All growths are not equal

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Companies that wish to "create value" for their shareholders (by giving them a TSR[1] that is higher than the cost of capital) must show profitable growth that is far greater than average economic growth (simply put, more than 4% to 5% per year).

Below this figure, even if the company is very profitable, the only return that shareholders can hope to make is the cost of capital. They will get a normal remuneration for the risk taken, but no creation of value.

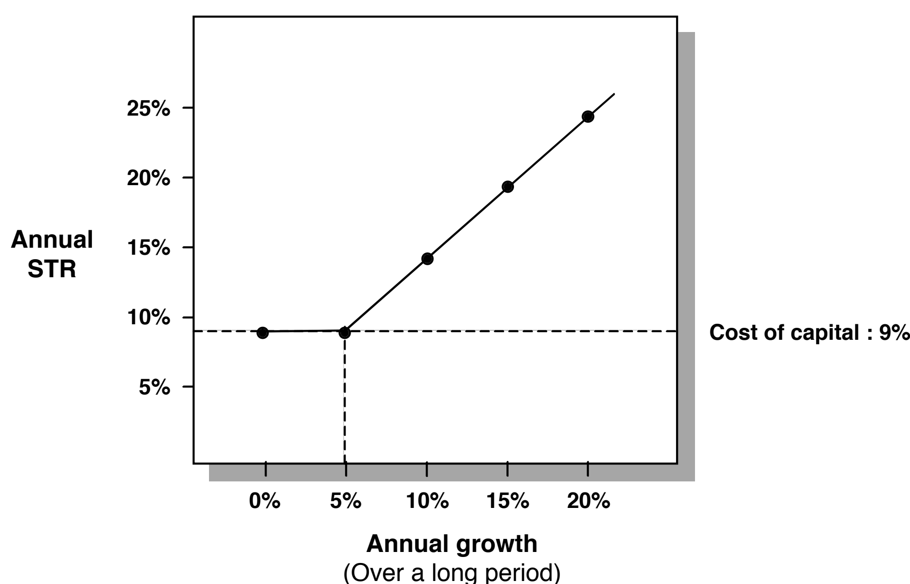
A (profitable) company with an annual growth of roughly 10%, today [2] gives its shareholders a TSR of approximately 14% (5% more than a typical cost of capital). A (profitable) company with an annual growth of 3% gives its shareholders a TSR of approximately 9% (i.e. more or less its specific cost of capital) (see table 1).

In other words, without growth, "cash cows" will not create value: they may be profitable (for example, with an ROCE two or three times higher than the cost of capital) and have a market capitalisation that is three times higher than their book value; however, their annual TSR cannot be very different from their cost of capital.

To create value, companies need to grow significantly and in the long term.

- Table 1 -

Only long-term growth that is higher than the average growth of the economy generates TSR higher than the cost of capital (2) (3)



Source : Estin & Co analyses over 20 years on all European and North American markets

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[1] TSR: Total Shareholder Return: return of the investment to a shareholder (dividends, bonus shares, share buybacks, capital gains on securities, etc.)

[2] Based on June 2007, all things being equal, without a change in interest rates and with a constant profitability that is higher than the cost of capital.

