DARDEN BUSINESS PUBLISHING
UNIVERSITY of VIRGINIA

UVA-S-0196
Rev. Oct. 4, 2011

GROWTH IS THE DYNAMIC CONFLUENCE OF STRATEGY, ENTREPRENEURSHIP, AND VALUES[1]

The research on high-performance companies (defined as consistent above-average growth), both public and private, demonstrates that consistent value creation requires a focused strategy that is implemented through a mixture of entrepreneurial activities and exploiting activities enabled by an internal system characterized by values-based (ethical) leadership, culture, and policies.

Growth research has demonstrated that growth is much more than a strategy. Growth happens when the right kind of leadership, internal environment, and processes come together to create a small-company-entrepreneurial soul in a large-company body. Growth requires experimental processes, an entrepreneurial mindset, iterative entrepreneurial learning, leadership that accepts entrepreneurial failures, and internal processes that mitigate the natural proclivities of human beings and organizations that inhibit growth.

Growth is not a linear or reductionist process. It is a human process that is modeled better by biology and complexity theory than economics or physics. Growth is a change process that requires experimentation, learning, and taking measured risks that can result in mistakes and failures—that contravenes the purpose of an organization, which is to produce standardization, predictability, reliability, and consistency.

[1] This note is adapted from the works of Edward D. Hess: "Why Everything You Know About Growth Is Probably Wrong" (UVA-S-0172), (University of Virginia Darden School Foundation, 2010); *Grow to Greatness: Smart Growth for Entrepreneurial Businesses* (Stanford University Press, Upcoming 2012); *Growing an Entrepreneurial Business: Concepts & Cases* (Stanford University Press, 2011); *Smart Growth: Building an Enduring Business by Managing the Risks of Growth* (Columbia Business School Publishing, 2010); Hess and Charles F. Goetz, *So, You Want To Start A Business? The 8 Key Business Concepts You Must Know*, (Free Press, 2008); *The Road To Organic Growth: How Great Companies Consistently Grow From Within* (McGraw-Hill, 2007); Hess and Kazanjian eds., *The Search For Organic Growth* (Cambridge University Press, 2006); Hess and Cameron, eds., *Leading With Values: Positivity, Virtue & High Performance* (Cambridge University Press, 2006).

This technical note was prepared by Edward D. Hess, Professor of Business Administration and Batten Executive-in-Residence.

Research of high-performance organizations over the past thirty years continues to confirm the same defining characteristics of such organizations.[2] We know the DNA of consistent growth or value-creating companies, and it appears that those defining characteristics apply to both public and private companies.

The DNA of consistent value creation is made up of:

- Simple, focused strategies
- Structures that enable entrepreneurial behaviors with customers
- Business purpose and meaning (values) above and beyond just creating shareholder value
- Relentless, constant improvement
- High employee engagement and high accountability
- Humble, passionate, values-based leaders
- Execution excellence

With respect to strategy, high-performance companies dominate an industry segment by (1) execution excellence driven by relentless constant improvement (exploitation) and (2) constant exploration of new potential advantages through learning processes. These companies excel in managing the tensions and inconsistencies between exploitation and exploration mindsets, processes, and tolerances for mistakes or variance. These companies are better able to differentiate between the relatively known environment of exploitation and the unknown environment of exploration. They create different risk management processes for exploration that in many cases are similar to effectuation theories of allowable loss and taking action based on what you have.

Formation of strategy is a more dynamic, ongoing process among these companies involving employees and customers in feedback (learning) loops in contrast with the common top-down, strategic process that often occurs as part of an annual budgeting process in other companies. Strategy in high-performance companies is more like the entrepreneurial venture capital investment process. Portfolios of strategic forays are built based on a $2 \times 2 \times 4$ matrix. This matrix characterizes opportunities as short term or long term; top line or bottom line; and as

[2] James C. Collins and Jerry I. Porras, *Built to Last: Successful Habits of Visionary Companies* (New York: HarperBusiness Essentials, 2002); Jim Collins, *Good to Great: Why Some Companies Make the Leap…and Others Don't* (New York: HarperBusiness, 2001); Arie de Geus, *The Living Company* (Boston: Harvard Business School Press, 1997); Hess, 2007); William Joyce, Nitin Nohria, and Bruce Roberson, *What Really Works: The 4 + 2 Formula For Sustained Business Success* (New York: HarperBusiness, 2003); Charles A. O'Reilly III and Jeffrey Pfeffer, *Hidden Value: How Great Companies Achieve Extraordinary Results with Ordinary People* (Boston: Harvard Business School Press, 2000); Thomas J. Peters and Robert H. Waterman Jr., *In Search Of Excellence: Lessons from America's Best-Run Companies* (New York: Warner Books, 1984); Hermann Simon, *Hidden Champions of the Twenty-First Century: Success Strategies of Unknown World Market Leaders* (New York: Springer, 2009).

improvements, innovations, scaling, or strategic acquisitions ranked by the relative riskiness or magnitude of unknowns. This portfolio is built and managed with the expectation of creating excess cash through operational excellence that funds a dynamic portfolio of investments which, over time, creates new S-Curves.

With respect to ethics, values, and the purpose of existence, these companies operate on various multiple-stakeholder models rejecting the premise that the sole purpose of business should be to create shareholder value. Many studies, including mine, have shown that companies that are consistent high performers focus on multiple stakeholders and that fuels their success. These companies, to varying degrees, view employees, customers, and society as stakeholders, too. While they have different cultures most have a stewardship mentality with policies that is employee-centric and results in employee loyalty, productivity, and engagement better than the competition.

This type of employee engagement does not just happen by culture. It takes a relentless focus to counter elitism, hypocrisy, arrogance, and complacency through policies and leadership behaviors that are defined, measured, and rewarded. Leaders in these companies are generally humble, passionate operators who have grown up in the company and who have been able to shift from a personal career focus to a stewardship focus.

