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By Donald Baer and Bill Liabotis

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## **Managing a portfolio of growth options: The strategic tradeoffs between growth and risk**

By Donald Baer and Bill Liabotis

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*Identifying and assessing growth options are complex, critical processes. Even more critical, and intricate, is the measurement of risk associated with each option. These authors provide a robust framework that will enable managers and their firms to choose those growth options that have the best chance of succeeding.*

There is no single path to growth. Any growth-focused enterprise owes it to its stakeholders to think out a series of alternative growth options and then critically assess each with respect to market dynamics, profitability potential, and risk. Focusing on a single growth option in isolation can lead to sub-optimal results and possibly disaster.

How to strategically manage the tradeoffs between growth and risk in a portfolio of growth options is the focus of this article. In the article, we develop a framework to assist leadership teams in determining the relative merits of alternative growth options and identifying those options with the strongest probability of success. The framework critically assesses each option with respect to:

- The market, revenue and profit growth potential
- The potential strategic risk
- The preferred trade-off between growth and risk

The framework has been developed with the small and medium-sized firm in mind. It can be applied by a firm's senior management team in a limited period of time, assuming prior research has been undertaken in developing growth options and the right people are at the table. The framework is purposefully flexible; dimensions can be added or deleted, in line with current market dynamics. The article illustrates the application of the framework developed through a practical case study (S&Q Financial).

### **A framework to assess alternative growth options**

The first prong of the framework assesses alternative growth options with respect to their market, revenue and profit potential. The dimensions selected are seen in the columns of Table 1 and include:

### **Current market demand**

- Current market demand for each growth option under consideration needs to be assessed in terms of its stability in light of current economic conditions and the demographics underpinning such demand. This assessment has significant implications on short-term growth.

### **Market growth potential**

- Each growth option needs to be assessed in terms of trends in current market demand and anticipated external factors that can be expected to either positively or negatively impact future demand. This has important medium- to longer-term implications. Entirely new products such as iPods in 2001 and iTunes in 2003 would have been rated low in terms of current market demand but extremely high in terms of market growth potential.

### **Degree of market differentiation**

- Next, the degree of competitive differentiation that the firm hopes to achieve in the delivery of the option needs to be assessed. The higher the degree of competitive differentiation, the higher the potential for profitable growth. Wal-Mart is currently focused on differentiating itself as an aggressive, environmentally sensitive enterprise. It has implemented a scorecard to rate its suppliers in regards to factors such as average distance the material is transported, package-to-product ratio, greenhouse gas emissions created during package production, and more.

### **Potential for achieving market leadership**

- How will growth be achieved, e.g. capturing market share from competitors, expanding demand for the product category, creating entirely new “market space” with a truly new product? Regardless of which approach is taken, a critical question to consider is, “Can the firm achieve a relatively strong competitive position - number 1 or 2 - in its target market niche?” The greater the likelihood of achieving a leadership position, the higher the rating. ING Direct entered the Canadian market in 1997 using on-line distribution solely and focused almost exclusively on a mature banking service – the savings account. However, through strong commitment, good timing, and effective promotion, ING was able to achieve a leadership position in this niche market in short order.

### **Profit potential**

- The current and potential profitability of the option in the market needs to be assessed in light of the industry structure (e.g. customers, suppliers, competitors) and business cyclicity. Is this a high-margin profit option? Are there significant current and potential profit pools? Is profitability particularly sensitive to business cycles? (The current economic downturn provides an excellent context for rating this factor.) The higher the anticipated profit margin and profit pools, and the lower the sensitivity to business cycles, the higher the rating.

### **Leadership team’s passion**

- From our experience, the passion of the firm’s leadership team for undertaking the option is possibly the single most important factor to address in assessing the viability of the growth option and its effective implementation. That passion is a necessary but not sufficient success factor in undertaking the option, and will underpin the

degree of leadership support for the option over time. Jeff Bezos' 1994 launch of Amazon.com generated its first profitable quarter only in late 2001; many had written off the venture by then. But Bezos and his leadership team's passion and long-term commitment created an environment to sustain the firm during these tough years.

### Identifying the growth options

Though it is counter-intuitive to some, generating the list of growth options to be evaluated is an iterative process. The starting point is often a combination of focus groups, research, brainstorming and the leadership team's personal network<sup>1</sup>. In the S & Q case in this article, five growth options are illustrated in line with the market, revenue and profit dimensions (Table 1):

- (A) Geographic expansion into a neighboring region
- (B) Geographic expansion into a neighboring country
- (C) Creating a new product line
- (D) Tailoring a current product for the senior executive market, leveraging sub-segmentation<sup>2</sup>
- (E) Utilizing a new distribution systems to market white label products

Each of these growth options is assessed on a scale of 1 to 10, with 10 being the strongest weighting.

