

The cost of growth

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Leaders in strong growth often have lower profitability than one might expect considering the strong scale effects from which they benefit.

Growth has a cost beyond investments in assets and working capital. It is the cost of innovation, the sales and marketing investments, the cost to temporarily sub-optimised industrial capacities during the ramp-up period, the specific costs of a competitive business model for clients, the price reductions to gain market share or the goodwill from acquisitions.

These costs are often hidden. Leaders in strong growth have high market shares and costs that are structurally lower than those of their competitors. Their profitability is in any case high. The cost which is both caused by their growth and makes this growth possible is not immediately identified. In addition, this cost is soon offset by the additional scale effects that it generates.

This cost is clear for followers, however, and is often an insurmountable obstacle. Except for price reductions and goodwill, it support the full impact of scale effects.

These costs are an investment, a driver of value creation¹. But as the investment is made through operating expenses and/or margins and is not capitalised, it is rarely analysed as such.

These costs must be optimised. Growth is necessary but can become dilutive if the scope and speed of investments are poorly calibrated, priorities poorly defined and costs poorly controlled. It is essential to achieve growth while also maintaining strong profitability.

The cost of growth through acquisitions

In businesses with strong scale effects, goodwill related to acquisitions temporarily damages leaders' profitability, which nevertheless remains very high. Implementing synergies makes it possible to partially offset the impact of such goodwill.

But for followers, weak structural profitability and insufficient cash flow make acquisitions difficult, given their impact on cash and net results.

It is therefore misleading to simply compare the apparent levels of profitability of competitors within an industry which is being consolidated through acquisitions. Profitability levels are linked to different growth rates and not only to market shares. The profitability levels of leaders are linked to growth rates which are higher than the industry average, while those of followers are often linked to a lack of growth and to a loss of market share. *They do not have the same value nor the same sustainability.*

Once the capital employed is retreated from goodwill, "organic" profitability is significantly higher for leaders. It reflects the real scale effects of the industry and explains the inevitable concentration of these industries (see table 1).

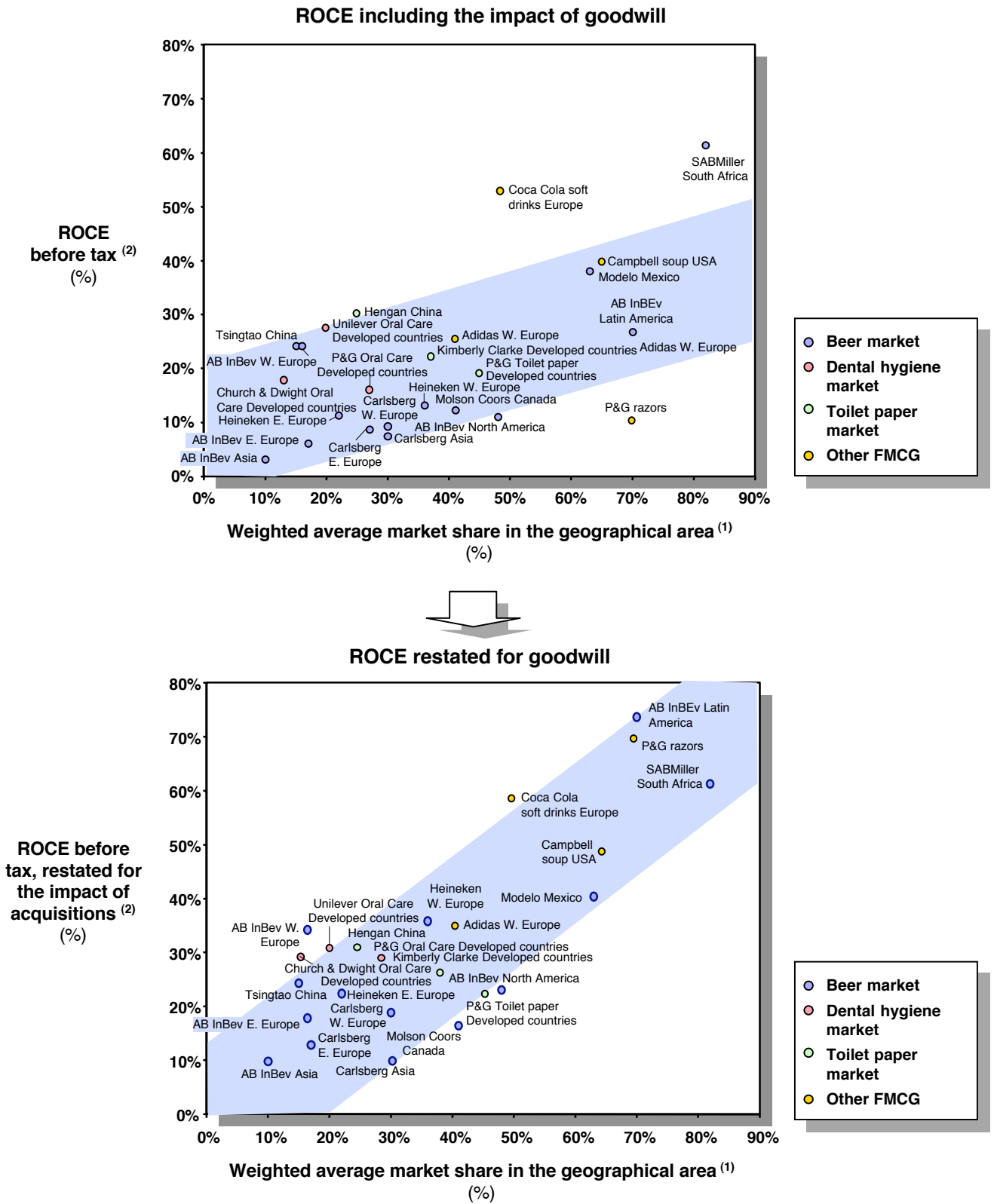
The cost of an attractive business model