[3] See also the article "Long-term growth is essential" of March 2007

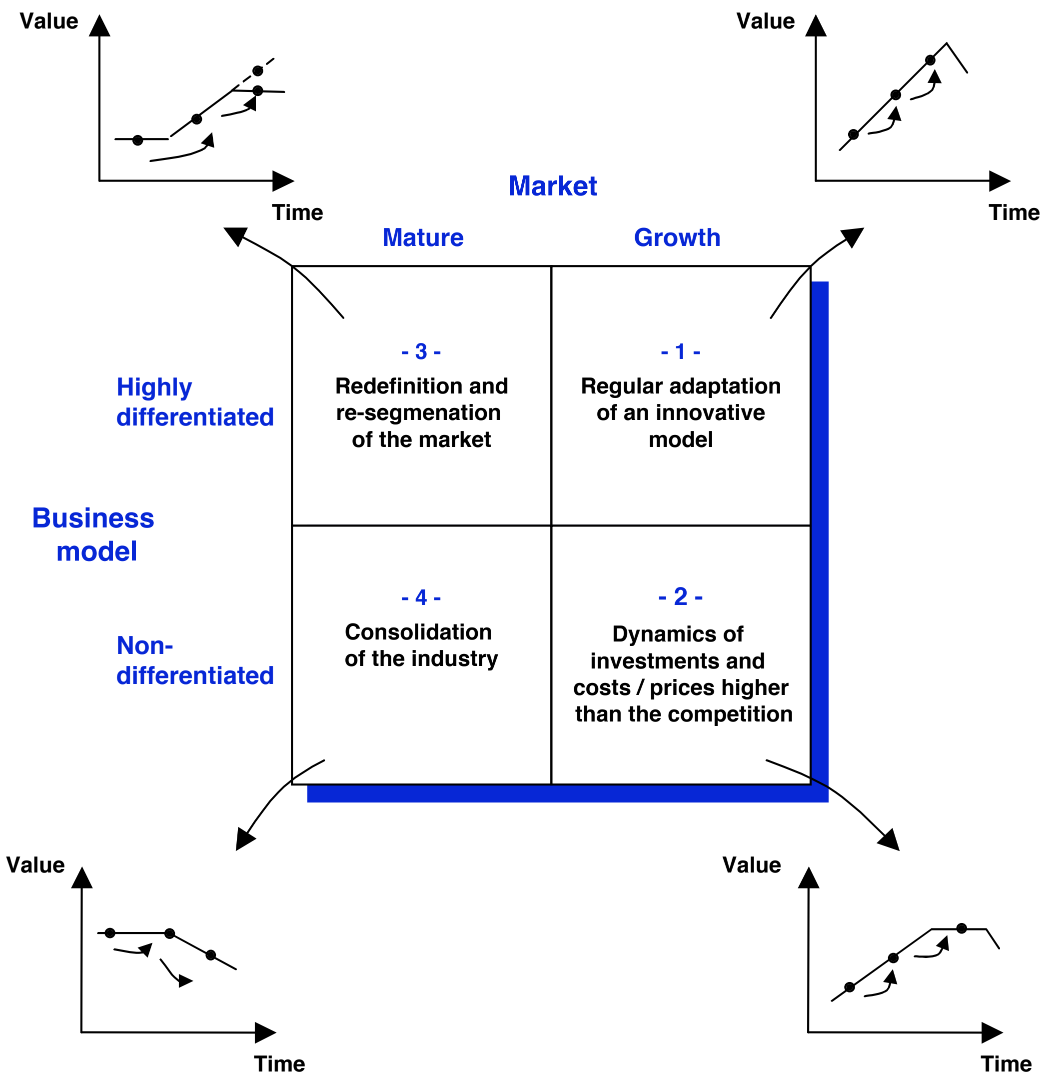
However, at a given growth rate, that is clearly beyond the average growth of the economy, *all growths are not equal*. The challenge is therefore to grow with sufficient profitability[4], without eroding this profitability and by containing investment. Growth must not lead to dilution.

The TSR achieved by growth depends on two underlying factors: the growth of the market on which the company operates and the strength of the business model (see table 2). The greater the growth of underlying markets, the less the need to "buy" this growth through price cuts, gains in market share, acquisition of competitors at prohibitive prices, etc.. The “stronger” the business model, (attractiveness, robustness, differentiation, etc.), the lesser the risk of value being transferred to clients or suppliers.

There are therefore four types of long-term growth.

- Table 2 -

The four types of long-term growth



[4] At least higher than the cost of capital, and if possible, capable of financing growth

1. *The transposition of the differentiated business model in a fast-growing market*

It is on markets with *long-term high growth* (overall growth or successive building up in different countries or of different products), where a leader can continue to systematically transpose a highly differentiated business model, that the stock market valuation can increase the most significantly and the most regularly, well above the normal return on capital.

Industry majors create value on these markets, not only for shareholders who invested in the company's book value from the beginning, but also for shareholders who "jump on the train" by investing at any time at market value.

We find examples of such strategies with companies such as Procter & Gamble, Home Depot, L'Oréal and Essilor. They resulted in *annual* growth rates of 10 to 30% over *twenty-five years* with TSRs ranging between 15 and 25% *per annum* for shareholders over the same period[5] (see table 3).

