

TOOL KIT

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*Companies that know where their revenues really come from are as disciplined in managing growth as they are in managing costs.*

## Take Command of Your Growth

by Michael Treacy and Jim Sims

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The top line—like the Socratic life—demands examination. Total revenues tell a story of growth, sometimes happy, sometimes less so, but they do not tell the story of *how* a company grows. That knowledge abides in the distinctive wellsprings from which revenues emerge. We have developed a tool—the sources of revenue statement (SRS)—that reveals those origins and helps companies make the kinds of smart, targeted decisions that transform business performance.

Many companies treat cost cutting as a core competency: Ask senior managers to pare costs by 10%, and they know just what to do. Ask them to boost growth by 10%, however, and they're stymied. That's because management tends to draw a Serenity Prayer–like distinction between things it can and cannot change. Costs fall into the former category. Growth is in the latter.

But that presumption turns out to be misguided, as the SRS amply demonstrates. The tool emerged from our research into publicly

traded companies that achieved steady double-digit growth in revenues and gross profits from 1997 to 2002. Looking for the strategies and management disciplines behind those results, we interviewed senior management, reviewed the financial filings of the companies, and discussed their performance with Wall Street analysts.

Managers can influence growth, we discovered, if they possess the right diagnostic information about revenue sources. Unfortunately, that information is often unavailable to management teams, who are blinkered by the narrow perspective of traditional financial reports. Income statements generally sort revenues by geographic market, business unit, or product line, which is useful—as far as it goes. But managers not only must know where sales encourage or disappoint, they also must understand why and what to do about it.

For many companies, the top line is terra incognita. So like Livingstone seeking the headwaters of the Nile, we set out to discover the revenue sources to which all business growth

can be traced. Unlike Livingstone, we found what we were looking for.

We've identified five distinct sources of growth, all centered on customers and sorted not according to the way a company is organized but, rather, by the range of strategies open to it. Three sources stem from a company's core business: continuing sales to established customers (*base retention*), sales won from the competition (*share gain*), and new sales in an expanding market (*market positioning*). The other two lie outside the core: moves into *adjacent markets* where core capabilities can be leveraged and entirely *new lines of business* unrelated to the core.<sup>1</sup> The exhibit "Building Growth from Five Revenue Sources" traces one company's 20% revenue rise back to these origins.

The SRS, then, is an income statement that breaks out revenue by provenance. By tracking the amount of revenue coming from each source, the SRS helps managers take control of their revenue streams, diagnose problems, and spot opportunities for growth. Yes, it is helpful to know that sales in Germany are falling short, but it is *illuminating* to identify a problem in base retention. A company aware that it is exceeding its customary share of an expanding market can try to snatch even more sales from the competition.

The SRS is equally effective in evaluating how well an acquisition target might be used to gain market share, reap the spoils in a faster-growing segment, enter an adjacent market, or move into an entirely new line of business. Knowing which sources of revenue an acquisition can potentially enhance helps to clarify how it should be treated. Say share gain is the chief objective of the deal. If the acquiring company is focused solely on picking up customers at comparatively low cost, then the target company is best dismembered and digested. Firms eyeing an adjacent market, by contrast, must consider that market's attractiveness, the acquired company's position within it, and how the new business and the core will strengthen each other. In such cases, integration need not progress beyond taking management control and making the changes necessary for collaboration.

### Tally the Top Line

The SRS relies on a formula not much more complex than an old-fashioned income state-

ment; its calculations are clear and straightforward. Let's take a basic example of a company operating in a single market. The exhibit "Inside the Top Line" shows SRS calculations for a midsize payment services company. (We've called it Payment Services Incorporated and disguised some data for competitive purposes.) Here's how it calculates its SRS:

- Determine total revenue for the current year and the previous one. (Revenue for Payment Services totaled \$247 million in 2001, and it rose to \$272.2 million in 2002.)