High-growth companies are more entrepreneurial than the competition in that they are constantly learning; iterating; improving; trying new things in small, risk controlled experiments; empowering employees to take ownership of their jobs; and, in defined areas, giving employees the power to take action and solve problems quickly and without having to worry about being punished for making mistakes unless such action crosses the line as to ethics, reputation, or capital risks.

My hypothesis is that for most organizations to achieve above average growth over an extensive period of time it is necessary to create the right mixture of strategy, entrepreneurial mindset and processes, and a values-based internal system. Now let me review the relevant research on growth from a multidisciplinary approach to see how it supports this hypothesis.

Common Growth Beliefs

Most U.S. business leaders believe that: (1) businesses either grow or die; (2) all growth is good; (3) growing bigger is always better; and (4) public companies should grow in a linear, continuous manner as evidenced by ever-increasing quarterly earnings. For our purposes, we will

call these beliefs the U.S. Growth Model.[3] Grow or Die has been a key business axiom for at least half a century, recognized as such by *Time* magazine in 1954 and repeatedly since.[4] Goggling the phrase "businesses grow or die" produces more than four million hits. Countless books and articles have been written about the imperative to continuously grow.[5]

The U.S. Growth Model

Surprisingly, the U.S. Growth Model has been embraced without rigorous analysis about how well it actually describes the growth of robust businesses or the benefits or risks to businesses when growth is the objective. Nonetheless, it is the foundation of the short-term business mentality dominant in many C-suites, boardrooms, and Wall Street firms that expect quarterly reporting of ever-increasing growth.

So powerful is the imprimatur for businesses to report growth that, to meet short-term earnings projections, companies engage in a widely acknowledged Earnings Game. I define the Earnings Game as the "creation" of earnings through accounting elections, valuations, reserves, liberalizing credit policies, channel stuffing, deferring needed expenditures, selling assets, and myriad structured financial transactions. These nonauthentic earnings are too often generated solely to meet Wall Street's earnings estimates.

The use of such strategies to satisfy the U.S. Growth Model, however, can drive businesses to make imprudent business decisions that can harm the fundamentals of the business in the long term. In some cases, these strategies are employed to camouflage a business's poor performance and underlying weaknesses. What is clear is that the Earnings Game, at best, makes it difficult for investors to assess the underlying strength of businesses—at its worst, it incentivizes short-term profits to the detriment of the business in the longer term. The perverse incentives of "short-termism" have been criticized by scholars and well-respected business

[3] The U.S. Growth Model, as used in this note, is the construct that there is a clear relationship about the underlying health of a business that can be measured easily by assessing quarterly earnings, regardless of how they were created. Growth is good, no matter what. Not only does this model fail to accurately describe how businesses actually grow, but when adopted as a goal of business the model often causes harm to the underlying businesses that ascribe to it.

[4] "The New Magic Word in Industry," *Time*, June 18, 1954.

[5] George T. Ainsworth-Land, *Grow or Die: The Unifying Principle of Transformation* (New York: Wiley, 1986); Ram Charan, Noel M. Tichy, *Every Business Is a Growth Business: How Your Company Can Prosper Year After Year* (New York: Three Rivers Press, 1998); Robert M. Tomasko, *Bigger Isn't Always Better* (New York: AMACOM, 2005); Bo Burlingham, *Small Giants: Companies That Choose to Be Great Instead of Big* (New York: Penguin, 2005); "More Than One Way to Help a Business Grow," *New York Times*, November 13, 2007; "The Big…Get Bigger," *Fortune*, April 30, 2007; "All Together Now?" *The New Yorker*, June 9, 2008; "Living in Dell Time," *Fast Company*, December 19, 2007.

leaders alike.[6] The dangers of the Earnings Game have been widely noted.[7] Nonetheless, despite attempts by regulators to improve financial reporting after the Enron debacle, the Earnings Game continues to be widely played because there is no obligation—but actually a disincentive—for businesses to clearly disclose nonauthentic earnings.

Because the U.S. Growth Model dominates business thinking, I decided to examine whether there was either theoretical or empirical support for it. As part of my research, I searched the disciplines of economics, strategy, finance, accounting, organizational design and behavior, and even biology and its related sciences to find either conceptual arguments or data in support of the U.S Growth Model. What support did I find?

No Support for the U.S. Growth Model

Given the prevalence of the U.S. Growth Model, I was surprised to find no support for it in science or in any area of business research. Furthermore, most research contradicts the tenet that companies should grow continuously in a linear manner. The U.S. Growth Model is pure and simple fiction. Growth is not always good; bigger is not always better; businesses do not have to grow to stay alive; and continuous linear growth is the rare exception not the rule. Blindly following the dictates of the U.S. Growth Model can drive bad corporate behaviors and inhibit real growth and innovation. It also can lead to artificially induced business volatility and premature destruction of businesses.

[6] Warren Buffett, 2003 Shareholder Letter, Berkshire Hathaway, February 27, 2004, http//www.berkshirehathaway.com/letters/2003lt.pdf; Thomas J. Donohue, "Enhancing America's Long-Term Competitiveness: Ending Wall Street's Quarterly Earnings Game" (Wall Street Analyst Forum, New York, November 30, 2005); Alfred Rappaport, "The Economics of Short-Term Performance Obsession," *Financial Analysts Journal* 61, 3 (2005): 65; Dean Krehmeyer, Matthew Orsagh CFA, Kurt N. Schacht CFA, "Breaking the Short-Term Cycle: Discussion and Recommendations on How Corporate Leaders, Asset Managers, Investors, and Analysts Can Refocus on Long-Term Value," CFA Centre for Financial Market Integrity, Business Roundtable Institute for Corporate Ethics, July 2006, 1–19; John R. Graham, Campbell R. Harvey, Shivaram Rajgopal, "Value Destruction and Financial Reporting Decisions," *Financial Analysts Journal* 62, 6 (2006): 27–39; Judith Samuelson, "The Aspen Principles: A Better Way Forward," *Directors & Boards* (Summer 2008); Aspen Institute Business & Society Program, "Overcoming Short-Termism: A Call for a More Responsible Approach to Investment and Business Management," September 2009; John C. Bogle, *Enough: True Measures of Money, Business and Life* (Hoboken, NJ: John Wiley & Sons, 2009), 10.

