L.E.K.

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Achieving Strategic Market Position to Create Shareholder Value

The ultimate task of the senior corporate decision maker is to create value for the company's shareholders.

Research conducted by L.E.K. Consulting, combined with experience gained from hundreds of client engagements, suggests that one of the most effective ways to create value is to understand and build what L.E.K. calls "Strategic Market Position," or SMP.

For a business or product line that competes in only one strategic segment, SMP is simply the market share of the business in its strategic market segment. For a company competing in multiple strategic segments, its overall SMP is the average of its SMPs in each strategic segment, weighted by the business's sales or investment in each strategic segment.

Achieving effective SMP involves analyzing an industry to determine strategic market segments and then making investments in those segments that will lead to increased returns. In other words, putting corporate assets where they are likely to be most productive and minimizing their use in less productive sectors. This issue of *Executive Insights* summarizes how leading companies create – and profit from – SMP.

Unequal Performance

An L.E.K. Consulting/*Wall Street Journal* study of shareholder value for 1,000 leading U.S. public companies during a recent five-year period revealed something very interesting. In almost every sector, the top-performing company was not 5% or 10% better than the worst performer; it was actually 200%, 300%, sometimes even 1,000% better.[1]

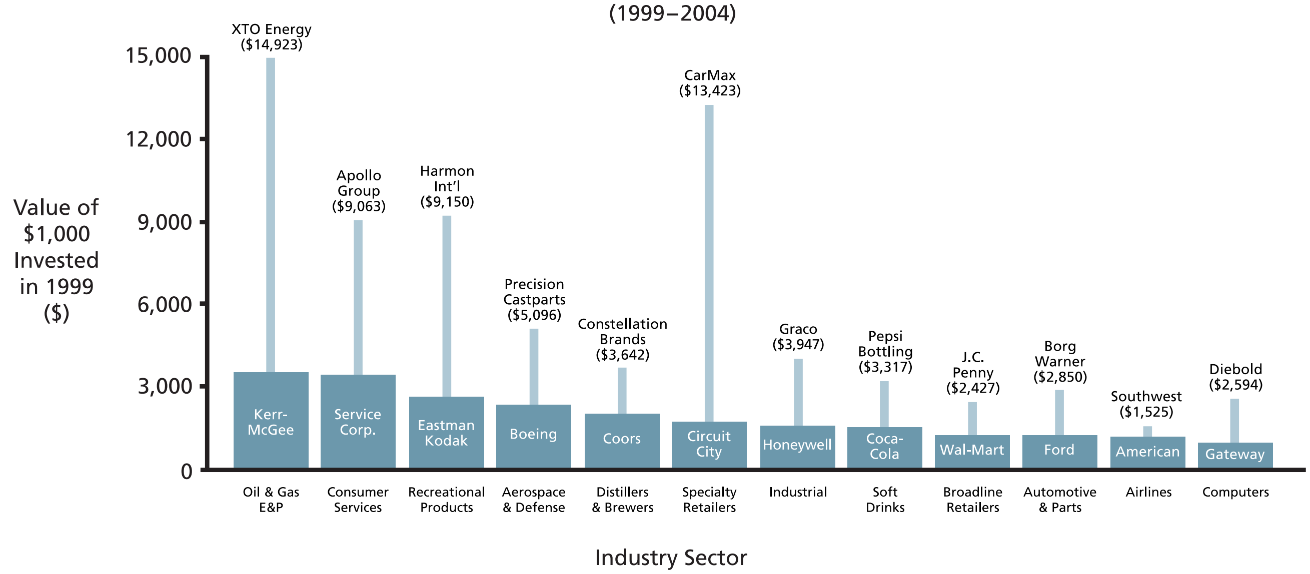
Consider an aggregate summary of this finding, with an eye toward the return on a $1,000 investment made in 1999: As Figure 1 illustrates, performance within an industry sector varies enormously. To cite one of the more dramatic examples, a $1,000 investment in specialty retailer CarMax in 1999 would have been worth more than $13,000 five years later; the same $1,000 investment in Circuit City would have been "below water" after the same five years. One should bear in mind that these are "top 1,000" companies, run by some of America's most experienced and skilled managers. What explains these huge differences in performance within a given sector? A major part of the difference comes from companies' respective choices about where and how to grow.

