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# How to Compete in Stagnant Industries

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*As more and more industries decline or increase only modestly, the need for competent managers in stagnant industries will grow. Instead of following the often-heard advice to harvest such businesses, managers should understand the characteristics of their markets and build strategy accordingly. On the basis of their study of a number of declining industries, these authors identify some consistent characteristics in companies that have competed successfully.*

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From 1950 to 1973, the U.S. economy enjoyed record prosperity. Gross national product and per capita disposable income, measured in real terms, grew at annual rates of 3.7% and 2.4%, respectively. Among the many consequences of this growth has been an attitude among managers that growth is beneficial and will continue and an assumption that the most talented and aggressive managers should lead rapidly growing divisions. Slowly growing or declining divisions have been left to the less aggressive or over-the-hill managers.

Such attitudes and assumptions may have made sense when growth seemed unlimited. Since 1973, however, economic growth has slowed, with real GNP moving up at only 2.3% per year and real per capita disposable income rising at only 1.7% per

year. And the limited supply of natural resources has led most economic observers to forecast a prolonged period of slower growth. Thus, in the future, more industries will experience declines or only modest increases in the demand for their products. This situation will create a tremendous need for managers who can effectively lead businesses that compete in stagnant industries.

Despite the increasing need for competent management in stagnant industries, little research has been conducted on what strategies make the most sense in such industries. Existing theory offers little sound advice. Instead it offers the glib recommendations that companies either divest these businesses or "harvest" them as "cash cows." Unfortunately, harvesting can often become synonymous with abandonment. Moreover, the difficulty of finding a buyer often makes divestment impossible, and liquidation is often impractical. One experienced division manager commented on the problem in the following way:

"Recently our corporate planning people studied our division and determined that we should drop certain product lines because they were in tough, slowly growing markets. But that isn't so easy. Without those sales, we'd no longer be covering our plant overhead and most of our other products would become unprofitable."

In our study of possible approaches to competing in stagnant industries, we first defined stagnant

industries as those whose total unit demand over a ten-year period had either declined or increased at less than half the rate of real GNP. After identifying 12 industries which met our criteria, we then looked carefully at those companies that were notably successful or unsuccessful in order to determine what competitive strategies were most likely to succeed or fail in such industries. Finally, through interviews with managers in many of these companies, we were able to gain a better understanding of the administrative problems of managing a stagnant industry.

Our research shows that it is possible to compete successfully and to earn high returns in these industries. More specifically, it reveals some important characteristics of the strategies of the successful businesses. Equally important, our work also indicates that the way top management interacts with and administers its stagnant businesses often has a substantial impact on their performance.

## Harsh Realities

Before turning to the most promising strategies, it is necessary to examine the difficult realities of life in a stagnant market. An appreciation of these realities is critical because, as we shall see, strategies that run counter to them nearly always fail, while the successful strategies are consistent with market conditions.

Perhaps the most difficult reality to accept is that rapid growth probably will not return to a stagnant industry. Consider the coffee industry. Between 1960 and 1975, total consumption of coffee fell 3.2%. Admittedly, in certain years demand has increased and in others price increases have led to pronounced declines. But over a long period of time, the overall trend has been a slow decline. The fact that consumption per person has fallen even more rapidly suggests that this trend will continue.

The point is an important one. In a declining or slowly growing industry, there may be some years when demand is buoyant. But it is essential for managers not to let wishful thinking color their views. Instead, they must accurately assess the long-range prospects and face the problems of competing in a stagnant marketplace. Management's acceptance of the reality of a continuing slow demand is a prerequisite for developing successful strategies.

For example, at one company we visited, we were told about the shaky relationship between the corporate office and a division that competed in a declining market. Corporate management was dissatisfied with the division's performance, while the division

was upset that none of its capital requests had been approved in the past four years. Closer examination revealed that, although top management did not want to commit additional resources to the division, it was still pressuring the division to grow. The division's response was to develop plans for growth that required additional capital investment.