[7] Jonathan St. B. T. Evans, "Theories of Human Reasoning: The Fragmented State of the Art," *Sage* 1, 1 (1991): 83; Dr. Steven Krull, "Corporate Guidance and Earnings Announcements: Are Companies Gaming the System to Beat the Analyst Mean When Announcing Earnings," Hofstra University, http://www.hofstra.edu/pdf/bizmlckrull3.pdf (accessed September 12, 2011); Arthur Levitt, "The Numbers Game" (Speech, NYU Center for Law and Business, New York, September 28, 1998); Joseph Fuller, Michael C. Jensen, "Just Say No to Wall Street: Putting a Stop to the Earnings Game," *Journal of Applied Corporate Finance* 14, 4 (2002): 45; Harris Collingwood, "The Earnings Game: Everyone Plays, Nobody Wins," *Harvard Business Review* 79, 6 (2001): 67; Buffett (2004); Donohue (2005); Krehmeyer, Orsagh, Schacht, 1–19.

Economics and finance

Economic theory, whether in neoclassical, new growth, industrial, behavioral, complexity, or ecological economics, fails to support the U.S. Growth Model. The closest support is that it is possible to construct a linear production model that produces continuous, smooth, linear growth by continuously adjusting inputs; however, Robert Solow, a leading researcher and Nobel laureate, has stated that such a model does not (and cannot) represent reality.[8] In addition, the theory of diminishing marginal returns makes even a *theoretical* linear production model suspect.

Complexity economics, which includes both theoretical models and data collection, posits that at some point every business reaches a size where being bigger produces diminishing returns because of the costs of added complexity due to size.[9]

What does the economic and finance research show about the relationship between growth and value? Key findings that are problematic for the U.S. Growth Model include the following observations:

- Few companies evidence any systematic, predictable patterns of growth even over the long term.[10]
- Corporate growth rates are only weakly correlated with profits.[11]
- Dividends and earnings growth rates are largely unpredictable.[12]
- Above-average operating income before depreciation growth for four consecutive years occurred in less than 7% of firms studied. Extending the time frame to seven or more years decreased the number to 1% of firms studied.[13]
- Growth is an evolutionary process that does not occur smoothly or continuously but rather occurs in spurts.[14]

[8] Robert M. Solow, "Perspectives on Growth Theory," *Journal of Economic Perspectives* 8, 1 (1994): 45–54; Robert M. Solow, "The Neoclassical Theory of Growth and Distribution," *BNL Quarterly Review* 215 (2000): 349; Robert M. Solow, "The Last 50 Years in Growth Theory and the Next 10," *Oxford Review of Economic Policy* 23, 1 (2007): 3–14.

[9] Paul M. Romer, "The Origins of Endogenous Growth," *Journal of Economic Perspectives* 8, 1 (1994): 3–22.

[10] Solow (2000), 349.

[11] Paul A. Geroski, "Understanding the Implications of Empirical Work on Corporate Growth Rates" *Managerial and Decision Economics* 26, 2 (2005): 129–38.

[12] Eugene F. Fama, Kenneth R. French, "The Equity Premium," *Journal of Finance* 57, 2 (2002): 640.

[13] Louis K. C. Chan, Jason Karceski, Josef Lakonishok, "The Level and Persistence of Growth Rates" *Journal of Finance* 58, 2 (2003): 643–84.

[14] Edith Penrose, "The Theory of the Growth of the Firm," *The International Encyclopedia of Business and Management* (Oxford: Oxford University Press, 1996), 2440–448.

These findings demonstrate the impracticality of achieving or even expecting continuous, linear business growth. Not finding theoretical or empirical support for the U.S. Growth Model in economics, I reviewed the business disciplines of accounting, strategy, and organizational behavior.

Business disciplines

In business strategy, researchers have sought to understand industry dynamics, competitive advantage, and sustained long-term competitive advantage.[15] In recent years, the very concept of sustainable competitive advantage has been challenged by the research on hypercompetition. Hypercompetition research has found that sustainable competitive advantage is not a realistic goal for most businesses. Instead, a string of short-term competitive advantages are more realistic to achieve and would be a more viable goal.[16]

Other business strategists have concluded that the concept of sustainable competitive advantage should be replaced by one of relative competitive advantage.[17] Their research has shown that across industries, the incidence and velocity of hypercompetition continues to increase, making any competitive advantage more fleeting, and thus the continuity of advantage harder to sustain.[18] These challenges to the very concept of sustainable advantage mean that, contrary to the U.S. Growth Model, continuous linear growth is not likely and may be an unrealistic norm.

At least six other studies, including one of mine, show that smooth and continuous growth is the exception and not the rule.[19] They also show that if a company is able to achieve such a result, it is more likely to be obtained by buying growth through serial acquisitions rather than core growth.[20] As one researcher concluded:

[15] Michael E. Porter, *Competitive Strategy: Techniques for Analyzing Industries and Competitors* (New York: Free Press, 1980); Michael E. Porter, *Competitive Advantage: Creating and Sustaining Superior Performance* (New York: Free Press, 1985), 11.

[16] Richard A. D'Aveni, *Hypercompetition* (New York: Free Press, 1994); Porter (1980); Robert R. Wiggins, Timothy W. Ruefli, "Sustained Competitive Advantage: Temporal Dynamics and the Incidence and Persistence of Superior Economic Performance," *Organization Science* 13, 1 (2002): 81–105; Robert R. Wiggins, Timothy W. Ruefli, "Schumpeter's Ghost: Is Hypercompetition Making the Best of Times Shorter?" *Strategic Management Journal* 26, 10 (2005): 887–11.

[17] Interview with Professor Ming-Jer Chen, Charlottesville, VA, February 2009.

[18] Wiggins, Ruefli, (2005), 887–911.