- Determine the revenue gain or loss from entry into or exit from adjacent markets and new lines of business in the current year. Deduct those amounts from total revenue to determine revenue within the core business. (In FY 2002, Payment Services acquired a small company in a related market, which brought in \$11.2 million, leaving a core revenue of \$261 million.)

- Estimate the market growth rate for the current year. (The young electronic payment market grew at a healthy 17.4% clip.) Multiply that rate by the prior year's revenue to calculate the dollar growth attributable to market position (\$43 million). Subtract that amount from core business revenue to determine what the revenue would have been if there had been no market growth (\$218 million).

- Estimate the customer churn rate. (Payment Services found that to be 12.7%.) Multiply that by the prior year's revenue to calculate revenue churn (\$31.4 million). Deduct revenue churn from the prior year's revenue to calculate base retention revenue in the current year (\$215.6 million).

- The balance of growth revenue that is not attributable to base retention, market positioning, new lines of business, or moves into adjacent markets is revenue attributable to gross share gain (\$2.4 million).

Like tests for steroids, the SRS may cast seemingly strong performance in a new light. Payment Services' total annual revenues grew a little more than 10%—not bad on the face of it. But an examination of sources on the company's SRS reveals that customer churn slashed revenues by more than 12%. The company had to find more than \$31 million in new revenues to compensate for customers walking out the door. Those defections cut sharply into overall growth.

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Furthermore, the company can ascribe the largest portion of its growth to an expanding market, which contributed \$43 million to total revenue. Yet the company grew more slowly than the market overall, ceding share to competitors. Adjacent market growth resulting from the acquisition was the second largest source of revenue.

Should the company be satisfied with those results? Yes and no. Its position in a fast-growing market raised revenues 17.4%. That bodes well. And management is doubtless pleased with the \$11.2 million generated in the adjacent market, although it's early days to pass judgment on the wisdom of that acquisition. More troubling are the paltry gross share gains of 1%, which didn't begin to make up for customer churn of 12.7%. The net share gain was actually negative—an 11.7% loss of share. That's alarming: It suggests that the company's value proposition has lost its allure. (Problems with base retention and share gain both generally arise from problems with a company's basic value proposition.) In sum, those superficially blue skies look cloudy, with a chance of rain.

**See the Trees for the Forest**

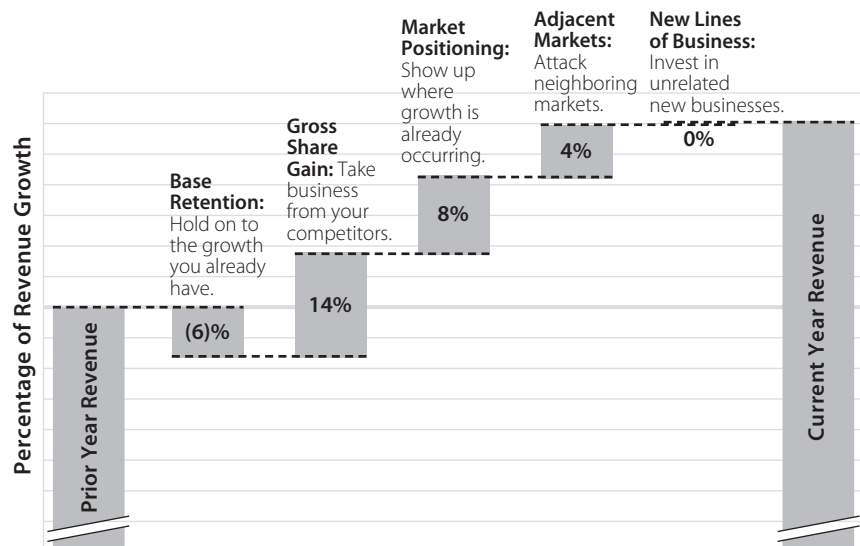
Such insights, and hundreds like them, are

the missing links in what passes for growth management. The focus on net share gain obscures its components—customer churn and gross share gains—and, by extension, both deeper problems and opportunities for improvement. It is possible to track churn rates, but too often they remain unknown, making it difficult to judge how to balance investments in customer retention with those in new-customer acquisition. Companies rarely measure market gain, even though the insight earned by doing so might spur them to upgrade their offerings in higher growth segments. Reporting adjacent market growth together with base business results further fogs the picture. The SRS makes such distinctions possible and in the process hands managers an accurate map from which to correct the company's course.