When both division and corporate management confronted the reality of declining demand in a series of strategy-setting meetings, the problem was eventually resolved. The division then adopted a set of goals consistent with its market opportunities, and corporate management began to measure divisional performance on the basis of cash flow and return on investment.

The next unpleasant reality is that competition is usually more intense in stagnant markets than in those that are growing rapidly.<sup>1</sup> A company can substantially increase its sales in a rapidly growing industry without taking market share from competitors. In fact, often it takes all of a company's managerial and financial resources just to meet growing demand. The major problem is expansion, not competition. When industry growth slows, however, company growth can be achieved only at the expense of others, and competition increases.

As competition intensifies, the number of companies competing in the industry usually declines, and the market shares of the largest companies increase. For example, in the cigar industry, where unit demand has been declining by 5% a year for 15 years, the number of manufacturers declined from 283 in 1958 to 132 in 1972. In the coffee industry, not only has the number of companies declined but the combined market shares of the three largest corporations increased from 47% in 1960 to 67% in 1976.

A final reality, and one that is often overlooked, is that changes in products, technology, production process, and distribution still occur in stagnant industries. In fact, research by William J. Abernathy and James M. Utterback has shown that some innovations, notably in the manufacturing process, tend to occur more frequently as a market matures.<sup>2</sup> For example, improvements in cigar-forming equipment have changed the industry from a "craftsman" business to an automated one. As we shall discuss later, improvements by the Japanese in the manufacturing process of motorcycles made possible the development of the recreational motorcycle market. Stagnant demand, then, does not prevent significant changes.

1. See Michael E. Porter, "How Competitive Forces Shape Strategy," HBR March-April 1979, p. 137.

2. See James M. Utterback and William J. Abernathy, "A Dynamic Model of Process and Product Innovation," *Omega*, 3, no. 6 (1975), p. 639.

Failure to recognize these realities can lead to competitive strategies that seem logical but are seldom successful. This is most likely to occur when stagnant sales are viewed as “a marketing problem” instead of as a fact of life. Rather than increasing total demand, typical marketing solutions such as brand proliferation and heavy advertising usually result in higher inventory investment, higher manufacturing costs, and lower profitability. Other research has shown that, although increased advertising tends to benefit businesses in their introduction or growth phases, it is seldom useful for declining businesses.<sup>3</sup>

## Strategies for Success

Given these realities, are there any approaches that not only avoid the possibility of extinction but that also offer hope for a reasonable return on investment in stagnant industries? Our research uncovered three common characteristics of the strategies of businesses that have succeeded in stagnant industries: they identify, create, and exploit growth segments within their industries; they emphasize product quality and innovative product improvement; and they systematically and consistently improve the efficiency of their production and distribution systems.

### Growth segments

Perhaps the best way to avoid some of the unpleasant realities in a stagnant industry is to concentrate on growth segments. A classic example is the strategy followed by General Cinema Corporation.

Over the past 30 years, the number of motion picture theaters in the United States has declined by almost 20%. As late as 1946, movie admissions accounted for \$1 out of every \$5 spent on recreational items versus \$1 out of every \$40 today. During this extended period of decline and stagnation, one market segment—the shopping center theater—has been growing at an impressive rate. And General Cinema Corporation has been the leader in recognizing this opportunity and in concentrating its resources in this growth segment. Today General Cinema has about 700 shopping center theaters, usually with multiple auditoriums (Cinema I and II theaters). In a declining total industry, General Cinema has been able to maintain average earnings

increases of over 20% during the past 10 years and a return on equity of 20%.

Of course, it can be argued that by competing in growth segments a company has merely figured out how to avoid competing in a stagnant industry. And this is precisely the point. Choosing what business to compete in is at the very heart of the strategy formulation problem, and the best strategists spend considerable time analyzing their industries in an effort to identify emerging or growth segments. Admittedly, there are some industries for which it is virtually impossible to identify growth segments, but in most industries opportunities do exist. As the chairman of a \$300 million specialty paper and chemical company recently told us, “There is a high-growth segment in every industry you can think of.”