[19] Hess, Kazanjian (2006), 147–48; Mark Lipton, *Guiding Growth: How Vision Keeps Companies on Course* (Boston: Harvard Business School Press, 2003), 36–37; Matthew S. Olson, Derek van Bever, *Stall Points: Most Companies Stop Growing—Yours Doesn't Have To* (New Haven, CT: Yale University Press, 2008); Sven Smit, Caroline M. Thompson, S. Patrick Viguerie, "The Do-or-Die Struggle for Growth," *McKinsey Quarterly* 3 (2005): 35–45; Wiggins, Ruefli (2002), 100; Wiggins, Ruefli (2005), 887–911.

[20] Hess, Kazanjian (2006), 103–23.

> One interpretation [of this study] is that acquisition activity as a source of growth may be far more prevalent than popular mythology suggests. Indeed, moving the pieces of companies around through ownership exchanges seemed to be far more popular than creating growing businesses within the firm.[21]

Another researcher reported:

> Forget the books showing smooth, linear line graphs that predict aggressive growth as an unbroken trajectory…Organizational growth is far from a smooth process…Research dating back to the 1960s shows clearly how extended periods of growth are characterized more by near-catastrophic turbulence than by universally smooth and predictable experience.[22]

Research by another team concluded:

> The key finding of this research for management practice is that the demonstrated rarity of achieving sustained superior economic performance implies that it is very difficult to achieve. The results also indicate that there may even be a question as to whether sustained economic performance is even a reasonable goal to set for a firm.[23]

Hess's Organic Growth Index[24]

In 2002, I began work to create a financial model that would identify those U.S. public companies that: (1) created substantial economic value; (2) outperformed their industry competition as measured by sales and cash flow from operations annual compounded growth rates; and (3) did so primarily through organic growth without resorting to material serial acquisitions or to the creation of material nonauthentic earnings. The result was the Organic Growth Index (OGI).[25]

In March 2008, the Batten Institute at the Darden Graduate School of Business Administration released the results of 10 years of OGI research (1996–2006) involving more than 1,300 public U.S. companies (**Table 1**).

[21] Hess, Kazanjian (2006), 148.
[22] Lipton (2003), 36–37.
[23] Wiggins, Ruefli (2002), 100.
[24] Edward D. Hess, "Organic Growth Index 'OGI' 1996–2006," 2008.
[25] Hess, Kazanjian (2006), 103–23.

Table 1. OGI results from 1996 to 2006.

Study Period	Sample Size	Number of Winners	Percentage of Winners
1996–2001	834	68	8%
1997–2002	862	47	5%
1998–2003	860	59	7%
1999–2004	801	77	10%
2000–2005	793	85	11%
2001–2006	799	85	11%

Source: Created by case writer from public data.

The winners in the OGI results are companies that passed the six-step screening process for each study period. The OGI results show that it is rare to grow organically for five years or more without utilizing nonauthentic earnings or making serial acquisitions or a large acquisition. During the 10-year study, only 10 out of 1,300 companies came through all study periods as winners, less than 1% of the companies studied. Only 27 companies out of 1,300 (approximately 2%) were winners in at least four out of the six periods. The OGI results are consistent with other studies in finding that smooth and continuous public company growth is the exception and not the rule.

The winners were the exceptions in that they were able to grow consistently over a long period. These winners also generated stock returns excluding dividends that were six to ten times the returns of the three major indices for the 10-year study.

For the next phase of the study, I am in the process of reviewing unpublished data for the years 2001–06 and analyzing the growth results of more than 4,000 domestic, listed public companies. Preliminary results show that only 276 (about 7%) of the 4,031 companies studied were able to produce, between 2001 and 2006, above-average industry returns primarily through organic growth.

That data raises interesting questions because, of those 276 winners, 243 of them had ending market caps of $10 billion or less. Only 4 of the 276 winners had ending market caps of $50 billion or greater.

With respect to the U.S. Growth Model, I found no empirical support in business research for the beliefs: Every business must grow or die; all growth is good; bigger is always better; or growth should be continuous and linear. Maybe the list of corporate half-truths is even longer.[26]

[26] Jeffrey Pfeffer, Robert I. Sutton, *Hard Facts, Dangerous Half-Truths, and Total Nonsense: Profiting from Evidence-Based Management* (Boston: Harvard Business School Press, 2006), 159.

Biology Growth Findings

Biology as a science is different in fundamental ways from economics and finance. Most economic and finance theory assumes a mechanistic, deterministic world that is predictable and linear.

In contrast, biology models reflect change, evolution, adaptation, changing environments, feedback loops, nonlinearity, and unexpected results. Biology has spawned new theories of change and growth, *complex adaptive systems* (CAS), and *complex evolving systems* (CES) that, along with systems thinking and chaos theory, comprise an area of science called *complexity theory*.

While biology does not concern itself with organizational growth, the research findings explaining how organisms grow may be useful in understanding how business organizations grow.

1. In many species, growth is not maximized in order to increase chances of survival.[27] This is the converse of the business axiom Grow or Die.
2. Increases in the size of an organism sometimes increase the risk of it being eaten by predators because predators typically prefer the biggest prey.[28] As species get larger, they are easier to see and cannot move or respond as fast. Growth can create survival risks, leading to the conclusion that being bigger is not always better.
3. Many organisms have a finite amount of expendable energy and therefore allocate that energy across competing functions: reproduction, growth, maintenance, and survival. As a result, at any given time there is a limit to the amount of energy available for growth.[29] This is somewhat consistent with the findings of Edith Penrose, the economist who reported that firms must have excess managerial capacity in order to grow.
4. In some species, growth requires trade-offs, resulting in periods of growth and periods of no growth.[30] Growth is not continuous.

