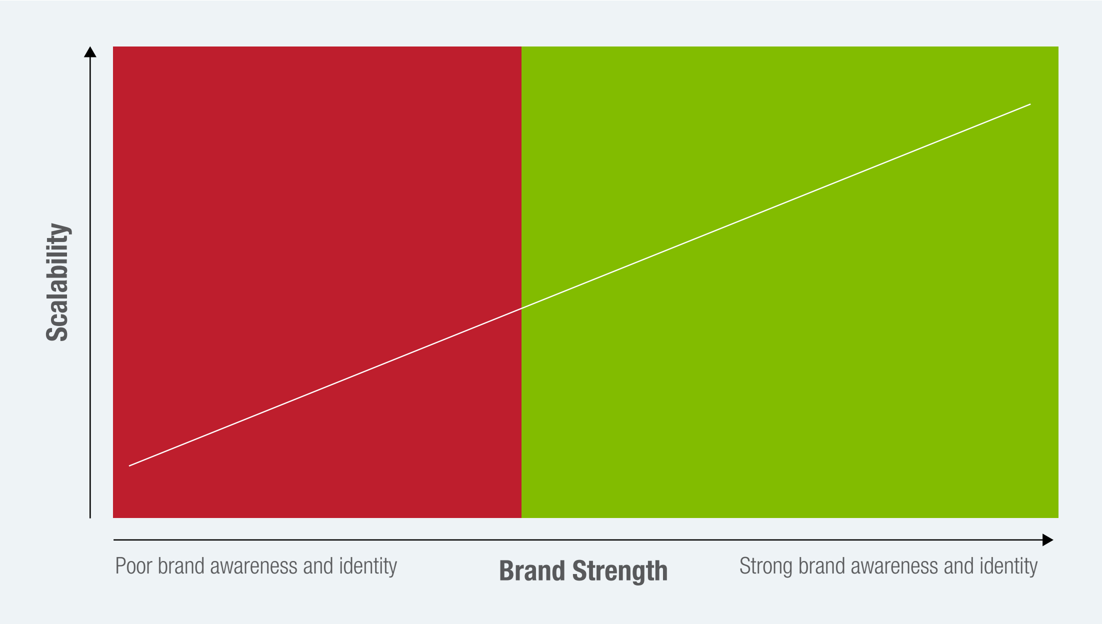

Figure 5: Brand Strength & Scale. Strong brands allow companies to expand with lower levels of investment by leveraging existing assets and capabilities and customer understanding of their brands.

How to Manage the Implications of Brand Strength

Due to the consistency and strength of Southwest Airlines' brand through the years, customers know they will not be getting the "typical" airline experience when they fly and appreciate the value being offered. Southwest does spend some money on marketing and advertising, but when they enter a new market it does not require an initial heavy-lift of awareness marketing. People know to look to Southwest to find a better deal and, perhaps, even a better flying experience.

Southwest's focus on its brand led it to make decisions that are a departure from the way traditional airlines operate. Southwest is not trying to be all things to all people; they have a focused niche in the market. As most people know, Southwest has no first class, does not offer assigned seating, does not fly long-haul or trans-Atlantic flights, and eschews the hub-and-spoke model that most airlines use. Southwest has now grown to be one of the largest and most profitable domestic US carrier thanks to its strong internal brand alignment and consistency in delivering on its brand promise to consumers.

Leverageable Assets

If a company has no available capacity, growing sales will require an investment in facilities, staff, and possibly new suppliers to support additional volume. These types of investments typically involve a step-change increase in costs, but those costs do not necessarily drive an immediate step-change increase in revenue. Therefore, understanding what assets can be leveraged to support growth and what level of growth will require additional investment is key to knowing if scalable growth is possible.

How Leverageable Assets Affect Costs?