In a typical industry with strong scale effects (e.g., a 20% reduction in costs each time the market share doubles) and well structured (the leader being twice the size of the immediate follower, which is in turn twice the size of the number three), the leader's EBIT should be between 30 and 40%.

¹ For a leader, it is actually better to slightly reduce profitability in order to boost growth, as long as profitability remains high, superior to the cost of capital and sufficient to finance growth.

- Table 1 -

Profitability and market share of FMCG leaders before and after goodwill



Note: (1) Average market share in countries in which the actor in question retails its products; (2) ROCE = EBIT / Employed Capital
 Sources: Annual reports, presentations to analysts, Bloomberg, Estin & Co analyses and estimates

In reality, such figures are rarely seen. It is always in the leader's interest to concentrate the industry to increase its competitive advantage. It therefore uses part of its "excess profitability" to invest in product quality or innovation, in building its brand, in customer service or in price decrease, and so in growing at a higher rate than its competitors.

For example, Germany's leading discount optical retailer should have very high structural margins (EBIT of up to 50%) given the scale effects experienced in purchasing and retail network. But, by investing 30 points in price reductions (versus independent retailers) and 9 points in advertising, it is able to grow at 7% per annum in a market growing at an average of 2% per annum. Its margin, net of growth costs, is "only" 17% (EBIT) and its profitability 50% (ROCE) (see table 2).

Growth is always the result of strong competitiveness, the benefits of which are partly passed on to customers.

The cost of innovation

In the majority of cases, innovation serves simply to maintain consumption levels, market shares and price levels in mature markets. It does not drive excessive cost or strong supplementary growth (unless it creates a too high poorly managed complexity). It is an inevitable cost to simply staying in the same place.

Innovations that truly drive growth in mature markets are those which create disruptions and new waves of consumption. They may lead to significant additional costs with no return during several years. Between 1999 and 2011, Apple spent \$11 billion on research and development to develop three major innovations: the iPod, the iPhone and the iPad. R&D expenditure increased by 19% per annum. At the height of investment, it accounted for 8% of total revenue (see table 4).