The more successful companies understand the importance of correctly assessing and achieving increased scale and market share and how they can build their competitive strength and thereby increase shareholder returns. In short, they achieve effective Strategic Market Position, or SMP.

Achieving Strategic Market Position to Create Shareholder Value was written by **Stuart Jackson,** Vice President in L.E.K.'s Chicago office, and author of *Where Value Hides*, an in-depth exploration of the concept of SMP. Please contact L.E.K. at finance@lek.com for additional information.

Figure 1

Variations in Performance for U.S. Top 1,000 Companies and Sectors (1999–2004)



SMP≠ Market Segmentation

The most common version of market positioning is the familiar process of market segmentation. This is a marketing technique. It involves breaking down a market into smaller segments in order to 1) better understand consumer behavior and 2) identify opportunities to increase overall market share. Strategic Market Positioning is different because it brings together the disciplines of strategy and finance to help shape a company's approach to value creation.

Organizations that fail to differentiate between market segmentation and Strategic Market Position may be at risk because the definition of market share often does not correlate with company profitability, returns and strategic potential. The SMP definition of market share, however, is strongly correlated with financial performance and value creation.

It is therefore critical to develop an appropriate definition of "market share" when applying SMP – a definition that captures the real drivers determining the economics of a particular industry or business.

This may sound elementary, but – in our experience – it actually is not that simple. Does market share mean share of product, share of category, share of channel, share of customer, share of region or share of something else? Companies that cannot answer this very important question cannot effectively engage in SMP, and, in the long term, will find it difficult to invest successfully for growth.

In addition to defining market share precisely and accurately, it is critical to understand the impact of different approaches to growing market share. Traditional strategic thinking would argue that bigger is better – that increased overall market share is better almost regardless of what the company has to do to achieve it. Our research and experience show, however, that this is not always the most effective approach. For example, a reasonably large player in a given industry may earn an average 7% return on $300 million in sales. A significantly smaller player, by contrast, may perform far better: earning, say, a 14% return on $150 million in sales.

1. "Shareholder Scoreboard," The Wall Street Journal. February 28, 2005.

In other words,the company that is half as big makes twice as much, on a percentage basis. There are several possible explanations for this difference. The smaller, more profitable company may avoid going head-to-head with larger, more powerful competitors. It may deploy its investments into segments where (among other things) the dominant players simply do not compete. In essence, it positions itself in its industry strategically and allocates more assets in fewer, carefully selected ways. As a result, it has a much higher market share in its chosen segments.

Creating Value through Strategic Market Positioning

SMP can be summarized in the following three-step action plan. Although plans will vary depending on a company's specific circumstances, a typical plan would include these three major activities:

1. Be creative and cast a broad net. To maximize the chances of identifying successful strategies, think beyond the current business offerings. Evaluate other businesses that share the same customers or leverage the same technologies. Consider service as well as product offerings. Identify the range of organic or acquisition initiatives that could be used to pursue potential growth strategies.

2. Apply the SMP test. Identify the growth strategies that have the greatest potential to increase the company's weighted average relative market share, as measured across all strategic segments impacted by the strategy. This will identify strategies that have the potential to improve the company's overall position on the most important drivers of profitability. Apply the SMP test quantitatively to specific initiatives to see whether market share, appropriately defined, increases or decreases.

3. Apply the value creation test. "Strategic value" is defined as the net present value of cash flow from higher revenues, lower costs, and lower capital requirements that will accrue from the growth opportunity and the existing business being run together versus separately.

If the strategic segmentation and value creation tests have both been performed correctly, the most attractive options should come out on top using both methods.

To explain in greater detail how SMP works, consider examples of competitors in two widely different sectors: the airline and the health club industries.