SRS calculations rely on estimates of customer churn and market growth rates. For some industries, those data are publicly available. According to Wall Street estimates, for example, the wireless phone company Nextel churned through 22% of its customer base in 2002 (a strong performance for that industry). Those analysts further surmise that the overall market for wireless services grew about 14% last year. Combining this information with fi-

**Building Growth from Five Revenue Sources**

*How one company built 20% revenue growth.*



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financial statements contained in Nextel's 10-k filings lets us compute the company's SRS, shown in the exhibit "The Challenge of Churn."

Nextel's SRS illustrates the hazards of the wireless phone business. Because it retains only about three-quarters of its customers in any one year, the company must invest considerable time and money to attract replacements. The bad news is that losses from customer churn (22%) outweighed all the gains in gross market share (21.4%). The good news is that the market continues to grow strongly. Thus, Nextel gets a big revenue boost (14%) just by showing up and winning its fair share.

And what happens when market growth fades, as fade it must? The SRS also provides Nextel with guidance for raising its own boat regardless of the state of the tide. For example, better tactics to strengthen base retention could pay huge dividends. As the incumbent wireless service provider for these customers, Nextel holds three advantages over competitors. First, it must necessarily have more information about its own customers and their usage patterns than its competitors would, and it can use that information to improve the value proposition it offers current customers.

Second, because it has those people's attention, it can influence their perceptions of various features and services. The final advantage is economic: Customers incur a switching cost to change suppliers. Nextel must use those natural advantages to maintain superior customer value so it can corral more people within its retained base year after year.

As for new customers, Nextel is racking them up. The challenge is to do so at lower cost every year. Revenue from market growth is predicted to decline as the market for wireless services saturates. Nextel needs to identify new growth opportunities within the wireless market before its rivals do, get established in those segments early, and deliver a patently better value proposition to new customers. Only by tracking revenues earned from share gain separately from those arising from market position can it begin to manage this difficult transition.

To further cushion the blow of declining market growth, Nextel may want to establish new revenue streams in adjacent markets, as mobile phone vendors did by moving into the pager market in the late 1990s, much to the chagrin of the incumbents there. The pager industry might still be vibrant today had compa-

## Inside the Top Line

*How an electronic payment company did the calculations for its sources of revenue statement (SRS).*

*(figures are in \$ millions)*

	FY 2001	FY 2002	% of FY 2001 Revenue
Total	\$247.0	\$272.2	110%
Adjacent Market Revenue		11.2	5%
New Line of Business Revenue		0	
Revenue from Core Business		261.0	106%
Market Growth Rate		17.4%	
Revenue from Market Growth (Market Positioning Revenue)		43.0	17.4%
Revenue Net of Market Growth		218.0	88.3%
Customer Churn Rate		12.7%	
Revenue Lost to Churn		(31.4)	
Base Retention Revenue		215.6	87.3%
Revenue Growth from Share Gain (Gross Share Gain Revenue)		2.4	1.0%

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nies in it sought new beachheads for their core capabilities in other adjacent markets—such as low-cost data networking that could support everything from smart soft-drink vending machines to new services for delivering customized real-time information.

Unfortunately, most industries don't produce reliable data on churn and market growth. But with just a little work, companies can develop surprisingly accurate assessments of those rates. Even crude estimates, so long as they are directionally correct, often yield valuable insights about the sources of revenue growth. (See the sidebar "First, Get the Numbers.")