Most Impacted Costs			
COGS	SG&A	R&D	**CapEx**

When a company is capacity-constrained, they will often see a disproportionate uplift in COGS as they try to squeeze out the last available capacity from existing assets. Working overtime typically comes with a 50% increase in wages. Adding a new production shift takes time to hire and train. Facilities running at 100%+ have less opportunity for maintence on equipment which can lead to unplanned downtime or costly repairs later. Overall, efficiency will suffer, COGS will be higher, and the growth in sales will not see a commensurate growth in profits.

Once current assets are operating at their maximum, any additional growth will require investment. This can come in the form of a new facility, additional warehouses, new equipment & tools, etc. Any investment in these areas will drive a step-change increase in CapEx, and the additional capacity being brought online will most likely exceed the current needs for volume. Therefore, those CapEx investments will inhibit scale as the short term costs will far outweigh the growth in revenue. People are also valuable assets—if the sales staff or corporate support staff does not have the available capacity to support growth, new members will have to be added to those teams. That will add chunks of cost at a higher rate than revenue is growing and will inhibit scale in the short term.

How Leverageable Assets Impact Scale?

Either an organization has available capacity to support revenue growth or it does not. If it does not, it will have to make an investment in buildings, equipment, or people to grow its capacity. And those types of investments will typically come in chunks—a plant, a warehouse, an employee—that may put the company in a position of overcapacity. In other words, they may have to spend more than necessary to meet their current needs and that can hurt their ability to achieve scale in the short term.

It is important to note that available capacity should not be the driver of growth decisions—too often companies try to fill available capacity by adding random products that introduce complexity, undermine their brand, and ultimately drive up costs.

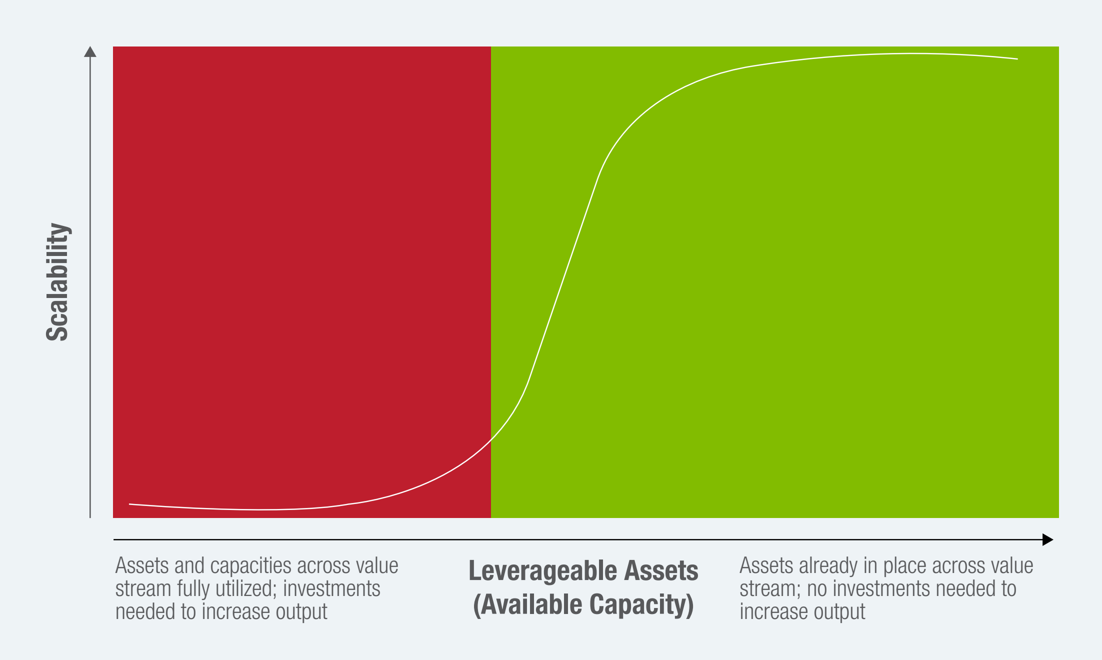

Figure 6: Leverageable Assets & Scale. Companies with few leverageable assets will not be able to grow with scale as they invest in new facilities and people. Companies with assets already in place can leverage those assets to attain and grow with scale.