- Table 3 -

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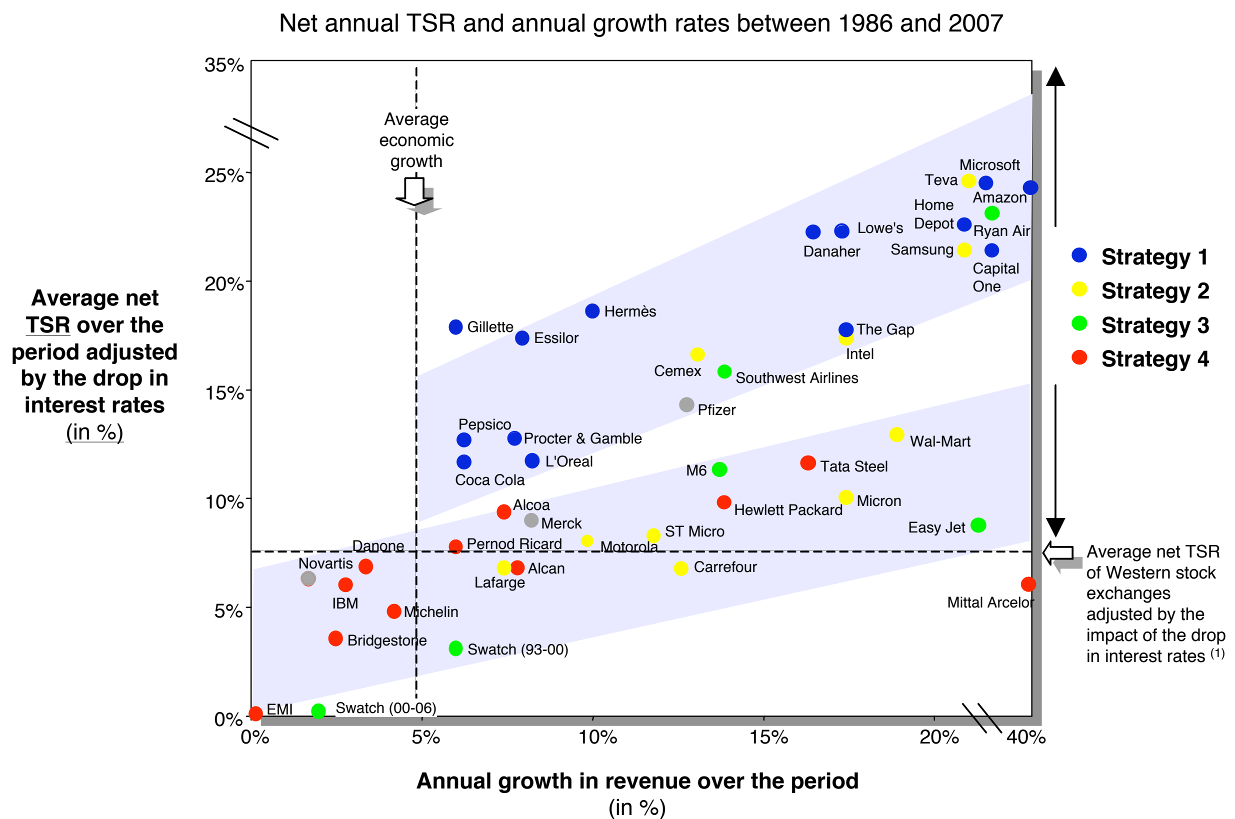

(1) Annual net TSR: annual compounded Total Shareholder Return achieved by a shareholder having invested at the beginning of the period (dividends, capital gains, distribution of bonus shares, etc.) less the natural TSR resulting from the structural fall of the interest rates over the period (between 0 and 8 points of annual TSR according to the financial markets of the various countries over the period considered); period considered: 1 January 1988 to 31 December 2006, i.e. 19 years.
Note: State Street, Citigroup since 1995; Adidas, SAP and Renault since 1994; Bombardier, Sony since 1990; Hanson from 1980 to 1996
Source: Bloomberg; analyses and estimates by Estin & Co

In this type of strategy, and over and above three– to five-year operational division plans, group managements must constantly focus on the search for new growth engines over five to ten-year periods. The precise management of the timing of these engines and their potential size in relation to existing structures are critical.

[5] Net of the positive impact of the drop in interest rates

There are two risks associated with this type of growth.

Strategic risk: A new growth engine does not materialise in the expected time or is affected by a serious setback in the economy (China, Russia, India, etc.); the business model or the technology are replaced by more high-performing ones; new competitors who are structurally superior pre-empt growth.

A temporary downturn of one of two years will not have serious consequences for a leader with a regular historic performance. However, a 15% to 5% drop in *long-term* annual growth expectations can cut the market price in two.

This risk can be anticipated and controlled by analyses of the market and the competition and by the constant vigilance to the company's environment. This calls for the systematic search and the will to pay heed to bad news in order to adopt the strategies needed in good time.