This illustration resulted in two options that stood out in terms of their market and profit potential: Creating a New Product Line, with a weighted score of 50, and Tailoring a Current Product to Executive Needs, Leveraging Sub-segmentation, with a weighted score of 52.

These results are important in assessing the best growth option, but are insufficient in terms of final decision-making. The second prong of our Framework focused on a risk assessment of each growth option needs to be next applied<sup>3</sup>.

**Table 1 Market and Profit Assessment**  
(Weighted on a scale of 1-10)

<u>Growth Option</u>	<u>Current Market Demand</u>	<u>Market Growth Potential</u>	<u>Degree of Market Differentiation</u>	<u>Profit Potential</u>	<u>Market Leader Potential</u>	<u>Passion</u>	<u>Total Potential</u>
(A) Geographic Expansion in Neighboring Region	4	5	4	4	3	7	<b>27</b>
(B) Geographic Expansion in Neighboring Country	8	6	3	4	2	5	<b>26</b>
(C) Creating a New Product Line	9	8	6	8	9	10	<b>50</b>
(D) Tailoring Current Product to Executive Needs – Sub-segmentation	9	9	8	9	9	8	<b>52</b>
(E) New Distribution System - White-Labeling	6	8	8	1	8	2	<b>33</b>

## **Case study: The S & Q Financial story**

S & Q Financial (the fictitious name of a real life company), is a leading niche financial intermediary which sells and services business clients. The president's vision is to create an innovative business model that strengthens its core business and at the same time facilitates:

Creating new value propositions through a process of sub-segmenting its current customer base to discover unmet needs.

Broadening S & Q's distribution capabilities to reach new customer segments.

Expanding beyond its current geographic footprint.

Thirty growth options were identified through a process that included focus groups and brainstorming sessions with major stakeholders -- S & Q's senior leadership team, board members, current customers, suppliers and business advisors.

The senior leadership team performed a Market & Profit and Risk Assessment (similar to Tables 1-3) for each growth option. The process, facilitated by the authors of this article, was highly interactive, with the president and members of the leadership team providing valuable insights and expressing strong opinions on the growth potential and risk levels of each option. The result was a portfolio of options with different levels of market- and profit-growth potential and risk. The following options are a sample of the thirty identified.

### **Creating winning value propositions: Sub-segmenting the most & least profitable customers**

Profitable customers were identified and sub-segmented into common groups based on industry sector, size and purchasing processes. Firms with similar needs and preferences were identified (new sub-segments) with tailored products created for the high potential sub-segments. This option is seen as holding a strong potential for increasing S & Q's revenue and profitability, with relatively low risk.

For customers generating low profits (or incurring a loss), pricing and service levels have been reviewed and a program initiated to increase efficiency and margins. In some cases, direct sales calls were curtailed.

### **Customer Reach: Accessing new customer segments**

Products are being tailored to meet the needs of a new market segment, senior executives of client organizations. Based on an assessment of non-competitive firms with ready access to these executives, new distribution partnerships will be created.

Also being considered is a partnership with a sector-based industry association to distribute S & Q's 'white label' product to a segment of the association's members. For example, firms too small to profitably service directly could be aggregated into clusters and reached indirectly through the association.

Both these options increase the firm's potential to increase revenue and profitability. However, the combination of a new distribution system, new customer segments and modified products is viewed to increase risk. Given that both these options carry significant risk, the focus has shifted to determining which of the two has greater potential to generate profitable revenue to offset the risks.

### **Geographic Expansion: Stretching out the business horizon, but how far?**

S & Q. is presently the leader in its niche market in a region of Ontario. Although there are still opportunities to grow the current business model in this region, the market is becoming saturated. Opportunities exist to grow the business in other

provinces and the USA, but these options entail higher risk. This risk is rooted in a lack of detailed knowledge of these markets and the demands such an initiative would place on an already very busy head-office staff. If the leaders intend to grow the current business geographically, expanding into a neighboring region has been determined to be the preferred route.

## **A framework to assess alternative growth options**

### **Risk dimensions**

The second prong of the framework focuses on the strategic risks associated with each of the growth options. The greater the separation between the growth option and the present business, the higher the risk level<sup>4</sup>. In the framework developed in this article, the higher the risk, the lower the ranking on a scale of 1 to 10. Six risk dimensions are incorporated into the assessment (Table 2). The assessment is based on the extent to which the growth option being considered focuses primarily on current (versus different):

#### **Customers**

- Every firm has core customers – those relatively loyal customers generating the highest proportion of revenue and profit. Leaders may choose to grow by leveraging the strong position with these customers and tailor growth initiatives to meet their needs. Such initiatives often prove to be of lower risk and would receive a higher ranking (score). Cardinal Health solidified its position with one of its core customer groups – hospitals - by developing unique, integrated products and systems to ensure efficient delivery of the right medications to the right patients at the right time<sup>5</sup>.