They are also innovations which make it possible to grow through different, increasingly sophisticated product ranges, in markets with high technological development, and where the intensity of development costs increases with each new wave. For example, development costs for a video game were \$1m in 1995, \$5m in 2000, \$10m in 2005, and \$15m-\$50m in 2010, with extremes of up to \$150m for an online multiplayer blockbuster. Since the costs of the next wave are driven by the margins of the current wave, profitability tends to deteriorate, unless you are a leader benefiting from strong scale effects and concentrating the industry.

Lastly, they are innovations which make it possible to significantly adapt products and services to a new geographical area with high growth (e.g. the Renault Logan in emerging countries, Unilever's 5-rupee products in India, Nokia's low-cost phones in India). The cost of growth is mainly linked to diseconomies of scale caused by this adaptation (specific R&D, shorter production runs, different production facilities, specific inventories, etc.).

Again, these additional costs are investments and barriers favouring leaders because there are strong scale effects on R&D. With the growth achieved through its new income streams, Apple's R&D costs increased from 5 to 8% of revenue between 1999 and 2001 (the additional costs of growth) and then fell to 2% in 2011 (see table 4).

Sales and marketing costs

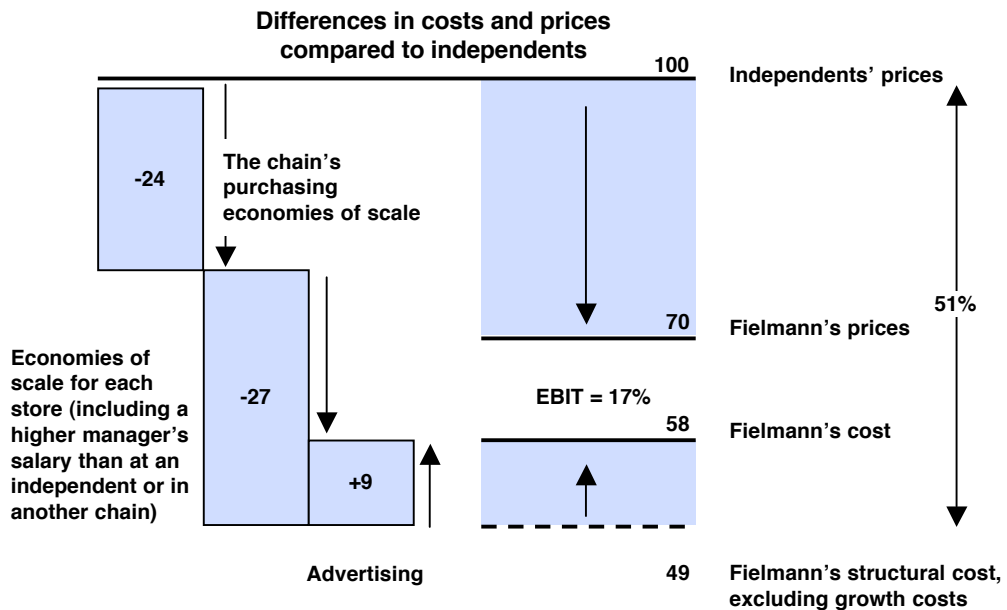
Sales and marketing investments depends on the magnitude of growth desired and on the structure of the market (see table 3).

In high growth markets that are not yet concentrated, market share is won on capturing the additional market, not by running one's competitors out of business. The investment is essentially additional costs linked to sales recruitments, advertising investment or technical support incurred in advance of achieving the desired additional revenue. This investment may be made six months, one year or 18 months in advance depending on the business. The higher the growth a company wants in a given period of time, the greater the additional costs will be (although they will then fall very quickly thanks to the scale effects). And the longer is the necessary time spent on training, adaptation and full ramp up of new teams, the greater the additional costs will be.