Another example illustrates how imaginative thinking can uncover growth opportunities, even within a sluggish capital goods industry. Since the Arab oil embargo in 1973, demand for electrical power in the United States has hardly risen, leading to a major reduction in orders for new power-generating equipment. Westinghouse Electric’s Power Systems Company has not been able to avoid this dearth of new orders, but it has compensated for these lost sales by expanding its service business.<sup>4</sup> As customers have postponed or canceled new purchases, demand for repair and maintenance work has surged. Not only is Westinghouse filling this demand, but it is also actively developing new products and concepts that should enable the company to exploit this growth segment.

For example, replacement parts are being developed that improve the efficiency of existing systems, and a portable precision machine shop allows technicians to machine heavy rotors on location. As a result of these efforts, during the past six years service volume has tripled, enabling the Power Systems Company to show steady gains in sales and earnings.

Since the identification of growth segments usually requires considerable insight and creativity, it is difficult to prescribe a set of procedures that will lead to their identification. Nevertheless, there probably is a way to think about an industry that should help identify growth segments. The key is to recognize that, on close examination, most industries are composed of numerous segments and subsegments. And these can be defined along a variety of dimensions: customer group, price, product characteristics, product use, geography, service, and technology.

Merely listing and thinking about segments, however, is not enough, for detailed breakdowns of industry statistics along the relevant dimensions are

3. See Paul W. Farris and Robert D. Buzzell, *Relationships Between Changes in Industrial Advertising and Promotion Expenditures and Changes in Market Share*, Marketing Science Institute Working Paper No. 76-119 (Cambridge, Mass.: December 1976).

4. See “More Manufacturers Are Selling Services to Increase Returns and Smooth Cycles,” *Wall Street Journal*, December 26, 1978, p. 24.

also required. This information is seldom publicly available and requires a research investment to collect and analyze it. For example, just considering customer grouping, simply to obtain a breakdown by age, sex, geographic location, economic status, and buying motivation may involve considerable effort. In some of the companies we visited, it was not unusual for one or two staff people to work full time at collecting and analyzing such data. Thus a creative management that is willing to view its stagnant industries as being composed of smaller segments and to collect and analyze detailed industry data is much more likely to identify segments with growth potential.

## Innovation & Quality

Another characteristic of successful strategies in stagnant industries is the pursuit of high-quality, innovative products. Such products allow the company to avoid some of the price competition that often typifies stagnant markets. Product innovations have the further advantage of being difficult and expensive for competitors to imitate.

An example of a high-quality innovative product is General Foods's freeze-dried instant coffee, which offers better-tasting instant coffee. For almost ten years, it has grown rapidly and achieved the highest margin of all coffee products. The freeze-dry technology is also more expensive than traditional technologies. Most coffee producers—with the notable exception of Nestlé—have been unwilling or unable to invest in either the research or the capital equipment necessary to compete in this segment. Thus this innovation has provided high margins in a segment with few competitors.

Further evidence that high quality and innovation are particularly important in stagnant industries comes from analysis of the 1,000 businesses in the PIMS (profit impact of market strategies) data base.<sup>5</sup> For all these businesses, higher product quality is associated with a larger return on investment, but the relationship appears to be most significant in stagnant markets (see *Exhibit I*). Also striking are the relationships among ROI, market growth, and expenditures for research and development (see *Exhibit II*). For moderate and rapid-growth markets, the PIMS data indicate no benefits to ROI from increased spending on R&D. However, in the stagnant markets, high rates of R&D spending correlate with higher ROIs.

The association between ROI and R&D spending in stagnant industries may indicate that, in addition

EXHIBIT I Return on Investment as a Function of Market Growth and Product Quality (in Percentages)

Market growth	Product quality		
	Low	Medium	High
Low	15	14	31
Medium	16	22	29
High	21	23	28

Source: Based on data from PIMS companies in *The Limited Information Report*, distributed by the Strategic Institute (Cambridge, Mass., 1977), p. 16.