[27] Jeffrey D. Arendt, "Adaptive Intrinsic Growth Rates: An Integration Across Taxa," *Quarterly Review of Biology* 72, 2 (1997): 149–77; Stephen A. Arnott, Susumu Chiba, David O. Conover, "Evolution of Intrinsic Growth Rate: Metabolic Costs Drive Trade-Offs Between Growth and Swimming Performance in *Menidia Menidia*," *Evolution* 60, 6 (2006): 1269–278; Karl Gotthard, "Increased Risk of Predation as a Cost of High Growth Rate: An Experimental Test in a Butterfly," *Journal of Animal Ecology* 69, 5 (2000): 896–902; Stephan B. Munch, David O. Conover, "Nonlinear Growth Cost in *Menidia Menidia*: Theory and Empirical Evidence," *Evolution* 58, 3 (2004): 661–64.

[28] John Henry Clippinger III, ed., *The Biology of Business: Decoding the Natural Laws of Enterprise* (San Francisco: Jossey-Bass, 1999), 7; José M. Gómez, "Bigger Is Not Always Better: Conflicting Selective Pressures on Seed Size in *Quercus Ilex*," *Evolution* 58, 1 (2004): 71–80.

[29] Arseniy S. Karkach, "Trajectories and Models of Individual Growth," *Demographic Research* 15, 12 (2006): 347–400.

[30] Arnott, Chiba, Conover (2006), 1269–278; Munch, Conover (2004), 661–64.

5. In plants, there appears to be two different strategies. Growth-dominated plants invest their energy in growth processes. Other plants invest in processes to differentiate themselves.[31] This seems to be consistent with the theory that businesses can either be high volume or niche players.
6. Growth can be continuous or not, determinate or not, but few things in nature can grow without limit.[32]

Although not directly undermining the viability of the U.S. Growth Model for businesses, these insights provided by biology raise questions that have some traction in challenging its assumptions.

Complexity Theory

Complexity theory, which in many ways resembles key biological observations, posits that organizations strive for fitness, defined as the ability to perceive, adjust, and adapt continuously to an unpredictable changing environment.[33] It rejects the U.S. Growth Model's tenet of continuous growth. For example:

> By far the most common methods for analyzing markets, economies, and enterprises are based on assumptions of linearity: The whole is the sum of the parts; the future is a linear projection of the past…The problem is that very few things in nature or commerce behave linearly. It is the rare exception rather than the rule.[34]

The applicability of complexity theory to the business world was advanced by the work of Shona Brown and Kathleen Eisenhardt.[35] They studied product innovation in the computer industry. Brown and Eisenhardt found that companies test ideas in small experiments and learn from experimentation and use that learning to create different views of reality, which can result in a pipeline of new products.

What do biology and complexity theories add to our understanding of growth? Their views are certainly more nuanced than the U.S. Growth Model. Biology raises the notions that growth has risks; that an entity has a finite amount of energy to expend at any time to be divided among maintenance, exploitation, and growth; that growth is rarely continuous; and that growth can increase predator risk. Complexity theory asserts that growth is an experimental learning

[31] Arendt (1997), 149–77.
[32] Karkach, 347–400.
[33] Clippinger, 7.
[34] Clippinger, 13.
[35] Shona L. Brown, Kathleen M. Eisenhardt, "The Art of Continuous Change: Linking Complexity Theory and Time-Paced Evolution in Relentlessly Shifting Organizations," *Administrative Science Quarterly* 42 (1997): 1–34; Shona L. Brown, Kathleen M. Eisenhardt, *Competing on the Edge: Strategy as Structured Chaos* (Boston: Harvard Business School Press, 1998).

process. Below I discuss new research about business growth demonstrating that biology and complexity theory may model business growth better than economics.

The DNA of Growth

Using data from my OGI studies, I followed two research paths. I studied some of those exceptional companies that were consistent "winners" in my OGI studies to understand how they were able to consistently grow above industry averages—some for 10 years or more. Then I explored the processes used by those companies and other high-growth companies to create growth, which led to the creation of the Darden Growth Model, a seven-step model that begins with a Growth System that enables Growth Processes that result in a Growth Portfolio designed to create new value. Growth Processes include Strategic Ideation and an experimental methodology called Learning Launches, which will be discussed later.[36]

Six Keys to Organic Growth

Twenty-two high-growth companies were studied in order to uncover their "secret sauce."[37] I began the organic growth study with several hypotheses based on my investment banking and strategy background. I hypothesized that these companies possessed the following characteristics:

- Unique products and/or services
- Best talent
- Visionary, charismatic leaders
- Superior innovation
- Cost superiority obtained by outsourcing and off-shoring
- Sophisticated diversified strategies

Counter to my six hypotheses, my research showed that none of those characteristics was necessary to produce consistently high performance. In fact, my research showed that most of those high-growth companies:

- Did not sell unique products or services;
- Did not have the best talent but got exceptional performances from the work force;
- Did not have visionary, charismatic leaders;

[36] Hess (2007).
[37] Hess (2007).

- Were not the most innovative;
- Did not offshore or outsource; and
- Did not have complex, diversified strategies.

My research found that these companies in general had simple focused strategies, which I called an "elevator-pitch" business model. They structured themselves to enable entrepreneurial behavior with customers. They had a multiple stakeholder philosophy and operating model. They had cultures of constant iterative learning and improvement. They had high employee engagement, loyalty, and productivity driven by culture and humble passionate leadership that in most cases acted as stewardship leaders. They were execution champions, and they created internal aligned systems to drive desired behaviors.

My findings in many ways are consistent with other studies of high-performance organizations.[38]

What is interesting is the integration of entrepreneurial mindset; entrepreneurial behavior; iterative learning; processes to experiment by making small bets; and the importance of values, meaning, and employee-centric policies in these big companies. Perhaps consistent high performance results when organizations create the right environment, processes, and mindsets that are entrepreneurial, values-based, and strategically ambidextrous.

Growth Is More Than a Strategy: It's a System

These consistently above-average growth companies had, over time, built an enabling internal Growth System. That Growth System linked, in a seamless, consistent, self-reinforcing manner, the firm's strategy, structure, culture, execution processes, leadership model, and human resources, and measurements and rewards policies to enable and drive specific growth-producing behaviors.[39] These companies focused measurements and rewards on concrete behaviors identified as fostering growth in addition to merely looking at financial metrics.

