Excess Growth

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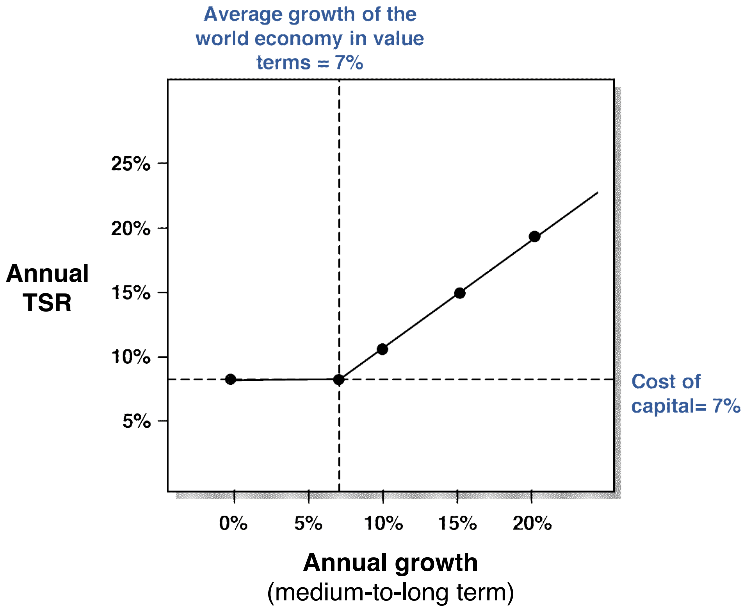
Let's get back to basics. Value creation is not tied to profitability. It is tied to profitable *growth*. Analyses on all stock markets show a correlation between TSR and growth (at a given profitability level). Developing the Gordon-Shapiro formula shows the components of TSR(1) more precisely. TSR is equal to the cost of capital plus the firm's *additional* medium-to-long-term growth above the average growth of the economy (based on a constant level of profitability that is higher than the cost of capital). TSR= Ke+ΔG(2).

Therefore, value creation (TSR-Ke) is equal to the *excess growth* generated by the company above the average growth of the economy (ΔG). This relationship can be seen across all time horizons (greater than five years) for all firms and on all major stock exchanges (see Table 1).

- Table 1 -

Value creation is tied to growth that exceeds the average growth of the economy



$$\text{TSR} = \text{Ke} + \Delta G$$

$$\underbrace{\text{TSR - Ke}}_{\text{Value creation}} = \underbrace{\Delta G}_{\text{Excess growth}}$$

Where does this excess growth come from? Obviously from two sources: medium-to-long-term growth in the market and from the firm's gains in market share. For both of these, the nature and dynamics of the markets in which the firm operates are critical.

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(1) TSR = Total Shareholder Return: shareholders' annual profit on his or her investment (stock-market gains, dividends, bonus-share distributions, etc).

(2) Where Ke is the cost of capital and ΔG is the difference between the firm's medium-to-long-term growth and the average growth of the economy at constant profitability.

Market growth is very much limited by structural dynamics. We can (and should) be looking for ways to constantly revitalise mature markets. But when you are operating at the end of a long cycle of development in a major industry in a developed country, and in highly concentrated markets, and when value is increasingly migrating downstream, it is difficult to recreate growth dynamics *that are significantly higher than the economy average*. That is why the big groups are rapidly developing an increasingly large percentage of revenues in emerging countries or in new businesses experiencing strong structural growth.

Not all businesses are equal when it comes to the potential for increasing market share. Business with high market-share value, such as those which offer major economies of scale, experience-curve effects, or positive effects associated with the size of production runs, always end up consolidating and offering the leader a profitability premium. Growth achieved through market-share gains (organic or through acquisitions) is necessary and has value. The investments made are earnings-enhancing if they can help to develop clear leadership positions.

Conversely, businesses in which there is little or no market-share value (economies of scale are low or quickly cease at a critical threshold that is well below the size of the market) are of little interest from this point of view. There is no value in combining them unless the intention is to establish a cartel (illegally). In this case, increasing market share lowers prices without decreasing costs.

The combination of these two drivers sheds light on the respective attractiveness of different types of businesses in terms of potential growth and therefore value creation (see Table 2). Excess-growth generation is potentially greatest in long-term growth sectors *and* where the economic nature of the business gives the leader a structural premium. The two sources of profitable growth, namely market expansion and market consolidation, coexist in this case. A group that really wants to create value for its shareholders should focus the bulk of its resources on such sectors (and become the leader in each of its targeted businesses).

In contrast, staying in businesses where there is no growth and no market-share value is an economic absurdity for a large group. Likewise, remaining in businesses where the market is no longer growing and there is no further potential for market concentration may be profitable and generate cash flow, but such positions do not create value.