Operational risk: the transposition of the business model in a new geographical area, a new product or client segment requires more effort time than expected; the support for the market growth requires more investments; the investment mix and the operational levers that support growth in a new market are not the same as those of the historical markets; the competencies required by the new markets are quite different from the key competencies of the management teams, etc.; there is a deterioration of economics and profitability: growth is diluted.

This second risk can also be anticipated or even managed. Operational growth is simply the product of an investment multiplied by its impact (strong or weak) and by the time needed for this impact to materialise (short or long). These factors can be identified or even modelled in certain businesses, and it is therefore possible to measure the growth potential of a business model in a new environment.

2. A momentum of investments, costs and prices higher than that of the competition

In high-growth global markets where there is little differentiation in products and services, a classic growth strategy consists in growing faster than the competition and in investing more and faster, gaining market shares and creating very high production, brand or distribution scales, and by smothering competitors with ever lower costs and prices at a pace they cannot follow.

Although the company's business model is not really differentiated, it gains a competitive edge with the momentum created by investments and the increased market share.

Examples of such strategies in the past 20 years are Cemex for the cement industry, General Electric Financial Services for the financing of movable assets (aircraft, containers, medical imaging, etc.), Wal-Mart in the hypermarket segment in the United States, Teva in the generic drug market or Samsung in the D-RAM market. In the case of the D-RAM market for example, annual growth is in the region of 60 to 80% (in volume), prices drop by roughly 30% per year (in constant dollars), and the market share of the three leaders has risen from approximately 30% in 1990 to over 65% today (Samsung currently has nearly 30% of market share).

Time, speed and competition are critical variables in such strategies (how far can a company safely go in terms of concentration of the industry? Is it possible to catch up with the cost advantage? Which competitors must be left to survive? What choices are to be made between profitability and growth, etc?).

After some years, although the TSR resulting from these strategies may continue to be high (and to be higher than the cost of capital), it is often lower than those of the previous scenario. This is because growth that is essentially based on competitive prices involves transferring at least part of the value to the client.

The strategic and operational risks of these strategies are the same as above, with two additional risks.

The risk of deciding between profitability and growth using price and investment policies that are not well mastered or are counter-cycle. This risk can be assessed and controlled through comparative analyses of competitors' costs and investments.

The risk of a gradual drop in effects of scale over time (changing technologies, cost structures, etc). The value of market share gains declines sharply: growth is diluted. This risk can also be anticipated through analyses about the development of the key economic factors of the business.

3. New segmentation and division of markets

In markets without growth, it is often possible to resegment the business by client segments, geographic area, service levels, parts of price range, etc. This focalisation results in strong growth with a highly redefined business model.

Examples of such strategies are Southwest and Ryanair in the low-cost transport market. Another example is Dyson in the upscale vacuum cleaner market.

The growth potential related to this market redefinition is more or less high depending on segmenting (price, offering, conditions, etc.) policies.

For a player on a niche market, the main risk of such a strategy is possible retaliation by the the size of the niche chosen in a market with general low growth. This is a boost that can last several years but rarely exceeds 10 years.

For a market leader, the risk of such a strategy is the cannibalisation of its own core businesses. This risk can be limited with the implementation of highly differentiated business models, or even independent organisations as well as the transposition of specific and self-major market leaders. The higher the proportion of shared costs between this niche and the rest of the market, the higher the risk of retaliation. The risk is particularly high in network businesses such as telecommunications, air transport and postal services.

When the market is redefined in a more structural way, these strategies can produce effects in the longer term. An example of a complete redefinition of the business is Swatch, for the watch business, between 1985 and 1995.

The growth of mutual insurance companies without intermediaries between the 1970s and 1990s or the current and future development of Chinese companies in the majority are also examples of such strategies. In this case, it is no longer a niche strategy, but a strategy consisting in fundamentally redefining the core market by practically replacing the established competition. The resulting TSR is thus the same as in case No.1. Unfortunately, when the strategy has perfectly succeeded and the substitution has covered the entire potential market, growth is no longer possible. TSR then often drop sharply.

4. Consolidation strategies in mature markets

These consist in organic growth or more often growth through the buying out of the competition in order to streamline the industry and continue to cut costs. The problem here is that the value created by this streamlining is often transferred to clients through price drops. Value growth is often less than volume growth. This is because in all mature markets, value tends to disappear by migrating upstream. The only winners are the shareholders of the companies that have been taken over:

Examples are consolidation strategies in the tyre, steel, aluminium, musical publishing and reinforcement fibreglass industries. The pharmaceutical industry could also go the same way. At a given growth rate, TSR is often lower than in the previous cases (see table 4).