These Growth Systems resulted in high employee engagement and execution excellence.[40] My research and consulting experience convinced me that high employee engagement is critical for consistent high organic growth.[41] Other researchers confirm the power

[38] Collins and Porras (2002); Collins (2001); de Geus (1997); Hess; O'Reilly and Pfeffer (2000); Peters and Waterman Jr. (1984); Simon (2009).

[39] Hess (2007); Hess, Liedtka (2008).

[40] Hess (2007).

[41] These high-performance organizations meet the criteria: Best Buy, UPS, Room & Board, Tiffany & Company, U.S. Marine Corps, San Antonio Spurs, Synovus Financial, TSYS, Ritz-Carlton, Southwest Airlines, Outback Steakhouse, Sysco, Chick-fil-A, Starbucks, Levy Restaurants, and McDonald's.

of high employee engagement.[42] High employee engagement results in high employee productivity, loyalty, and the daily pursuit of improvement and execution excellence. It is the result of consistent policies and consistent behavior by leaders and managers. Highly engaged employees take "ownership" of their jobs, believing that if they play by the company's rules, they will be treated fairly and have the opportunity to be all they can be and achieve a better life for themselves and their loved ones.

What facilitates high employee engagement? My research suggests the following:

- Stock ownership
- Promotion from within policies
- Humble, passionate stewardship leaders
- Fairly applied, transparent, and stable HR policies[43]

In addition, most of the leaders in the companies I studied were humble, passionate stewards, who had spent the majority of their career with the company. At some point, most had been able to transfer their ambition and focus from "me" to "them." Few were visionary or charismatic, but most were operators intent on knowing the details of their business and leading the daily fight against elitism (other than in compensation), arrogance, hubris, and complacency. Interestingly, of the 22 companies in the study, only three of the CEOs had MBA degrees.

While this research is not predictive, it raises a hypothesis about the link between the values of these leaders and the kind of internal environment that resulted in high employee engagement. Leadership behavior evidences values and beliefs about people and about the purpose or meaning of business. Also the integrity, consistency, and fair application of employee policies are evidence that an ethical perspective permeates these organizations. I am not saying they are perfect—no organization is. What I am saying is that values and ethics, in addition to an entrepreneurial mindset and experimental iterative entrepreneurial learning, may be foundational building blocks for these high-performance companies. Maybe it is the systemic integration of these characteristics that enables and promotes certain types of behaviors and results.

One hypothesis that warrants further research is how a sustainable strategic competitive advantage may be related to an integrated Systems approach to creating value for multiple stakeholders. This approach requires the integration of various disciplines including strategy, entrepreneurship, ethics, leadership, and human resource reward and measurement policies. One example of such an integrated approach is posed by the leading consumer electronics retailer, Best Buy.

[42] Cameron, Dutton, Quinn (2003); Heskett, Sasser Jr., Schlesinger (2003); Heskett, Sasser, Jr., Schlesinger (1997); Hess (2007); Hess, Cameron, (2006); Hess, working paper (2007); O'Reilly III and Pfeffer (2000).

[43] Hess (working paper, 2007).

Best Buy Co., Inc. (Best Buy)[44]

One company that illustrates the concept that growth is a system is Best Buy. In 2005, Best Buy undertook a major redesign of its business model in an attempt to change from a centralized, top-down, product-centric organization to a decentralized, customer-centric organization. This required the company, over a period of years, to roll out a new operating system and retrain more than 100,000 employees, which proved to be a major undertaking. Not surprisingly, there were bumps in the road resulting in missed earnings estimates for a few quarters, which translated to stock price declines.

Best Buy's new business model of *customer centricity* required it to adopt a new structure, culture, leadership model, and employee measurement and rewards policy.

To implement customer centricity, Best Buy had to change its culture from a traditional hierarchical top-down culture to a new culture that defined customers as kings and queens, store employees as royalty, and headquarters employees and management as servants to employees and customers. This concept of servant leadership was illustrated by Brad Anderson, president and CEO, when he turned down the offer of substantial stock options and had those same options put into a pool for Best Buy headquarters administrative employees.[45]

In addition, to motivate servant leadership behavior by top management, Best Buy made 20% of its annual stock option grants for those leaders dependent on "walking the talk."

Best Buy also decentralized its operating structure by making each store a separate business unit and changed how it measured and rewarded store employees from the standard retail measurements of traffic count, conversions, and same-store sales to store ROA (return on assets).

When Best Buy decided to change its business model, it had to make consistent changes to its leadership model, culture, structure, metrics, and rewards. This alignment was made in order to create the enabling environment to drive the right employee behaviors that were necessary to build customer relationships.

Organizations such as Best Buy, Sysco, Costco, UPS, Starbucks, Southwest Airlines, Tiffany, Container Store, AFLAC, Room & Board, Ritz Carlton, Outback Steakhouses, Walgreen, Chick-fil-A, Levy Restaurants, Zappos, Wegmans, Men's Warehouse, TD Industries, San Antonio Spurs, United States Marine Corps, SAS, and Whole Foods have built integrated internal systems that resulted in entrepreneurial, values-based multiple stakeholder value creation.

[44] Edward D. Hess, "Best Buy Co., Inc." (UVA-S-0142). This case has been updated for material events.
[45] Joann S. Lubin, "A Few Share the Wealth," *Wall Street Journal*, December 12, 2005, B1.

Growth Is Entrepreneurial Learning

The right culture, leadership, and processes can create growth. A key process in our Darden Growth/Innovation Model is the *Learning Launch*.[46] Learning Launches are an experimental process based on the scientific method that tests growth ideas quickly and cheaply to see if they are worth pursuing.[47]

The purpose of a Learning Launch is to test critical customer value, execution, and defensibility assumptions that have to be true in order for the idea to warrant further investigation, time, and investment. The goal here is to learn critical information quickly and cheaply, in order to make better decisions. Learning Launches are an evidence-based management tool in a learning-by-doing process that is customer-centric. Learning by doing has subsequently been advocated by other researchers.[48] Learning by doing is a key part of entrepreneurial effectuation theory.