#### **Strategic & differentiating capabilities in the market**

- Leaders who choose to grow without leveraging their current strategic and differentiating capability(ies) in the market assume higher risks. The more a firm is able to leverage its current differentiating capabilities and competitive advantages as it undertakes a new growth option, the lower the risk.

#### **Products**

- Risk level will vary depending on the extent to which the new product differs from the current product line. Is the new product an extension of the current line or is it significantly different? The latter option can significantly increase risk. Sears' 2002 purchase of Lands' End extended its clothing product line through adding a recognized higher-end brand, with minimal risk.

#### **Supply and distribution chains**

- Options requiring different sources of supply and/or distribution can significantly increase risk. The more that the growth option leverages current suppliers and distribution systems, the lower the risk.

#### **Geographic markets**

- Larger organizations with a strong brand, deep pockets and a single product line often are successful in expanding geographically. Risk associated with entering new geographic markets can be reduced by acquiring established regional or national businesses, not overpaying and driving operating costs down. Alternatively, high market-entry barriers and a commensurate increased risk level can discourage 'green field' entry strategies. TD Bank Financial Group's purchase of New Jersey based Commerce Bankcorp in 2007 is an example of furthering TD's U.S. geographic footprint through acquisition..

Small and mid-sized firms often expand their geographic footprint and manage the level of risk by expanding into adjacent or neighboring regions. By venturing too far afield, these firms assume higher risk

### Competitors

- If a growth option requires competing with different firms with which there is no prior experience, risk is significantly increased. A key element of this risk is the lack of a clear understanding of why the potential competitor is in business, their longer-term goals and the extent to which the competitor will defend their market position.

**Table 2 Risk Assessment**

(Weighted on a scale of 1-10)  
(The higher the ranking, the lower the risk)

<u>Growth Option</u>	<u>Customers Served</u>	<u>Strategic &amp; Differentiating Capabilities</u>	<u>Product</u>	<u>Supply &amp; Distribution Chain</u>	<u>Geographic Markets</u>	<u>Competitors</u>	<u>Total Risk</u>
(A) Geographic Expansion in Neighboring Region	6	7	7	6	3	7	36
(B) Geographic Expansion in a Neighboring Country	2	4	5	2	1	1	15
(C) Creating a New Product Line	9	6	4	8	8	5	40
(D) Tailoring Current Product to Executive Needs – Sub-segmentation	5	7	4	4	8	3	31
(E) New Distribution System - White-Labeling	3	5	5	2	5	6	26

## A framework to assess alternative growth options

### Integrating market, profit and risk dimensions

Table 3 integrates the two prongs of the framework: the Market & Profit Assessment and the Risk Assessment.

**Table 3 Market, Profit and Risk Assessment**

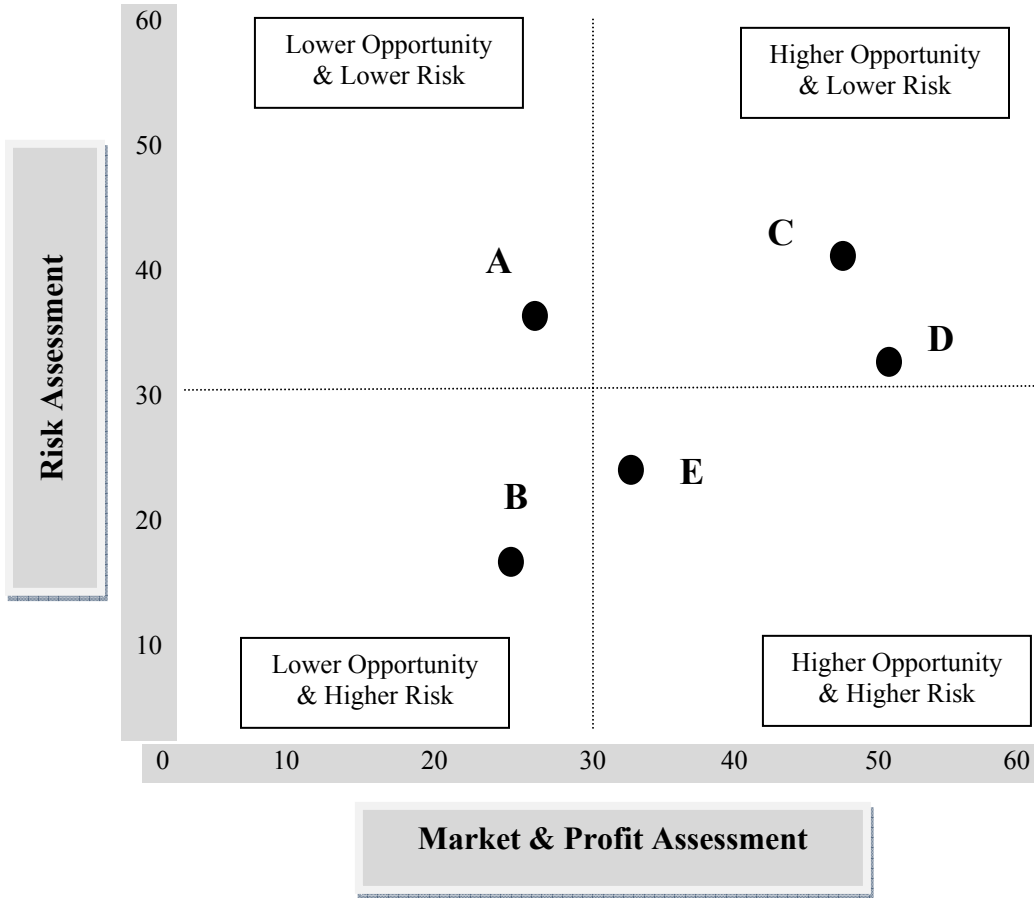
(Weighted on a scale of 1-10)  
(The higher the ranking, the higher the potential success)