### Exploit the Power of Divisions

Even finer-grained analysis is feasible in large companies comprising several business units, each with its own revenue stream. Armed with reasonable estimates of customer churn and market growth rates, senior managers can create SRSs for business units, product lines, geographic markets, and the like. In fact, the tool's ability to identify variances in revenue sources from one unit to another is what makes it so powerfully diagnostic.

We worked with one medical supply business that built an SRS for the corporation and one for each of its product divisions. The data, slightly altered for proprietary reasons, are

summarized in the exhibit "A Table of Elements."

Corporate-level analysis reveals that the chief growth drivers were \$7.5 million from moves into adjacent markets and \$4.5 million from new lines of business. In addition, the company's core markets expanded at a healthy annual 5.8% clip, adding \$10 million in revenues. But clearly, the company needs to work on its value proposition and effectiveness in selling against competitors. Market share declined, as the medical supplier lost more revenues from defecting customers (-16.5%) than it earned from new ones (11.1%). In fact, customer churn drained \$28.4 million of revenue and, had it not lost these customers' business, the growth rate would have tripled. Retaining more base customers would appear to be paramount.

But the divisions'-eye view tells a more complicated story:

- Division I contributed most of the company's revenue gain without achieving any substantial market share gain. Its very high base-retention rate, coupled with strong market growth, assured its performance. It also made inroads into an adjacent market that will expand its growth horizons.
- Division II's revenues have sunk, but management appears to have done its best. The division gained substantial gross share (up more

## The Challenge of Churn

Where Nextel's FY 2001 revenues came from.

Nextel's 13.4% total annual growth rate is lower than the rate at which its market grew (14%); that's because all the inroads it made against competitors were wiped out by revenue lost to customer churn.

(figures are in \$ millions)

		% of Prior Year's Revenue
Prior Year Revenue	\$7,689.0	
Revenue Lost to Churn	(1,692.0)	22.0%
Base Retention Revenue	5,997.0	78.0%
Gross Share Gain Revenue	1,648.0	21.4%
Market Positioning Revenue	1,076.0	14.0%
Adjacent Market Revenue	0.0	0.0%
New Line of Business Revenue	0.0	0.0%
Current Year Revenue	\$8,721.0	113.4%

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than 20%) at the expense of competitors, indicating a strong customer value proposition. Too bad that gain has been more than wiped out by a 12% customer churn rate and a 12% drop in the overall market. This division should focus on stanching base-customer losses, but it should also stake out the segments of its diminishing market with the most growth potential.

- Division III's modest growth of 3.8% masks an alarming performance. Net market share declined precipitously—by 24.5%—in a market that grew more than 18% in the past year. This divisional management team is squandering a huge growth opportunity.

- Division IV achieved impressive gross market share gains that were wiped out by 20% customer churn. The overall effect was a small decline in net market share. Reducing that churn rate will pay big dividends in this modestly growing market.

The SRS data reveal that Division III, although growing, is wasting a larger opportunity. Division II, meanwhile, is fighting the good fight in a rapidly deteriorating situation. The other two divisions confront mirror-image challenges of base retention, share gain, and market positioning. Had managers focused only on total revenue, they would have missed those important conclusions.

### Build In Stretch

The SRS is not merely an instrument for diagnosing present performance but also a tool for planning future growth. One hotel property company we've worked with is using it to set multiyear targets for its properties. Like most companies in this industry, this business confronted a sharp fall in overall market demand after the terrorist attacks: 18% in 2001, another 6% in 2002, and 8% more in 2003.

## First, Get the Numbers

Companies have been measuring costs for more than a century—plenty of time to develop an array of reliable data sources. But businesses are nowhere near as proficient at producing data on market growth and customer churn, which are needed to calculate sources of revenue statements (SRSs). Fortunately, even an SRS based on guesstimates of churn and market growth rates provides far more value than traditional reports. In addition, companies can begin with rough numbers and then iteratively improve their estimates of churn and market growth, producing ever more accurate SRSs as a result.