High organic growth companies do not take big risks—they experiment by placing "small bets" and investigating before making big changes or rolling out big new initiatives. This is the Learning Launch philosophy. It is consistent with the theory of "allowable loss" in entrepreneurial effectuation theory.

Interestingly, Professor Jeanne Liedtka's research on growth leaders in big companies found that those leaders had the ability to act in appropriate circumstances much like entrepreneurs in that they were action-oriented; not constrained by corporate restraints; learned by doing; and minimized loss by focusing on allowable losses.[49] Professor Liedtka's work demonstrates that entrepreneurial mindsets and behaviors are not limited to small ventures. Big companies that consistently grow have figured out how and where to enable and promote entrepreneurial behaviors while, at the same time, maintaining areas where standardization, predictability, and no variance dominate processes.

Growth companies still manage risks by defining clearly where employees have freedom to experiment. Good growth companies experiment and test in order to learn, adapt, minimize loss, and gather data in order to make better investment decisions.

My research and real-world experience have taught me that business growth is the result of complex interaction between a business and its environment. It depends on many human beings, with their cognitive limitations and biases, are able to perceive and process information

[46] Jeanne M. Liedtka, Edward D. Hess, "Designing Learning Launches," (UVA-BP-0529).

[47] Liedtka, Hess (2008).

[48] Liedtka, Hess (2008); Peter Skarzynski, Rowan Gibson, *Innovation to the Core: A Blueprint for Transforming the Way Your Company Innovates* (Boston: Harvard Business Press, 2008); Alexander B. van Putten, Ian C. MacMillan, *Unlocking Opportunities for Growth: How to Profit from Uncertainty While Limiting Your Risk* (Upper Saddle River, NJ: Wharton School Publishing, 2009).

[49] Jeanne M. Liedtka, Robert Rosen, Robert Wiltbank, *The Catalyst: How You Can Become an Extraordinary Growth Leader* (New York: Crown Business, 2009).

and communicate with each other in a manner that results in learning and adaptation to constantly changing situations. Growth is change, and growth creates change. Change makes smoothness, predictability, and continuity of growth difficult.

Growth Results from a Portfolio of Growth Initiatives

Another research finding from the Darden Growth/Innovation Model is the Growth Portfolio concept. Many consistent high-growth companies create a pipeline of growth experiments (Learning Launches) that funnel into a portfolio of growth initiatives (Growth Portfolio). These Learning Launches are managed across a timeline (short-term and long-term) and grouped into two clusters: top-line initiatives and bottom-line initiatives. This Growth Portfolio comprises initiatives involving the four different ways to grow a business: improvements, innovations, scaling, and strategic acquisitions.

Improvements are doing something better, faster, or cheaper. Innovations are doing something new. Scaling is doing more of what you are already doing. Strategic acquisitions are usually small acquisitions of something new or something to scale.

The size and composition of the Growth Portfolio will vary depending on the size of the business and the life cycle of its products and services. Companies with revenues between $25 billion and $40 billion that I have studied may have as many as 20 growth initiatives annually.

While much research needs to be done in this area, I do think that these hypotheses can be formed:

- Most disruptive innovation comes from smaller companies;
- High-growth phases result from scaling, and high-growth large companies are able to continuously create or acquire new opportunities to scale;
- Improvements, especially business process improvements, are the foundation of continuous growth; and
- Companies with consistent growth make small strategic acquisitions of new products, services, and customer segments to create more scaling opportunities.

The purpose of a Growth Portfolio is to produce either new scalable S-Curves of revenue or scalable efficiencies and productivity. Improvements and scaling are fundamental for growth.

The Risks of Growth

Is growth always good? Can too much growth destroy value or damage your brand?

In the fall of 2008, I spoke with the CEO of a major global company that had experienced high growth during the previous five years. Most calls I receive from big companies involve conversations focused on "fixing us so we can grow more or faster." But this call was unique. This CEO was concerned that his people, processes, and controls were being stressed by too much growth. He wanted to spend three days with his top global leaders in a workshop talking about the risks of growth.

At the time, I was engaged in the Darden Private Growth Company Research Project,[50] where I was researching the major management challenges faced by successful CEOs who had built recognized, high-growth, private companies. Many of those CEOs were respectful of the risks of growth and were challenged to pace and manage growth so as not to overwhelm their people, processes, and controls.

Those two occurrences led to my next research project, which continues today: looking into the circumstances of when and how public companies incur self-inflicted wounds as a result of too much ambition for growth.[51] Examples include Toyota, Starbucks, JetBlue, and Harley-Davidson. What are my research findings so far?

All growth is not good. Growth can stress people, processes, and controls. If not managed, growth can dilute a company's culture, customer value proposition, and brand. Growth creates risks that have to be managed. In my book *Smart Growth*, I set forth a Growth Risks Audit for companies to use in analyzing the potential risks of growth, so they can devise plans to minimize those risks.[52]

This research has produced the following questions that I continue to pursue:

- Are constantly increasing BHAGs[53] (big hairy audacious goals) a signal that an organization could be putting too much growth stress on its people, processes, and controls?
- Can the cumulative effect of many small internal changes made in the pursuit of high growth have a "black swan" effect?[54]
- Since managing the risks of growth requires a completely different mindset than for creating growth, how can companies put early warning systems in place to alert them that the systemic stresses of growth are too high and should be addressed?

[50] Research conducted by Professor Edward D. Hess, Darden Graduate School of Business Administration, funded by the Batten Institute and the University of Virginia Darden Foundation.

[51] Edward D. Hess, "Bigger Is Not Always Better," http://www.forbes.com (accessed February 3, 2010).

[52] Hess (2010), 138.

[53] Collins, Porras (1994), 93.

[54] Nassim Taleb, *The Black Swan: The Impact of the Highly Improbable* (New York: Random House, 2007).