EXHIBIT II Return on Investment as a Function of Market Growth and Research and Development Expenditures (in Percentages)

Market growth	R&D/sales		
	Low	Medium	High
Low	14	21	19
Medium	22	19	15
High	21	20	12

Source: Based on data from PIMS companies in *The Limited Information Report*, distributed by the Strategic Planning Institute (Cambridge, Mass., 1977), p. 16.

to the benefits from a major new product innovation, in many cases there is also a payoff from consistently higher levels of spending on research that produces a steady stream of higher-quality products. The group vice president in charge of the fastener divisions in a large corporation explained:

“Our business is a mature one, and in some divisions unit demand is actually declining. But because of the nature of our business and our own efforts, each year 20% of our products are new ones designed for the new models in the appliance, clothing, auto industry, and so on. Thus there would be a danger in reducing our spending on R&D. By designing innovative new products we not only maintain our volume but also avoid competing in commodity items.”

One result of this strategy was that the fastener group's return on assets was among the highest in the corporation.

## Operating Efficiencies

Another characteristic of the successful stagnant industry businesses we studied was their constant attention to cost reduction. The most common way to achieve lower costs seems to be by improving the manufacturing process. Often these improvements stem from constant and systematic attention to efficiency. For example, Samuel Hollander has shown that more than half of the reduction in rayon costs at Du Pont has resulted from gradual improvements rather than from major investments and programs.<sup>6</sup>

5. For a more complete description of the PIMS project, see Robert D. Buzzell, Bradley T. Gale, and Ralph G.M. Sultan, “Market Share—A Key to Profitability,” *HBR* January–February 1975, p. 97.

6. See William J. Abernathy and James M. Utterback, “Patterns of Industrial Innovation,” *Technology Review*, June–July 1978, p. 3.

A dramatic example of the power of process innovations is the Japanese approach to the motorcycle industry. During the 1950s, demand for motorcycles declined as fewer people used them as a primary mode of transportation. Rather than exit from this sick industry, the major Japanese manufacturers embarked on an ambitious program to lower their costs and to concentrate on smaller motorcycles (under 750 cc). High degrees of specialization and automation have been the hallmarks of the approach. One Honda plant, for example, makes only engines. Both Suzuki and Yamaha have plants almost entirely dedicated to the manufacture of specialized machine tools. As the Japanese lowered their costs and broke price barriers, they were able to create a new growth segment in the industry—the recreational bike.

Although improvements in the manufacturing process are the most common way of lowering costs, other efficiencies can be achieved. For example, the orderly and planned consolidation of production facilities can have a dramatic impact on ROI. In the previously mentioned fasteners group, one division's ROI was less than 10%. Consolidation of its manufacturing facilities with those of other divisions has helped to lift its ROI to 35%.

The important point, however, is not only that facility consolidations lead to higher rates of return; it is also that by accepting the realities of stagnant demand, management can plan for the orderly consolidation of manufacturing facilities. For example, the division manager of a business that supplies materials to U.S. shoe manufacturers determined that over a three-year period his need for two manufacturing plants would disappear. He used this time to identify another division in the company that needed manufacturing capacity. The shift from a two to a one-factory operation has enabled the division to operate at high levels of efficiency, and the changeover was implemented with a minimum of disruption.

A final form of operating efficiency is possible through broad and efficient distribution, which is especially important in stagnant industries requiring high volumes for efficient manufacturing operations. For example, Whirlpool's appliance business is concentrated in the stagnant washer, dryer, and refrigerator segments. To ensure the volume needed to manufacture at efficient scale, Whirlpool has used Sears as the distribution outlet for 60% of its production. Indeed, private labeling is a common way of achieving broad and efficient distribution in stagnant industries.

It should be noted that the three characteristics we have identified of the strategies of the successful businesses often reinforce each other. In both the motorcycle and the appliance industries, attention

to operating efficiencies led to concentration on growth segments. And in the motorcycle industry, the smaller, cheaper recreational bikes were high-quality product improvements. Clearly, the successful companies differ in the degree to which they emphasize the three strategies, but most of them exploit elements of each.

## Top Management's Role

When we began this study, our objective was to identify the characteristics of successful strategies for competing in stagnant industries. In talking with managers in these businesses, however, it quickly became apparent that the nature of top management's involvement and its choice of general managers for these businesses were also critical determinants of their success.

