

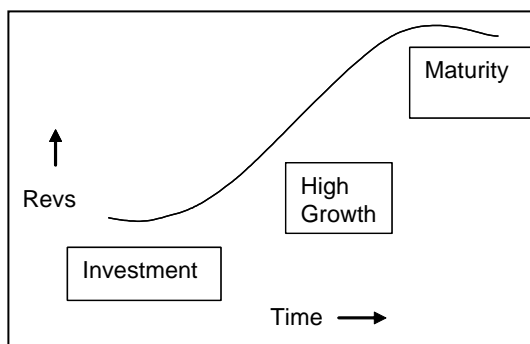
When Growth Companies Don't

By Jack Alexander

All companies will eventually experience some form of the famous “S curve” phenomenon. After a period of rapid growth, most experience a decline in revenue growth, if not revenue levels. In addition, as growth slows the company tends to generate and accumulate significant cash. Companies deal with this phenomenon in a variety of ways. What is best for shareholders?

Revenue growth is a key value driver. Companies with high revenue growth rates are afforded high multiples of earnings and revenues. In discounted cash flow and other economic valuation models, valuation will be very sensitive to the estimated revenue growth rate.

The Organization Life Cycle: S Curve



Many companies experience a period of rapid growth. This growth typically results from new product development, a distinct competitive advantage, or high market growth rates. Except in rare situations, this period of rapid growth is not sustainable over the long term. High growth is typically slowed by market saturation, competitive forces, obsolescence, or management missteps.

As high-growth companies approach the top of the high growth cycle, managers react in a number of different ways:

Denial: Many managers of high growth firms are the founders/entrepreneurs who are typically emotionally attached to the firm

and its offerings. Managers and investors place such an emphasis on growth, that it is often viewed as an admission of failure to accept lower growth rates.

In addition, some managers may have limited experience with other businesses, including exposure to the inevitability of the S curve phenomena. Consequently, some may not be fully aware of the key drivers that have provided historical growth, nor of the impending factors that will dampen future growth. As a result, they will often view any decrease in the growth rate as temporary, and continue to manage the organization based on historical growth patterns. As sales growth continues to slow, margins will decline due to excess investment levels and pricing pressures. Volatility in the company's stock will lead to a higher cost of capital/lower valuation multiples. Excess cash will be held, diluting key measures such as Return on Equity and Return on Invested Capital.

Invest to restore growth: Once accepting that a business may be maturing, many technology and other high-growth company managers attempt to restart the high growth by accelerating investments, often in areas outside the core business. These often involve applying the same technology to a different market. These investments are typically higher risk than the company's base business, often arising from entering unfamiliar markets with different customers and competitors.

One notable exception is Dell Computers. Dell has “refreshed” the S curve by successfully redefining their markets. Dell has successfully morphed from a PC supplier to an electronics distributor by leveraging its core competencies in supply chain management, distribution and customer fulfillment well beyond the original PC product line. This has substantially extended the period of high revenue growth for the company.

Acquire to grow: Facing declining growth rates and a strong bank balance, many of these former growth companies elect to return to growth through acquisition. Most acquisitions fail to create value for the acquiring company. The challenge is particularly difficult for former high-growth companies. Successful acquisition programs require a broad set of management skills, including strategic planning, financing, valuation, integration and organization development. The significant challenges presented by an acquisition continue well into the future as the management team must manage a more complex organization.

Evolve thinking: Some former growth companies, after evaluating the options above, choose to evolve their strategy and business model to succeed as a mature company. Many recognize that their companies may be more successful in the future as part of a larger organization, taking advantages of combined scale, market access and management competencies. Others recognize that while important, high revenue growth is not the only value driver. They reevaluate their business models and align investment levels with expected growth rates. More emphasis is placed on operational efficiency and capital utilization to improve margins and returns. Many will repurchase shares or begin paying dividends to return the cash that has been accumulated in excess of future needs. Some will focus on the firm's cost of capital and will introduce debt in the capital structure or work to reduce investor's perception of risk.

Managers of high-growth companies face many challenges. These challenges change as the company approaches the top of the growth curve. Shareholders and employees would be better served if managers anticipated and recognized these phenomena and considered a broad set of options. These options should be evaluated in the context of long-term shareholder value.

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