Here's how to do it.

Let's start with some definitions. *Market growth* is the rate of growth in demand—expressed in dollars—of an entire market. It is best computed by estimating the growth rate of each market segment and then calculating the weighted average growth rate of all the segments across the entire market. **If a company shifts its mix of revenue toward higher growth market segments, its market growth rate will rise.** Thus, market growth rates can be actively managed.

*Customer churn* is the weighted average rate of customer defections to competitors. In its simplest form, customers do business

frequently and exclusively with one supplier—the model for the consumer wireless industry. In that case, churn is the rate at which customers cancel their accounts in favor of another supplier, adjusted for the size of those accounts. (Customer churn should not be confused with negative market growth, in which customers withdraw from the market altogether rather than just switch suppliers.)

The calculation gets trickier when a customer uses several suppliers at once. In that case, customer churn is the weighted average loss of a company's "share of wallet" for those customers. When share of wallet increases, churn is zero, and the growth, of course, counts as share gain.

For markets—such as automobiles—in which purchases typically occur only once every few years, there is churn whenever the customer chooses a brand different from the one chosen the time before. Straightforward enough. But there are complications. For example, across the entire U.S. auto market, only about 44% of consumers buy the same brand of vehicle twice in a row. Another 11%, however, choose a different brand from the same automaker. Thus, churn is either 45% or 56%, depending on whether the supplier views its sister divisions as competitors.

Several independent firms reliably track market growth and customer churn for the automotive sector. Companies in most other industries must compile their own numbers by collecting data from customers—a non-trivial task in terms of time and effort. There are several ways to go about it. One East Coast building materials distributor, for example, began collecting data on housing starts of its customers (who are home builders). It then created a simple model that translates monthly housing starts into demand for building materials. By matching those data with its sales to those customers, the distributor was able to determine changes in share of wallet, churn, and market growth.

A large computer hardware manufacturer, by contrast, employs an independent research firm to survey samples of customers every month about their total hardware purchases and brand selection. It then uses those data to estimate market growth and customer churn for each of its products and geographic segments. Many other firms use less formal sampling techniques to develop reasonably accurate estimates of market segment growth and customer churn rates.



After examining industry forecasts and regional data, hotel management teams concluded that demand in 2005 would rebound only to 2002 levels. They had given little thought to initiatives that might change the writing on that wall.

Having made the acquaintance of the SRS, these managers began using it to set stretch growth targets for each revenue source and to develop tactics for reaching those targets. The exhibit, "Growth Gauge" illustrates the revenue plan for one of the company's properties as of January 2003.

Customer churn spiked in 2002 for both the

company and the industry, as competitors fought one another to fill rooms. Aggressive price and promotional competition caused most of the decline in base retention. In response, the management team of this particular hotel developed more than two dozen tactics to coax base retention back to its historical 70% rate and then improve it year after year. By building a base retention stretch objective into its plans and monitoring performance month to month, the team brought focus and energy to a troubling source of revenue loss.

As base retention declined in 2002, managers balanced those losses with new-client ac-

## A Table of Elements

*How the sources of, and opportunities for, revenue differ in the divisions of a medical supply company.*

This company appears to be losing customers in a slow-growing (5.8%) market. But that's an oversimplification that masks different challenges for each of its divisions. Division III, for instance, is failing to take advantage of a fast-growing (18.7%) market, whereas Division I is growing faster than its market by holding on to much of its customer base and making successful forays into adjacent markets.