- Table 2 -

Fielmann (a discount chain of opticians in Germany) has a business model which enables it to grow profitably while still being 30% cheaper than independent opticians

Fielmann 2010



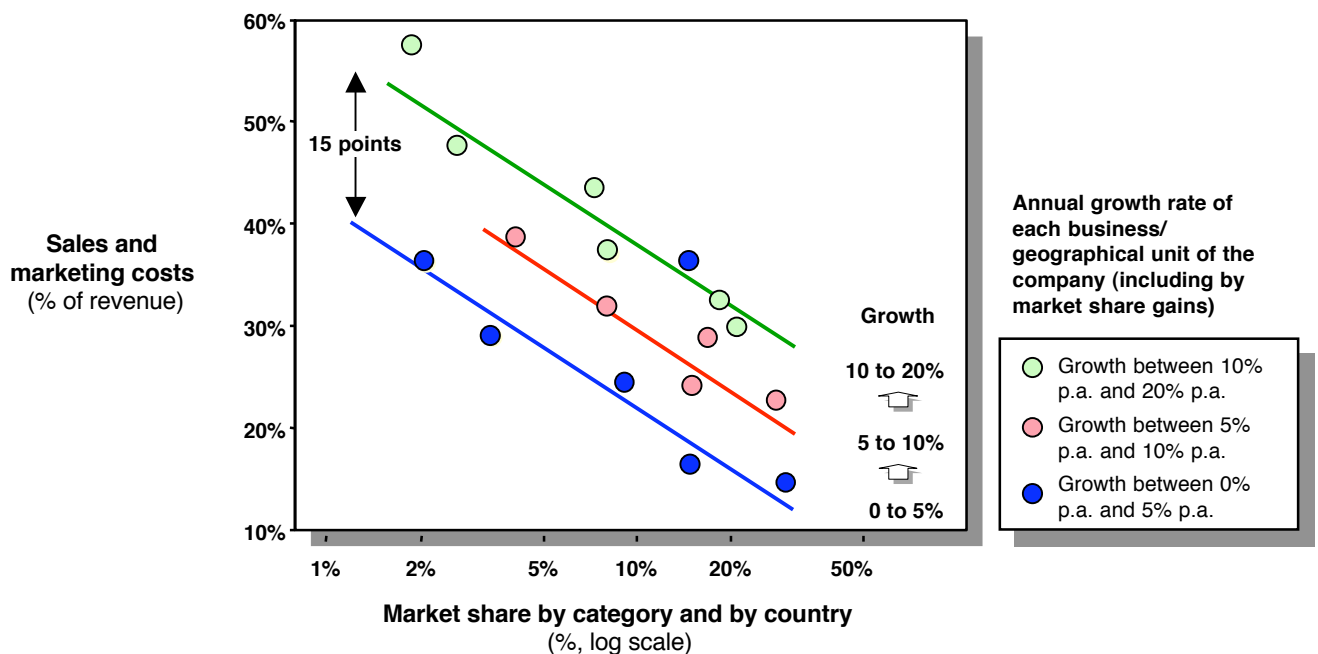
- Annual growth of 15 to 20% between 2000 and 2010, in a market with average growth of 2% per annum
- EBIT of 17% and ROCE of 35%

Source: Fielmann, interviews, German Association of Opticians, Estin & Co analyses and estimates

- Table 3 -

Sales and marketing costs depend on market share and on growth

Example of an FMCG company (each point represents a product category in a country)



Source: Estin & Co analyses and estimates

Conversely, in a mature market that is not growing and is highly concentrated, market share gains can only be achieved through direct attacks on the client base of competitors. The cost of this (organic) gain in market share often ends up being equal to or higher than the cost of acquiring a competitor with equivalent market share.

Analysis confirms experience: in markets with strong growth, organic investment is preferable if strong business models are in place and a competitive platform exists to start from². In mature and concentrated markets, it is better to acquire a competitor if market share gains are desired.

For challengers with low market shares, it is always very difficult and expensive to grow organically so it may be preferable to make acquisitions. There is no scale effect on goodwill (the only obstacle being the availability of resources), whereas scale effects impact strongly on all the additional costs of organic growth.