Southwest & America West. Southwest Airlines & America West Airlines started in roughly the same position but ended in very different places. Both formed as low-cost, low-fare regional carriers. Although Southwest's first flight took off 12 years before that of America West,[2] both airlines grew their operations and profits on roughly parallel tracks through the early 1990s.[3]

America West followed a traditional hub-and-spoke design for its flights and became well known for its expansionist strategy. Southwest, on the other hand, grew at a slower pace, taking the time to build up strong positions in specific markets before penetrating additional markets. Southwest's emerging strategy was creative in that it focused on short-haul, high-frequency flights in city pairs where the airline could secure a strong market share position, often flying to a secondary, lower-cost airport. In addition, its costs were controlled as a result of the corporate decision to use (and therefore maintain) only one type of aircraft: the Boeing 737.[4]

2. www.southwest.com, Southwest website

3. Bloomberg

4. "Southwest Airlines 2005," Thunderbird, *The Garvin School of International Management, from Department of Transportation*

By contrast, America West's expansionist strategy called for international routes, which in turn called for a heterogeneous and expensive-to-maintain fleet. Table 1 summarizes the two airlines' positions and strategies in 1990.

Table 1

Summary Statistics (1990)	Southwest	America West
Revenue	$1,186M	$1,315M
Number of Aircraft	106	104
Types of Aircraft	1	4
Flight Design	Point-to-point short haul	Hub and spoke

Source: *Thunderbird*, The Garvin School of International Management, from Department of Transportation, Bloomberg

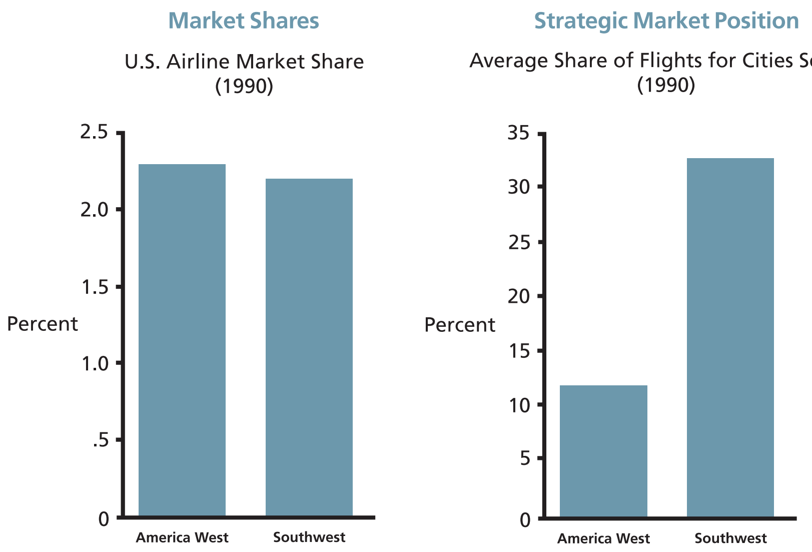
America West did not base its strategy on the core tenet of SMP: Build the type of market share that maximizes high-impact growth and leverages economies to the greatest extent possible. Figure 2 compares the two airlines in terms of traditional market share and strategic market position to reveal the true impact of their different strategies.

First consider overall market share. This is the measure that is most often considered relevant. Unfortunately, it is not a terribly helpful measure when analyzing and developing growth strategies. Although America West and Southwest had similar U.S. total market shares in 1990, this measure obscures their relative competitive strengths.

In the airline business, pricing power and operating costs are driven more by share of flights between states or, more precisely, by share of flights between specific city pairs. Travelers prefer to fly an airline that has several daily flights between two points because it gives them more flexibility in the event of a missed or delayed flight. This is better for airlines because they are likely to have larger-scale and more efficient operations at each end.