In most large, diversified corporations, it is beyond the scope of corporate management to set strategy for individual business units. Nevertheless, top managers do influence business unit strategy through the reporting system, compensation system, planning system, organizational arrangements, and personnel selection. Obviously, corporate managers attempt to establish systems and an organizational context that facilitate the business units' efforts to compete successfully. For business units that compete in stagnant industries, corporate-level managers can accomplish this by not labeling the status of these business units, by not mandating "milking" strategies, and by assigning talented general managers to run these businesses.

## Avoiding labels

Throughout this article, we have pointed to the payoffs of accepting and dealing with slowing sales as a reality of life. Although it is essential that top management consider this reality when developing business plans, it is also important not to assign pejorative labels to these businesses.

One label sometimes used for low-growth businesses is "dog." Such a characterization can have a debilitating effect on morale within the division, and it suggests that not much attention needs to be given to these businesses. But, as we have seen, competition in stagnant industries is usually intense, and success is dependent on creative strategies and skilled implementation. A group vice president of a large industrial company explained his experiences as follows:

"Two of the divisions that report to me are in very sluggish industries. In one case, we have been able to

develop more original strategies, have the employees all fired up, and are making a good return. But I have had to fight to keep the corporate planners from giving their view of the situation. In the other division, the notion that they have a dog has been allowed to permeate from the top. I feel there are some original things we could do there, but it's impossible to get anyone at the division very excited to try something new. Eventually we'll probably sell or liquidate the division."

The point is a simple one. Top managers do have the responsibility to make sure that the business unit accepts stagnant industry demand as fact. But, as we have shown, stagnation does not mean that successful ways of competing do not exist. Successful strategies are more likely to be adopted when the stagnant condition is accepted as a fact of life rather than labeled as a dreaded condition.

## Avoiding milking

Another inappropriate top management response is to require these businesses to adopt milking, or harvesting, strategies automatically. The overwhelming defect of these strategies is that they are internally oriented, ignoring events in the external environment and assuming a lack of change within the industry. This attitude is often reflected by attempts to milk the businesses for cash and thus to minimize investments in research and engineering. Unfortunately, there is often a thin line between managing a business in this way as a cash cow and abandoning it.

When Alcoa and Reynolds Aluminum developed a process to produce two-piece cans, their intentions reportedly were to make the process available to can manufacturers in order to increase their raw material sales. However, the two largest can producers, American Can and Continental Group, were reluctant to incur the costs involved in line changeovers at a time when they were diversifying into growth businesses and de-emphasizing their slowly growing can operations.

The result was that Alcoa and Reynolds began to build their own can lines and that two smaller producers, National Can and Crown Cork & Seal, also invested heavily in new two-piece can lines. Because the new cans have proved very popular and offer important manufacturing benefits, the companies that were willing to invest in the new process have gained market share at the expense of their larger competitors, who assumed a static situation and were harvesting their can manufacturing businesses.

The penalties for adopting milking strategies that assume a static competitive and technological situation can be severe. The director of corporate plan-

ning at one of the widely diversified companies we visited explained:

"If one of our high-growth divisions misses or is late on an innovation, it is not that serious, because in a few months they will have another chance to be first on the next set of innovations. But in slowly growing divisions, change is less frequent. And if you miss a change, the next one may not come for another five to ten years. By that time, you could be out of business."

Admittedly, many successful businesses that compete in stagnant industries do generate more cash than they consume and in this sense could be considered cash cows. But there is an important distinction between generating positive cash flows as the result of strategic actions aimed at improving a business's competitive position and making positive cash flows the major objective of a business.

In the former approach, a business develops its strategy after assessing conditions and changes in the external environment and relates these to internal competence. After management formulates a strategy, it applies financial tests such as ROI, cash flow, or rate of growth and makes a decision whether to adopt the proposed strategy. Conversely, the milking approach leads to a strategy that is consistent with a certain set of cash flows. In our view, this approach is much less likely to produce creative strategies that will be successful over a long period of time.