The cost of increasing the production facilities

Beyond investments hitting the balance sheet, growth also has a cost in terms of ramping up production facilities, distribution networks or teams delivering a service. It is the cost of lower industrial productivity during ramp-up, of the time it takes a retail outlet to reach its full potential, or of the investment needed to train employees.

These issues can therefore be analysed in the same way as for sales and marketing costs. In all cases, these additional costs are incurred in year n and so reduce the profit of year n , with the aim of producing additional revenue in year $n+1$, $n+2$, ... or $n+5$.

Resource allocation

All of these additional costs can be observed, analysed and *standardised*, just like any other investment. They can be optimized and allocated to best serve the strategy followed, forcing to key choices between businesses and geographical areas.

If strong growth is desired, the issue of allocation does not only concern “investments” (those which hit the balance sheet). All costs must be rigorously examined and managed by:

- Eliminating additional growth costs, which often remain due to apathy in mature businesses where their returns are decreasing, if not nil;
- Carefully selecting, from growing activities and geographies, those on which it is most strategic and profitable to focus efforts, rather than spreading resources too thinly over too many areas where the company will never reach leading positions;
- Optimising the mix and level of expenditure in line with growth targets, the nature of the activity, the desired speed of market share gain, market trends and the competitive landscape.

These are the requirements for strong growth, with profitability levels differing across business units or geographical areas but remaining high overall.

For example, in a fast-moving consumer goods company with overall growth at 6% per annum, with strong differences between businesses and geographies, total additional growth costs can reach 3% of total costs (and reduce EBIT by 30%). What allocation will best lead to higher growth and profitability?

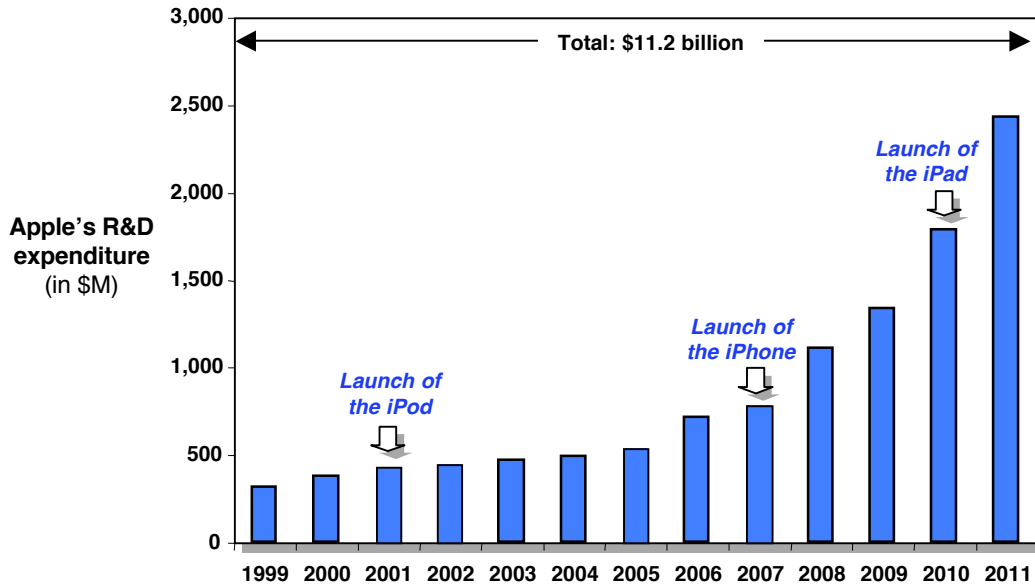
This supposes to identify these additional growth costs and to standardise them, beyond costs for “static” operations.

² However, in certain cases it may be necessary to make acquisitions in order to move faster and beat others to strategic market share gains.