Is any of this news? It is obvious or should be. However, in this case, a reason is needed to go against the tide. Long-term growth businesses with strong leadership value account for a small percentage of the business portfolios of large Western groups (less than 20% of revenues on average). Therefore, the majority of these groups cannot claim to be creating value for their shareholders based on their existing business portfolios (and, in fact, are no longer doing so).

The pursuit of excess growth requires firms to reconsider and actively manage their business portfolios in terms of sectors and countries.

Firms must be concerned with improving performances and, indeed, strategies within existing businesses on a day-to-day basis just to stay in the race. That is the challenge for management teams and head offices. With many major industries at the end of the cycle in developed countries, the challenge for CEOs and shareholders is to move to more attractive battlefields. Organisational inertia and the culture of large corporations are naturally opposed to this. But excess value above the cost of capital, i.e. *excess growth* is not created without breaking sharply away from the economy average.

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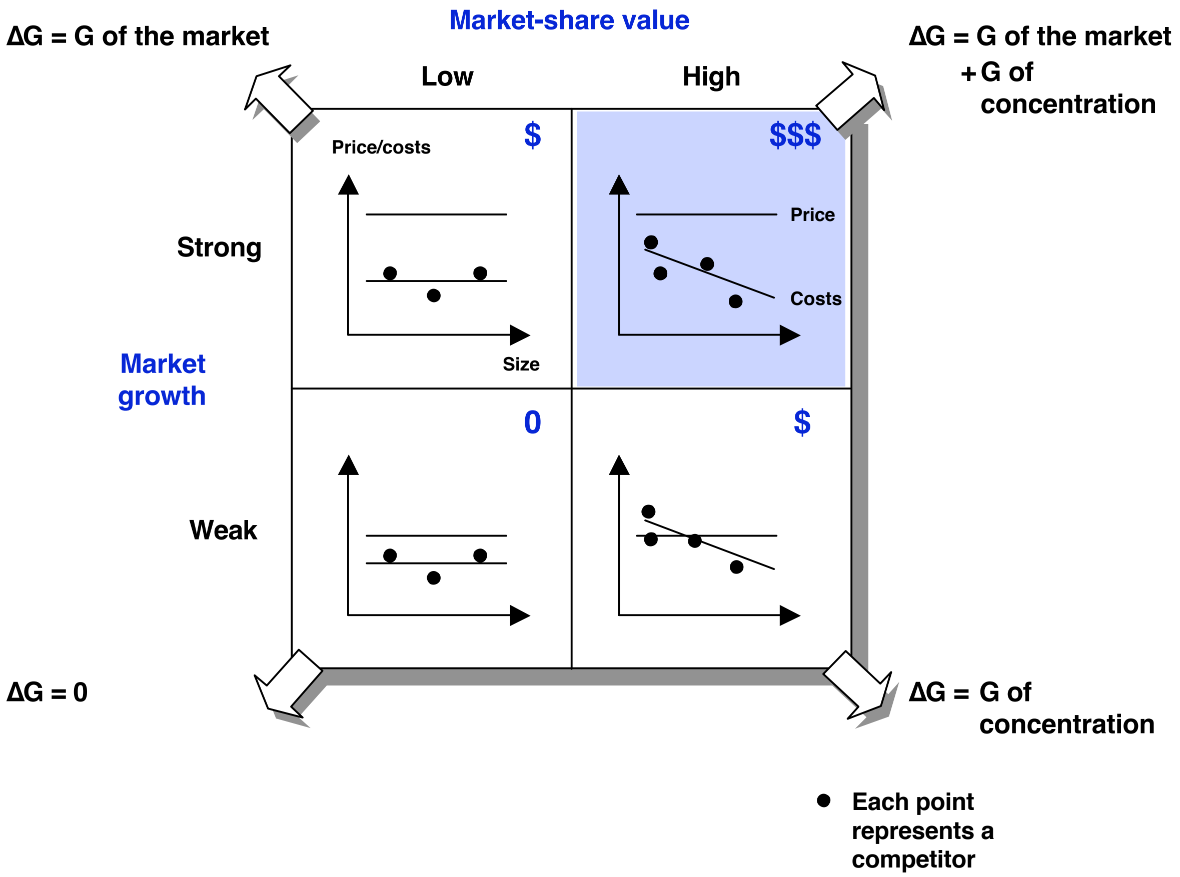
Estin & Co is an international strategy consultancy based in Paris, London, Geneva and Shanghai. The firm assists the boards of major European, North American and Asian groups in their growth strategies, and private equity funds in analysing and improving the value of their investments.

- Table 2 -

Sectors vary in terms of their structural attractiveness based on potential growth and therefore value creation



ΔG = Difference between the medium-to-long-term growth of the firm and the average growth of the economy