The four scale factors are interrelated and complexity ties them all together. Complexity is at the root of scalable growth—more complexity makes scale difficult to achieve and amplifies scale issues with Brand Strength, Product Adoption, and Leverageable Assets. Understanding how growth will impact the other scale factors can also give insights into how complexity will be impacted, and ultimately how quickly costs will grow.

How to Manage the Implications of Leverageable Assets

From 2010 to 2013, Amazon invested over $13.9 billion to build 50 new warehouses. This huge investment increased capacity far beyond the existing needs in terms of space and ability to serve customers. Amazon was not achieving scale during this time—costs were growing much faster than revenue. In fact, profits suffered and Amazon was notoriously unprofitable for over 20 years. But Amazon was looking to the future and laying the groundwork for the fast, scalable growth they are seeing today. In fact, Amazon had its most profitable quarter in Q1 2016 and has been profitable for four straight quarters with North American operating income more doubling from Q1 2015 to Q1 2016. Amazon invested to ensure it would always have the assets in place to grow and could enjoy the benefits of scale in the future.

Amazon has not only leveraged its investment in warehouses to support massive growth, they have also been able to increase service levels with the added capacity. Where it was once able to deliver products in two days, it is now able to deliver to some customers in less than two hours. Because of its early investments in physical warehouses, along with accompanying technology platforms and merchandise partners that were far beyond its needs at the time, Amazon is now in a position to scale and grow revenues and profits at a tremendous rate.

Relationships Between the Scale Factors

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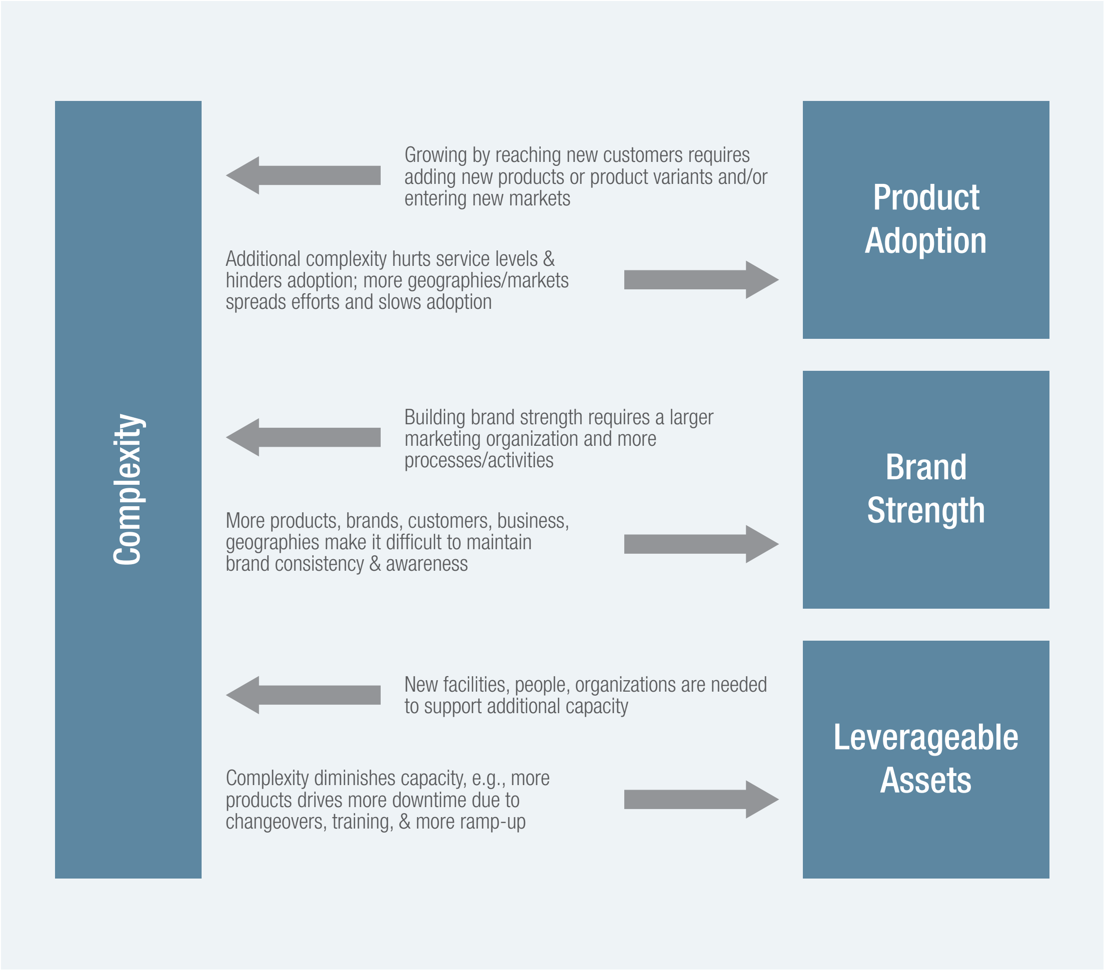