<u>Growth Option</u>	<u>Market &amp; Profit Potential</u>	<u>Risk Assessment</u>	<u>Total Score</u>
(A) Geographic Expansion in Neighboring Region	27	36	63
(B) Geographic Expansion in a Neighboring Country	26	15	41
(C) Creating a New Product Line	50	40	90
(D) Tailoring Current Product to Executive Needs – Sub-segmentation	52	31	83
(E) New Distribution System - White-Labeling	33	26	59

A more interesting option is to evaluate the results using a four-quadrant matrix, plotting the results from the Market and Profitability Assessment on the horizontal axis and the Risk Assessment on the vertical axis (Chart 1). The upper right-hand quadrant reflects the most attractive growth options, taking into account the market opportunity & profitability as well as the level of risk.

In this example, two growth options stand out: Creating a New Product Line (Option C) and Tailoring a Product to Executive needs Leveraging Sub-segmentation (Option D). Geographic Expansion into a Neighboring Country (Option B) in the lower left quadrant is the least appealing – this option is seen to entail both high risk and lower opportunity.

**Chart 1  
Market/Profit & Risk Matrix**



<b>Growth Options Legend</b>	
<b>A</b>	<b>Geographic Expansion in Neighboring Region</b>
<b>B</b>	<b>Geographic Expansion in a Neighboring Country</b>
<b>C</b>	<b>Creating a New Product Line</b>
<b>D</b>	<b>Tailoring Current Product to Executive Needs: Sub-segmentation</b>
<b>E</b>	<b>New Distribution System - White-Labeling</b>

Any firm seeking to optimize growth needs to develop a number of alternative options rather than focus on single opportunities in isolation. Such options can then be filtered to determine which have the greatest likelihood of success. Focusing on the Market and Profitability Potential of each option is a good starting point, but in itself this can lead to disastrous results. Similarly, concentrating exclusively on risk can significantly limit the firm's growth potential.

This article formulates a two-prong framework which integrates Market and Profit Growth Potential with Risk. The growth options with the highest probability of success are graphically identified utilizing a four quadrant matrix. The framework can be easily aligned with customer, industry and market dynamics.

The framework guides leadership teams in evaluating the relative merits of alternative growth options. Once such a framework has been put into practice, the firm's success rate in undertaking subsequent growth options significantly increases by leveraging learning from prior experiences.

*The authors acknowledge the contribution of David Day in the preparation of this article.*

#### Footnotes

1. A previous article by Bill Liabotis, *Three Strategies for Achieving and Sustaining Growth*, Ivey Business Journal, July/August 2007 describes a process for identifying growth options and increasing the likelihood of successful implementation by strengthening the firm's infrastructure.
2. Ian MacMillan & Larry Selden's two articles, *The Incumbent's Advantage*, Harvard Business Review, October 2008 and *Managing Customer-Centric Innovation Systematically*, Harvard Business Review, April 2006 describe the growth option of creating value propositions based on leveraging relationship with core customers and sub-segmenting customer needs. Such an approach can be particularly effective during economic slowdowns.
3. Norman T. Sheehan's article, *Making risk pay: the board's role*, Journal of Business Strategy, Volume 30, Number 1, 2009 strongly endorses integrating the evaluation of growth options with risk assessment – "two sides of the same coin". The article indicates that at the board level, the integration of growth potential with risk assessment occurs less than 50% of the time and cites some consequences of failing to do so.
4. The dimensions for assessing risk level are adapted from the framework presented by Chris Zook in *Beyond the Core: Expanding your market without abandoning your roots*, Harvard Business School Press, 2004.
5. Cardinal Health's strategy is described in *How to Grow when Market's Don't* by Adrian Slywotzky, Richard Wise with Karl Weber, Warner Business Books, 2003.