



# THE PREREQUISITES OF PROFITABLE ADJACENT GROWTH

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**A**DJACENT GROWTH IS A hallmark of innovation leaders. Recurring members of BCG's annual list of the 50 most innovative companies—3M, General Electric, and Procter & Gamble, for example—have long succeeded by developing new products in nearby markets that lead to incremental profitable growth. Younger, tech-based innovators such as Apple, Amazon, and Google have aggressively followed a similar strategy.

They've done so for good reasons. As markets mature and competition increases, growth in the core portfolio inevitably slows. Introducing new products means going up against entrenched competition, and even companies that innovate successfully in existing markets often end up cannibalizing sales of their own brands. Adjacencies help innovative companies open new ave-

nues for growth through exposure to markets in which they benefit from 100% of the share that they achieve.

Adjacent growth is sound strategy, but there's a hitch: it's difficult for most mature companies to pull off. Big companies are often victims of their own success; they operate according to cultures and business systems that are set up to drive growth in the core. The key success factors for developing profitable new products in adjacent markets are often different.

There are five ways for companies to expand into adjacencies: by exploring demand-centric growth, by cultivating a new organization with new talent, by employing separate governance, by adopting an experimental approach, or by building the right cultural enablers.

## Explore Demand-Centric Growth

Even today, there are still companies that view their categories, and the segments

within them, through either an industrial lens (grouping by production technology) or a demographic lens (such as Millennials compared with baby boomers). Historically, this approach was understandable because companies often lacked the data to segment consumers more precisely. But in the age of big data, it has become much more feasible to think deeply about different types of consumers and their motivations. (See *Enabling Big Data: Building the Capabilities That Really Matter*, BCG Focus, May 2014.)

World-class innovators are moving from industry- or demographic-based segmentation to what we call “demand centric” segmentation, which identifies the drivers of decision-making by looking at the intersection of context (who the customer is, how he or she thinks, and what he or she does) and emotional or functional needs. Using richer data than was ever available before, companies can construct a “demand map” that clusters consumer choices in a particular category into common need bundles—or “demand spaces.” These spaces are usually expressed in everyday language, such as “perfect for my family” or “the kind of break I need.” When clearly articulated, they provide the right targets for innovation by adjacency teams.

This kind of thinking can also be applied to drive growth in the core. For example, Hilton Hotels eschewed conventional market research that groups people broadly by age, income, and occasion (such as “leisure versus business” or “long stay versus short stay”) in favor of asking people to describe what they want in a hotel and when and why they want it. Based on the results, the company was able to construct a map of what really matters to consumers. It could separate the hospitality market into multiple categories—demand spaces—such as “cool and hip” and “recharge and refresh,” and allocate each of its brands to one or more of them.

The results were startling. Not only did the demand space analysis help separate and reduce cannibalization among Hilton’s nine brands; it also uncovered an opportunity to reposition the company’s flagship

brand into the “recharge and refresh” space. This was a high-growth area making up 25% of the market—and it was therefore far more attractive than the travel segment that Hilton had previously targeted. In only a few years, demand-centric growth at Hilton contributed to a dramatic improvement in the value of the business. In 2013, Hilton’s private equity owner took the company public at a 27% premium over the 2007 purchase price. It was the largest IPO ever for a hotel operator.

## Cultivate a New Organization with New Talent

We consistently find that teams charged with adjacent innovation need to be organizationally separate from other innovation teams. There are several reasons. One is day-to-day reality. If adjacent teams are not separate, they are almost inevitably pulled into core efforts, and their budgets often get repurposed to address short-term challenges in the core business. Another reason is that adjacent innovation requires different people with different capabilities from those who drive core innovation. Companies that try to use the same people in new roles find that the adjacent teams tend to drift back toward core ideas and to miss adjacent opportunities. Adjacent innovation also requires an “investor” as opposed to an “operator” mind-set, which means populating teams with individuals with different management outlooks, an entrepreneurial bent, and a longer-term focus. These sorts of individuals are more amenable to risk-taking and more resilient in the event of failure.

## Employ Separate Governance

Adjacent innovation generally requires a senior governance team that can play a role equivalent to that of a private equity or venture capital investment committee. Its members need the breadth of vision, practical experience, and organizational clout to review adjacent opportunities with an understanding of the risks involved, the ability to make choices to narrow the funnel, and, ultimately, to allocate capital to the best ideas. This is quite a different set of capabilities than is typically found in a

core business's governance body, which focuses first on execution and may look askance at anything that is new or different. The adjacency governance body also needs to play a defensive role—hence the requirement for organizational clout—protecting new adjacent initiatives and their funding from attacks stemming from the near-term urgency of the core.

## Adopt an Experimental Approach

Since adjacencies are often uncharted territory and involve plenty of unknowns, failures are likely. What's important is to employ a low-cost, fast-fail methodology that is based on a test, learn, adapt, and move on approach. Those overseeing the teams need to plan for the higher likelihood of initial failure and design their approach accordingly, using these early forays as learning opportunities.

## Build the Right Cultural Enablers

Culture can be a highly effective killer of new ideas. If adjacency projects get measured against existing norms and expectations, the effort to move into new markets is doomed. Companies need to put in place the necessary cultural enablers to support an adjacency innovation program. These include:

- A long-term focus given longer development and incubation periods
- A greater appetite for risk given inherently higher failure rates
- Recognition of the value of novel sources of growth (which risk little or no cannibalization of existing revenues) compared with projects evaluated on the basis of near-term profit
- Avoiding the tendency (and it is strong) to migrate toward developing products, services, and business systems that look exactly like those in the core
- Incentives to support all of the above

## Learning from the Masters

As we observed in last year's report on the world's most innovative companies, some breakthrough innovators manage to use the entire company as a new-idea laboratory. Apple under the late Steve Jobs is perhaps the best-known example. Google, with its policy of encouraging employees to spend 20% of their time working on their own ideas, using the company's tools and data, is another. 3M has long allowed its employees to spend up to 15% of their time on projects of their choosing, using the company's resources.

Perhaps no company better exemplifies adjacent innovation than Amazon. The company moved from its initial innovative notion of selling books online to become the most disruptive force in retailing by selling just about everything online. Along the way it built a global network of 80 fulfillment centers—so it started offering fulfillment services as an option for small merchants, which could thereby distribute almost as efficiently as Walmart. In parallel, it built enormous scale in its data centers and world-class skill in operating them. It then reconceptualized this computing infrastructure as a product in its own right. In 2006, the company opened Amazon Web Services (AWS) as a standalone cloud computing service, renting out raw computing capacity that ultimately evolved into a complex stack of computing services. Today Amazon even sells the service to competitors such as Netflix. By the second quarter of 2015, AWS had become a \$1.8 billion business growing at more than 80% year over year, with a profit margin of 21%.

## It's Not All or Nothing

Plenty of companies are better placed than they think to explore adjacent innovation. As we describe in companion articles in this series, strong innovators have considerable assets that they can draw on in areas such as speed, lean processes, and the application of technology, and these often provide starting points to explore adjacencies. In parallel, a company thinking about adjacent growth should also determine where its gaps are vis-à-vis the five areas

outlined above and develop a plan to address them. Once the internal house is in order, companies can begin to look around

the neighborhood for attractive opportunities for incremental profitable growth.

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