Figure 7: Relationships between the four scale factors. Complexity ties the factors together, as it is the driving force behind shifting away from the “bigger is better” paradigm.

CASE STUDY

When assessing a company's ability to scale, the four scale factors need to be considered together. Only by looking at them together can a holistic view of the company's ability to maintain control of costs be developed. When comparing or assessing growth opportunities, companies should look to answer the following questions:

- What are the current complexity levels in the business?
- How will the company handle the additional complexity added by the growth strategy?
- How well does the opportunity align with the company's brand? Will the growth strategy leverage existing brand strength?
- Are assets currently in place, or will additional investments be required?
- Is the current supply chain network able to support the growth?

Evaluating McDonald's Growth Opportunties with the 4 Scale Factors		
	McWraps	**All-Day Breakfast**
Complexity	• New ingredients, new equipment, and processes needed	• No new product or process complexity
Product Adoption	• New product requiring development and awareness marketing	• Existing customer knowledge of products and demand for them
Brand Strength	• Longer preparation time, does not support "fast" brand; new product category	• Existing products used leveraging brand strength
Leverageable Assets	• New ingredients requiring new preparation equipment and storage space	• Uses existing equipment
Recommendation		✓

By answering these questions, companies will be able to make better decisions that will grow sales faster than costs and lead to scale. For example, McDonald's could have used the four scale factors to compare the addition of McWraps with all-day breakfast to make the better decision:

By thinking through the four scale factors when assessing the growth opportunities above, McDonald's could see that McWraps would very likely lead to a greater increase of costs than an all-day breakfast menu. This means that McDonalds would have to expect to see much higher sales growths from McWraps compared to all-day breakfast to make it more worthwhile. Otherwise, McDonald's should recommend all-day breakfast over introducing McWraps if making a decision between the two. The example above is obviously simplified but shows how companies can start thinking about the four Scale Factors to compare growth opportunities to make better decisions.

Conclusion

Bigger is no longer better. The levels of complexity that companies now have to manage drives costs exponentially higher and erodes profitability—large companies no longer enjoy a scale advantage over smaller competitors by simply having more sales. As our research into the companies of the S&P 500 shows, there are companies that are able to grow revenues much faster than costs, but size is not the indicator of which companies are able to do this. Instead, to determine if a company is able scale, companies should look at and assess opportunities using the four Scale Factors: Existing Complexity, Product Adoption, Brand Strength, and Leverageable Assets.

Is your company growing but failing to achieve scale?

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Wilson Perumal & Company is a premier management consulting firm and the leading advisor on how to manage and capitalize upon the complexity of today's world. To learn more, visit www.wilsonperumal.com.

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