- Table 4 -

Apple has spent a total of \$11 billion on R&D since 1999 to develop three major innovations

Apple's R&D expenditure 1999-2010

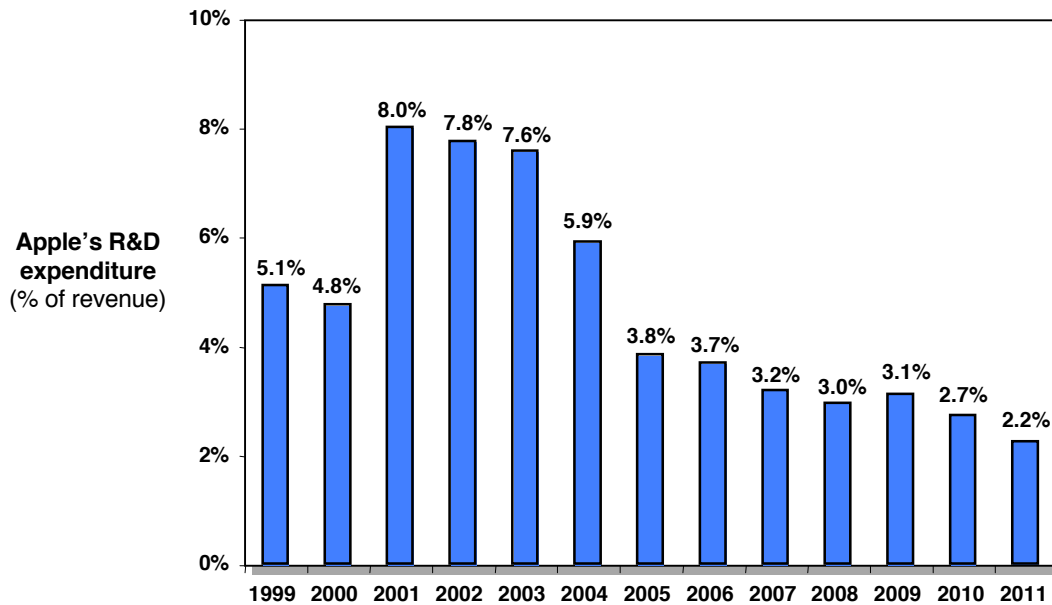


CAGR
(1999-2011)

19%

Apple's strong growth has enabled it to reduce the impact of its R&D from 5% to 2% of its revenue (after peaking at 8%)

Apple's revenue and R&D expenditure 1999-2010



Sources: Apple, Estin & Co analyses and estimates



• Apple's revenue has soared from \$6 billion in 1999 to \$108 billion in 2010

To conclude

Costs do not depend on scale effects or factor costs alone. *They also depend on growth.*

Unadjusted comparisons of profitability levels for different competitors in a given industry are deceptive. Each profitability level must be understood in relation to its growth rate, because this growth rate creates structural differences in costs and investments, for a given market share.

The same issue exists within a corporate portfolio when comparing different business units and geographical areas. The same levels of profitability at 0%, 5% or 10% growth per annum obviously have different values (normally resulting in different TSRs or discounted future cash flows).

In businesses with strong scale effects, the apparent profitability levels of leaders in strong growth give a false image of their true competitiveness. They include additional costs linked to growth and to market share gains. “Statically”, these profitability levels would often be higher by 5 to 10 points (ROCE).

Conversely, in these same businesses, the apparent profitability levels of challengers and marginal competitors that are losing market share are often overvalued because they are not sustainable in the long term. They do not integrate the (prohibitive) investments which would make it possible to ensure their long-term survival.

Within a corporate portfolio, it is necessary to measure, screen and optimise additional growth costs, just as we analyse and optimise “investments”. Failure to do so will ensure that growth dilutes profitability.

It is necessary to challenge both dilutive additional costs in mature businesses as well as underinvestment leading to strategic deadlocks in markets with high growth.

For a leader, a slight reduction in profitability (as long as it remains high and greater than the cost of capital) to increase growth creates value. But why reduce profitability at all when higher growth can be achieved by redeploying costs intelligently?

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Estin & Co is an international strategy consulting firm based in Paris, London, Geneva and Shanghai. The firm assists CEOs and senior executives of major European, North American and Asian corporations in their growth strategies, as well as the managers of private equity funds in selecting investments and improving their value.

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