Figure 2

American West vs. Southwest



Source: Bloomberg, Investext, Annual Reports, OAG Flight Guide, L.E.K. Interviews, L.E.K. Analysis

critical factor and was careful to enter a new market only when it felt it could achieve substantial strategic share in that market. By contrast, America West assumed that, by entering larger and increasingly international markets, it was strengthening its overall position in the airline market. In fact, it was neglecting its core franchise and spending limited resources to enter new market segments where it had little to offer against strong competitors.

The financial outcomes that resulted, in part from these very different strategies, are striking, as **Figure 3** illustrates.

Since America West's emergence from Chapter 11 in 1994, its stock has declined at a CAGR of -4.9%, while Southwest's stock has grown at a CAGR of 9.9%.[5]

To be sure, Southwest is an excellent operator, which has helped to drive its growth. Superior operations, however, have far more impact when they advance a strategy based on the principles of SMP.

5. Bloomberg

Bally Total Fitness & Town Sports International Holdings

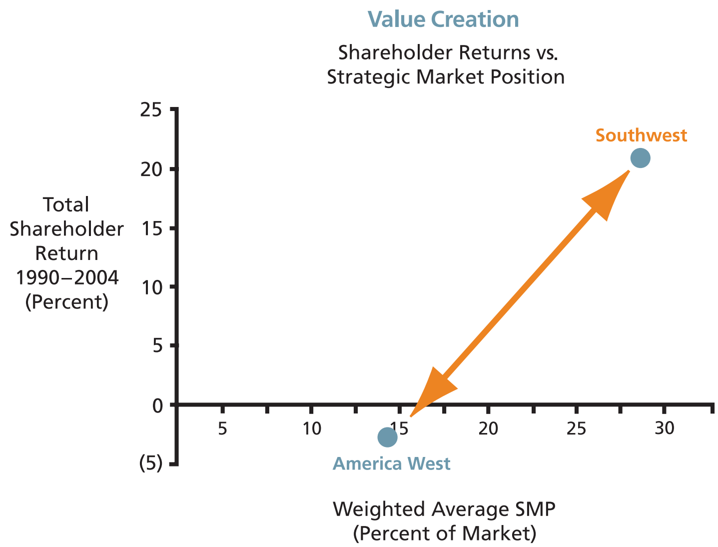
The previous example illustrates the power of SMP from a retrospective view. To understand how to look forward and uncover value through the SMP lens, consider a very different context: the health club industry. If one competes in this industry, and a key goal is to understand and improve SMP, what is the most effective approach?

Table 2 summarizes basic financials for four different growth strategies in the health club sector. Assume that, in this industry, revenue and expense items in the column entitled "Club Details" are the critical drivers in this business. The question to answer is *What happens along each of these key dimensions as one goes up in organizational scale?*

In the case of a single club in this example, salaries account for 25% of revenues, and rent constitutes another 15%, while advertising and marketing make up just over 11% of total revenues. Add in depreciation, other expenses, and then overhead to operate the business as a whole, and it is clear that, in the case of a single club, this is a difficult business. Very few stand-alone clubs approach a 5% operating margin.

Figure 3

American West vs. Southwest



Consider how that changes if one operates five clubs, all within the same city. This scale of operation will require five times as many fitness instructors, five times as many receptionists, etc., and most likely is going to pay five times the rent. Other expenses, such as laundry and cleaning services, are also going to increase in proportion to revenue. Consequently, little advantage is gained within these expense categories.

Advertising and marketing, though, is a different matter. One can leverage advertising costs across multiple locations, which has the effect of reducing costs as a percent of revenue by something over a third in this example. In addition, some improvement in depreciation is likely, because the cost of purchasing five times the equipment allows for more aggressive negotiations with suppliers.