I submit that the U.S. capital markets dominant theme of short-termism contributes materially to the creation of these kinds of growth risks. Fortunately, some companies choose not to play that game.

Costco[55]

Costco Wholesale Corporation (Costco) is a good illustration of a company that has taken a long-term view and managed its risks of growth. It has vigorously guarded its internal growth system, customer value proposition, and business model from the perils of short-termism and has resisted calls for more emphasis on short-term earnings. Costco also demonstrates the interrelationship between value creation, business model, and employee-centric values and policies.

Costco is the fifth-largest retailer in the United States and eighth-largest retailer in the world.[56] For the fiscal year ended August 31, 2009, Costco generated more than $71.42 billion of revenue, employed 147,000 full- and part-time employees, and had more than 60 million members.

Costco's business model is based on rapid inventory turnover, minimal advertising, high employee retention, low employee theft, and price markups limited to either 14% or 15% over costs. Costco's sole exception to its low-cost strategy is in the area of employee pay and benefits.

The average employee makes about $18 per hour, and Costco pays for almost all the healthcare insurance of its employees. Costco defends paying these employee costs as being economically good for the business because it results in higher employee engagement, an employee retention rate substantially above the retail industry average, and less theft by employees. Costco wants to be the best retail employer with respect to wages. Not surprisingly, Costco has been criticized by a Wall Street analyst for its policies. One analyst, Bill Dreher of Deutsche Bank, complained that at Costco "it is better to be an employee or a customer than a shareholder."[57] Costco CEO Jim Sinegal has repeatedly responded to critics in the following way:

> You have to recognize…and I don't mean this in an acrimonious sense—that the people in that business (Wall Street) are trying to make money between now and next Thursday. We're trying to build a company that's going to be here 50 to 60 years from now. We owe that to the communities where we do business. We owe that to our employees who count on us for security. We have 140,000 employees

[55] Hess (2010).

[56] Jeff Brotman, Jim Sinegal, Letter to Costco Shareholders, December 12, 2008; Jeff Chu, Kate Rockwood, "CEO Interview: Costco's Jim Sinegal," *Fast Company*, October 13, 2008; Steven Greenhouse, "How Costco Became the Anti-Wal-Mart," *New York Times*, July 17, 2005; Greg Lamm, "2008 Executive of the Year," *Puget Sound Business Journal*, March 19, 2008; Dyan Machan, "CEO Interview: Costco's James Sinegal," *SmartMoney*, March 27, 2008; O'Reilly, Pfeffer (2000).

[57] Greenhouse (2005).

> and their families: That's a significant number of people who count on us. We owe it to our suppliers. Think about the people who produce products for us—you could probably multiply our family of employees by three or four times. And we owe it to our customers to continue to offer good prices.[58]

Sinegal is managing for the long term and trying to protect his business model from creeping dilution. He responds to similar criticism about his strict gross profit margins of no more than 14% or 15% by stating that "increasing markups to say 16% or 18% might cause Costco to slip down a dangerous slope and lose discipline in minimizing costs and prices."[59]

Sinegal's views are refreshing. He is not only cognizant of the risks of growth but also relentless in refusing to compromise the Costco system that works. That is Smart Growth.

Smart Growth: My Conclusions[60]

From my research plus the work of numerous other researchers, I suggest that the following is a more accurate model of growth:

- Growth can be good, and growth can be bad.
- Being better is more important than being bigger.
- Grow or Die should be replaced by Improve or Die.
- Continuous linear growth is rarely achieved and not a good objective or standard.
- Growth is a complex experimental learning process dependent, in most cases, on humans whom we know are not always efficient, rational, or unbiased cognitive processors; therefore, growth is not a mechanistic, linear predictable process.
- Growth is much more than a strategy—it is a comprehensive internally linked system.
- Continuous growth requires specific types of leaders, internal environments, and processes.
- Growth cultures, leaders, and processes encourage diversity of thinking, strategic reframing, high employee engagement, customer co-creation, experimentation, hypothesis testing, a tolerance for mistakes and heightened paranoia about complacency, group think, legacy mental models, and management elitism.

[58] Chu, Rockwood (2008).
[59] Greenhouse (2005).
[60] Hess (upcoming 2012); Hess (2011); Hess (2010); Hess and Goetz (2008); Hess (2007); Hess and Kazanjian (2006); Hess and Cameron (2006).

- The enemies of continuous growth are a short-term mentality, ROI-tis, arrogance, cognitive blindness, legacy mental models, penalizing mistakes, product centricity, and measurement and reward policies that are too short-term oriented.
- Growth and innovation are enabled by growth mindsets, high employee engagement, and customer co-creation.
- Constant improvement is the DNA of growth; scaling is the foundation of high organic growth; and strategic acquisitions can be scaling accelerators.
- Growth is probability-based, requiring a diversified portfolio of growth initiatives.
- Growth can stress people, processes and controls, and even dilute the company's brand, culture, and customer value propositions.
- Growth creates risks that need to be managed.
- Every business does not have to grow in the Wall Street sense; but every business does have to continuously improve its customer value proposition better than its competitors.

Conclusion

Growth, sometimes solely for the sake of growth, is a primary goal of many business organizations. Historically, strategy and finance have dominated growth conversations and many business leaders look no further that those disciplines when making decisions about and planning for growth. I believe that view is too narrow. This note seeks to expand that conversation by systematically examining the characteristics of consistently high-growth companies and asking the question of what actually contributes to growth. I contend that consistent growth or value creation occurs when the right combination of strategy, cultural values, entrepreneurial mindset, experimental processes, values-based leadership, and people-centric human resource policies combine to enable high employee engagement that results in consistent simultaneous strategic exploitation and exploration.

Consistent growth requires the design and management of the right mixture of ambidextrous strategic processes, entrepreneurial mindsets, and experimental processes all enabled by a values-based people-centric internal system. Growth is the dynamic confluence of strategy, entrepreneurship, and values. Consistent growth requires business leaders to take an active role in ensuring the right ingredients for growth are present.