## Choosing managers

Earlier in this article, we noted the historical tendency of most top managements to assign their most talented and aggressive managers to their rapidly growing divisions while leaving their stagnant divisions to less aggressive and competent managers. Keeping in mind that competition in stagnant industries is usually more intense than in growth situations, it is easy to see the problems that arise when less competent managers are assigned to these businesses.

Choosing appropriate general managers for low-growth businesses, then, is a major challenge. For example, selecting "marketing men" who only focus on increasing sales is likely to lead to strategies that are inappropriate in these industries. Our observation has been that it is crucial for an experienced general manager to be assigned to run one of these businesses and that his or her future promotions be tied to success with these divisions. A group vice president at an industrial company explained.

"I try to assign these [stagnant] businesses to people who are ready for their second or third general management job. These are real good positions to

test the flexibility of these people. Also, I think by assigning talented people we get a leg up on our competitors who may be downplaying these businesses."

Of course, choosing good people becomes a hollow gesture if it is not backed up with bonuses and promotions for outstanding performance. And here it is important to remember that success will usually not manifest itself in high rates of sales growth but rather in high levels of ROI. Nothing signals top management's expectations more clearly than the promotion of general managers who have competed successfully in a stagnant marketplace.

## In Summary

We have tried to address one of the most difficult strategic problems that managers face, a problem we think will proliferate in the future. Despite our recommendations regarding successful strategies and management's involvement, it should be apparent that competing in these industries will always be difficult. We can then ask: Why bother? Why not diversify into higher-growth businesses and simply divest low-growth businesses?

In answering these questions, it is important to recognize that, from the corporate perspective, diversification is often an effective way to deal with these problems. In fact, one of the major roles of top management in a diversified company is to ensure that growth businesses will be maintained within the corporation. But it is a rare company that competes only in rapidly growing industries. Thus corporations must eventually address problems of competing in slower industries.

There are other reasons why diversification is not a panacea for the problems of competing in stagnant industries. In some companies, these businesses are

simply too large to be disposed of or liquidated. For example, even though the coffee industry is declining, General Foods still derives 40% of its sales and one-third of its earnings from its coffee business. It has no choice but to compete vigorously and effectively in the coffee industry.

In other circumstances, divestment is simply impossible. Who would want to buy one of these businesses? So, in many cases, management cannot avoid the problems of competing in stagnant industries. Indeed, as we pointed out earlier, accepting and dealing directly with the problem is usually the first step in adopting and implementing a successful strategy.

The next step is to choose a strategy and stick with it. In several of the situations we studied, divisional management kept wavering among a broad range of strategies. One month management proposed a series of product line extensions, while the following month simplifying distribution would be the fad. This lack of consistency not only wastes valuable time and fails to produce results for the division but also confuses the corporate managers who are trying to understand and help the divisions.

Competing in stagnant industries requires adoption of clear strategies that emphasize growth segments, innovative products, and production efficiencies. At the same time, top managers must avoid the tendency to label these businesses pejoratively, to require them to implement harvesting strategies, and to assign them to weak managers.

When these guidelines are followed, competing in these industries can be profitable and slow growth can become an ally. As competitors stumble into the ever-present pitfalls, a tremendous opportunity is created for companies that are willing to compete aggressively and imaginatively. For them, competition in these industries is by no means dull; rather, it is exciting and profitable.

## Adam Smith Today

That Adam Smith, were he alive today, would be highly suspicious of those who are prepared to ignore the important part which 'the market' could play in the proper ordering of economic affairs, there can be little doubt. It is understandable that, given the widespread attack on the value of the market mechanism, many should be tempted, paraphrasing Wordsworth, to say 'Adam Smith! thou should'st be living at this hour: England hath need of thee'. But it is not likely, in my view, that Smith would endorse an exclusive reliance on market forces in all cases, particularly when the

democratic process has put power into the hands of different groups to adapt the operation of these forces so as to favour sometimes one and sometimes the other group. We would certainly be praying for the presence of one whose good sense and broad humanity would be of inestimable value amid the shrill clamour of divergent views which are vying for our support. But we should, I think, do so without illusion.

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