For the shareholder, there are four types of growth and four types of TSR: a high TSR over the long term in the first case (as long as the growth is maintained); often lower in the second case, but still significant; higher than the cost of capital but often short lived in the third case if it is a niche strategy, or very high if it is a complete redefinition of the market; slightly higher or even lower than the cost of capital in the fourth case (see table 4).

- Table 4 -

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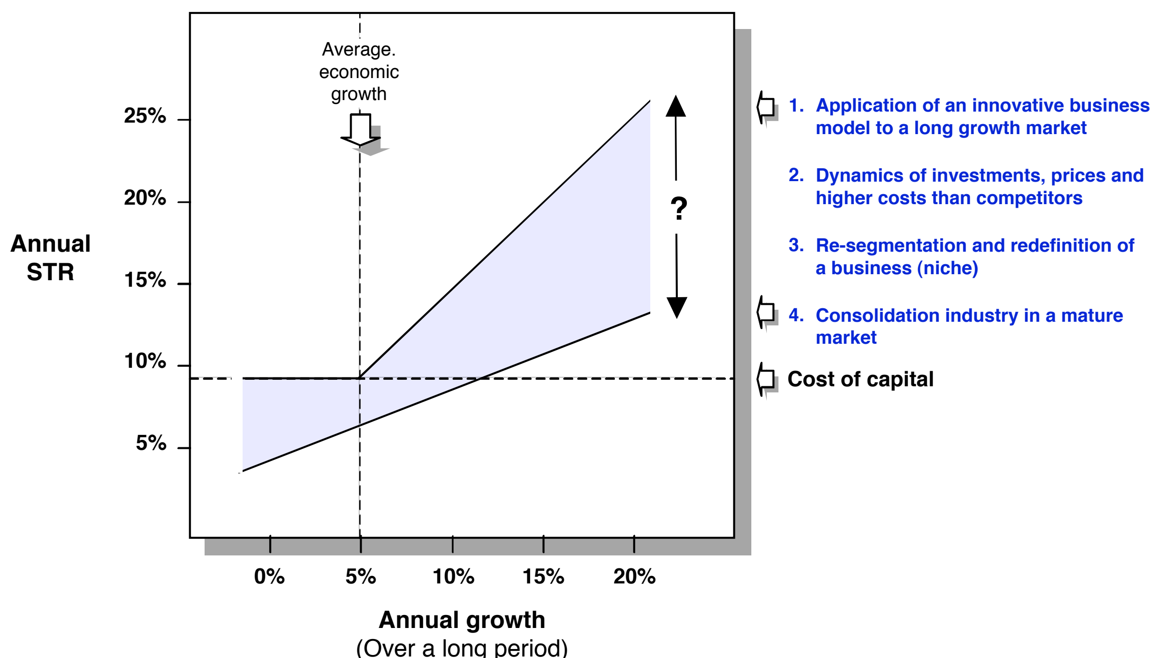

Source: Estin & Co analyses over 20 years on all European and North American markets

What actions can therefore be taken?

Nothing, if we consider that the company is bound by a business or a portfolio of businesses and geographic zones. In this case, we can only adapt to the growth strategy allowed by the dynamics of this portfolio, apply it as best as possible by managing the associated risks (see above) and benefit from the TSR that is a structural result of this strategy (low or high).

Everything, if we consider that the role of a manager is to develop the company's business and geographical mix to maximise TSR for its shareholders, and not merely to manage existing businesses. Over and above streamlining and turnarounds that can only be temporary, there's no getting away from the facts: companies can give their shareholders a TSR that is higher than the cost of capital only if they are present in markets and geographical areas with a high long-term growth, have strong business models and are leaders in these markets and geographical areas.

No growth, no value. Certain types of growth are more profitable to shareholders than others.

The structural drop in interest rates over the last 25 years has disguised this fact by adding 3!to 5 TSR points to most major groups regardless of their growth. If interest rates were to become stable (or worse, to grow), the difference between profitable growth strategies and no-growth strategies would become critical.

During their first two years in the position, managers are prisoners of the business portfolio that they have inherited. However, after five to eight years in office, they are fully responsible for the business and geographical mix and therefore for the company’s growth rate.

It is not possible to want to create value and not change the businesses as often as is required. The *active* management of the business and geographical portfolio is an essential element of growth and therefore of value creation.