Table 2

	Single		Local (5 locations)		Regional (30 locations)		National (150 locations)	
Club Details	000s	% of Rev	000s	% of Rev	000s	% of Rev	000s	% of Rev
Revenue ('000)	$1,350	100%	$6,750	100%	$40,500	100%	$202,500	100%
Salaries	$337	25%	$1,688	25%	$10,125	25%	$50,625	25%
Rent	$200	15%	$1,000	15%	$6,000	15%	$30,000	15%
Adv & Mktg	$150	11%	$450	7%	$1,575	4%	$7,875	4%
Depreciation	$86	6%	$407	6%	$2,314	6%	$11,250	6%
Other Exp	$202	15%	$1,012	15%	$6,075	15%	$30,375	15%
Total Op Exp	$975	72%	$4,557	68%	$26,089	64%	$130,125	64%
Overhead	$338	25%	$1,321	20%	$6,038	15%	$30,188	15%
EBT	**$37**	**3%**	**$872**	**13%**	**$8,373**	**21%**	**$42,187**	**21%**

Source: L.E.K. Analysis

Overhead, too, should show improvement. Whereas a single operation requires only one general manager, a five-location organization can be structured with one senior general manager who oversees the clubs, with a more junior supervisor at each location, resulting in cost savings. Similarly, this structure allows a single individual each to be responsible for HR issues, recruitment, etc. Running a five-location operation – provided those locations are all within a single city – versus a stand-alone operation reduces overhead by roughly 20% and will likely result in low double-digit profitability.

One level up in terms of scale is the regional player. Assume this is an organization with 30 locations that are all within a closely packed geographic region. How are costs impacted in this scenario? Again, salaries, rent, and other expenses are likely to remain constant in proportion to revenue, resulting in insignificant real benefits. Further economies in advertising and marketing may be possible, allowing for media insertions in radio and TV, or in larger newspapers, which might not be possible at a smaller scale. One can probably further leverage overhead, in terms supervisory staffing. As a result, profitability increases from low double digits to something closer to 20% or more.

Finally, consider a national operation with 150 locations concentrated within five regions. What impact does this scale have on the economics of the business? There will be minimal improvement in advertising and marketing benefits, because media insertions will be purchased across different media markets. Furthermore, little additional benefit from depreciation is available. Extra discounts from suppliers may be possible; but, with 30 locations as a regional player, excellent discounts are already in place. In terms of overhead, it is not terribly reasonable to expect that a manager based in Chicago will be effectively positioned to oversee an operation that is on the West Coast or in the Southeast. Regional overhead, therefore, will need to be replicated.

In summary, when shifting from being a regional player to a concentrated national player, *one remains profitable, but profitability does not increase significantly.* This assumes that shifting from a regional to a national scale is achieved by growing a number of strong regions, which can drive excellent economics.

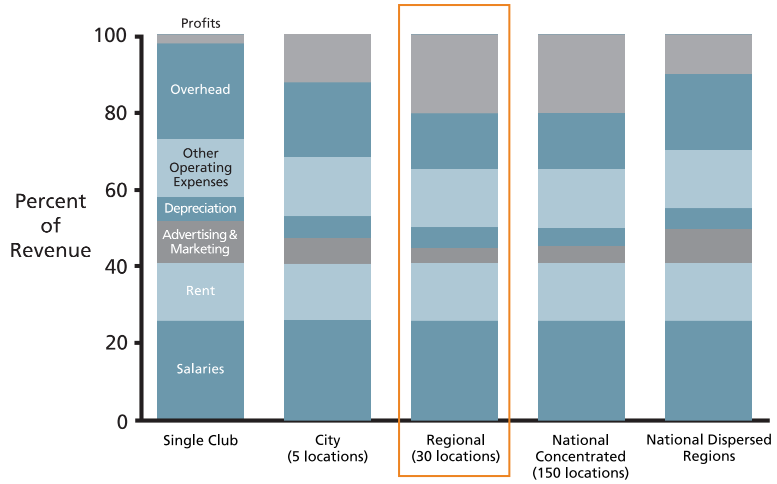
By comparison, a dispersed national scale operation with 150 facilities that are distributed across 20 or 30 states may not substantially increase value and may, in fact, destroy it. In terms of advertising and marketing, the same economies possible at the regional and concentrated national levels are unavailable because media is purchased across many more markets. Overhead savings are limited because, again, managers must be located across several regions. Depreciation from more effective equipment-buying may generate some benefits; but, as noted above, those savings are limited because the company is already down the discount curve once it has reached the regional level.