(figures are in \$ millions)

	Total Company		Division I		Division II		Division III		Division IV	
Prior Year Revenue	\$172.6		\$41.3		\$52.1		\$62.4		\$16.8	
Revenue Lost to Churn	(28.4)	-16.5%	(0.8)	-1.9%	(6.3)	-12.1%	(18.0)	-28.8%	(3.4)	-20.2%
Base Retention Revenue	144.2	83.5%	40.5	98.1%	45.8	87.9%	44.4	71.2%	13.4	79.8%
Gross Share Gain Revenue	19.2	11.1%	2.4	5.8%	10.9	20.9%	2.7	4.3%	3.2	19.0%
Market Positioning Revenue	10.0	5.8%	4.3	10.4%	(6.3)	-12.1%	11.7	18.7%	0.3	1.8%
Adjacent Market Revenue	7.5	4.3%	1.5	3.6%	0.0	0.0%	6.0	9.6%	0.0	0.0%
New Line of Business Revenue	4.5	2.6%	0.0	0.0%	0.0	0.0%	0.0	0.0%	0.0	0.0%
Current Year Revenue	\$185.4	107.4%	\$48.7	117.9%	\$50.4	96.7%	\$64.8	103.8%	\$16.9	100.6%

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## Growth Gauge

*How one hotel traced its sources of revenue over time to set stretch goals for future years.*

By tracing this company's revenue sources for the past three years, managers learned that they needed to focus on customer retention and moves into adjacent markets to beat projections of slowing market growth through 2006.

(figures are in \$ millions)

	2001		2002		2003		2004		2005		2006	
Prior Year Revenue	\$38.2		\$32.8		\$31.7		\$34.1		\$38.0		\$42.1	
Revenue Lost to Churn	(11.3)	-30%	(12.2)	-37%	(9.5)	-30%	(10.2)	-30%	(10.3)	-27%	(10.5)	-25%
Base Retention Revenue	26.9	70%	20.6	63%	22.2	70%	23.9	70%	27.7	73%	31.6	75%
Gross Share Gain Revenue	12.9	34%	13.1	40%	14.3	45%	13.4	39%	12.3	32%	13.3	31%
Market Positioning Revenue	(7.0)	-18%	(2.0)	-6%	(2.4)	-8%	0.7	2%	1.5	4%	1.7	4%
Adjacent Market Revenue	0	0%	0	0%	0	0%	0	0%	0.6	2%	1.1	3%
New Line of Business Revenue	0	0%	0	0%	0	0%	0	0%	0	0%	0	0%
Current Year Revenue	\$32.8	86%	\$31.7	97%	\$34.1	108%	\$38.0	111%	\$42.1	111%	\$47.7	113%

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quisitions, causing a share gain spike in 2002 and 2003. Although it experimented with aggressive tactics and planned more of the same for the following year, the team deemed it prudent to reduce its stretch target for share gain after 2003, and setting the level became a negotiating point with upper management.

The travel slump had also scotched plans to dip a toe in adjacent markets. Before September 11, the team had been eyeing off-premises catering, corporate concierge services, even a membership-oriented fitness center. Empty rooms had meant lack of access to capital, rendering adjacent markets unbreachable.


The SRS changed all that. By looking at each revenue source separately, the team could identify appropriate stretch targets and develop practical tactics to achieve them. The managers gained confidence in their ability to deliver growth in the core hotel business and set aside capital for one foray into an adjacent market. The revenue goal for the adjacent market investment is \$600,000 in 2005, the first year of operation.

The SRS also enriched the conversation between the hotel's property management team and the parent company's senior management. Enlightened through the revenue source data about issues limiting growth, senior manage-

ment could better apply its experience and judgment to negotiating aggressive—but not excessive—revenue targets with the team managing the property. Finally, the SRS led to a new reporting-and-control system that measures the impact of each tactic on the revenue source at which it is directed.

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Hundreds of companies are perched atop enormous potential that they don't exploit because they can't see it. The SRS can endow them with sight and, more important, with understanding. Once these businesses master revenue growth, the effect on their overall growth may be phenomenal.

Seekers of truth are routinely enjoined to go to the source. Executives seeking to make the best decisions about managing revenue growth should do the same. 

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1. A sixth source—pricing—comes into play for businesses in markets that exhibit meaningful price fluctuations, such as those for commodities, and in industries beset by significant inflation or deflation, such as those for computer memory chips.

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