The economics for a dispersed national player, therefore, are substantially worse than those for a strong regional player. Figure 4 illustrates the comparative economics of the scenarios described above.

The goal, of course, is to grow the "profit" segment (at the top of each bar in Figure 4) to the greatest extent possible. Note how the economics of the "Regional" (i.e.,30 locations) bar

Figure 4

Health Club Economics



are almost identical to "National Concentrated" (i.e.,150 locations).

To see how this can play out with real companies, consider Bally Total Fitness, an operation with more than 400 health club locations and $800 million in annual revenues.[6] Bally began as a tennis and health club in 1962 and grew to become the largest publicly held health-club operator in the U.S.[7]

Like Bally, Town Sports International Holdings, Inc. (TSI), has been in business for more than 30 years. With annual revenues of $365 million, it is one of the leading operators of fitness clubs in the Northeast and Mid-Atlantic regions of the US.[8] TSI is known by its many regional brands: New York Sports Clubs, Boston Sports Clubs, Washington Sports Clubs and Philadelphia Sports Clubs. Table 3 compares the number of locations for Bally and TSI as of this writing.

Table 3

	Number of Clubs	
Metro Area	**Bally Total Fitness**	**Town Sports International**
NYC	36	89
Boston	12	19
Washington, D.C.	8	20
Rest of U.S.	308	11
Total	364	139

Source: Company websites

Bally pursued a national strategy that did not focus on specific regions. Its strategy resembles the fifth column of Figure 4, making it difficult to realize strong returns from its overall scale. TSI's strategy, by contrast, focuses on the regional scale: only 11 of the company's 139 facilities are outside its top three metropolitan markets. Its strategy is best reflected by the fourth column in Figure 4. TSI refers to this strategy as "regional clustering":

A regional clustering strategy [is] designed to maximize revenues and achieve economies of scale. We believe our regional clustering strategy allows us to maximize revenue and earnings growth by providing high-quality, conveniently located fitness facilities on a cost-effective basis while making it more difficult for potential new entrants into our markets.[9]

Unlike Bally's, TSI's growth plan incorporated the three sub-strategies of SMP; the approach was creative in that it did not follow the standard model of broad national expansion and instead concentrated on regional development. The result has been an increase in the company's weighted average relative market share as well as higher net present value of cash flows from higher revenues, lower costs, and lower capital requirements.

TSI's regional clustering strategy has had a powerful and positive impact on company profitability, producing operating margins at least 50% higher than Bally's.

Conclusion

Strategic market positioning (SMP) is a proven and highly effective tool for creating value. It is founded on the assumption that not all growth is good – in fact, that some growth actually destroys value. SMP helps companies identify the difference and respond accordingly. By being creative and casting a broad net to maximize the chances of identifying successful strategies, and by applying the SMP and value-creation tests, an organization's leadership can gain valuable insight into organic growth, acquisitions, and other growth investments and be better able to formulate strategies that have the potential to improve the company's overall performance.

6. Bally's-related financial information is from Business Wire and Bloomberg. Also useful is "Bally Total Fitness," Harvard Business School Case #9-706-450

7. See the Bally's entry in Wikipedia at en.wikipedia.org/wiki/Bally_Total_Fitness.

8. Town Sports International Holdings, Inc. S1, July 6, 2005

9. Town Sports International Holdings, Inc. S1, July 6, 2005

L.E.K. Consulting is a global management consulting firm that uses deep industry expertise and analytical rigor to help clients solve their most critical business problems. Founded more than 25 years ago, L.E.K. employs more than 900 professionals in 20 offices across Europe, the Americas and Asia-Pacific. L.E.K. advises and supports global companies that are leaders in their industries – including the largest private and public sector organizations, private equity firms and emerging entrepreneurial businesses. L.E.K. helps business leaders consistently make better decisions, deliver improved business performance and create greater shareholder returns. For more information, go to www.lek.com.

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