Long-term growth is essential

By
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The only dictatorship of the markets for the company is that of value. And, after achieving a certain level of profitability[1], value is dependent on only one factor: long-term growth.

How can we grow over a period of ten or twenty years, systematically and strongly (8 to 15% per annum) which is clearly well beyond the average growth of the economy (approximately 5% per annum), without diluting profitability?

Defined in these terms, such an objective may appear like the Holy Grail. However many companies do achieve such performance (cf table 1). And in terms of simple financial mathematics, it is simply impossible "to create value" if one does not match such performance[2].

Improvement of profitability over a period of two or three years does indeed temporarily increase value but without a longer-term potential; one cannot in fact increase the rate of profitability ad infinitum. Strong growth over a period of five years also improves value, but invites brutal falls of the stock exchange price at the end of the period if this growth shows itself as not sustainable.

To grow to a significant and profitable degree in the long term is truly the only worthwhile objective for the management of a group with respect to its shareholders; shareholders "from the beginning" of course, but also shareholders who join the growth train at any time (cf table 2). The four recipes to achieve this are well known but difficult to implement over time.

1. Growth of the model of long-term activity

This growth depends on:

- Growth of the subjacent market: for how much longer? Is one at the beginning or the end of this growth?
- Focusing on the segments of customers, geographical areas, products,… which are growing fastest within the targeted market;
- The force of penetration of the activity model *with respect to* the target customers and *against* the competitors which are close in terms of offering; on which levers does this force depend (break-through innovation, costs and price, rate of innovation or renewal of product ranges, quality, image, specific technology or know how,…) ? Do they risk being eroded or changed fundamentally over the course of time?
- Significant, repeated, and focused investment by the company on some these levers in order to be the absolute reference for these (but one still needs to know them); what share of the investments of the company (CAPEX *and* cash costs) are actually focused on these distinguishing levers of growth? Rare are the companies which devote more than 20 to 30% of their CAPEX and their discretionary costs to investments of growth, compared to simple investments in the maintenance of the current state of the activity;

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(1) When this is higher than the cost of capital.

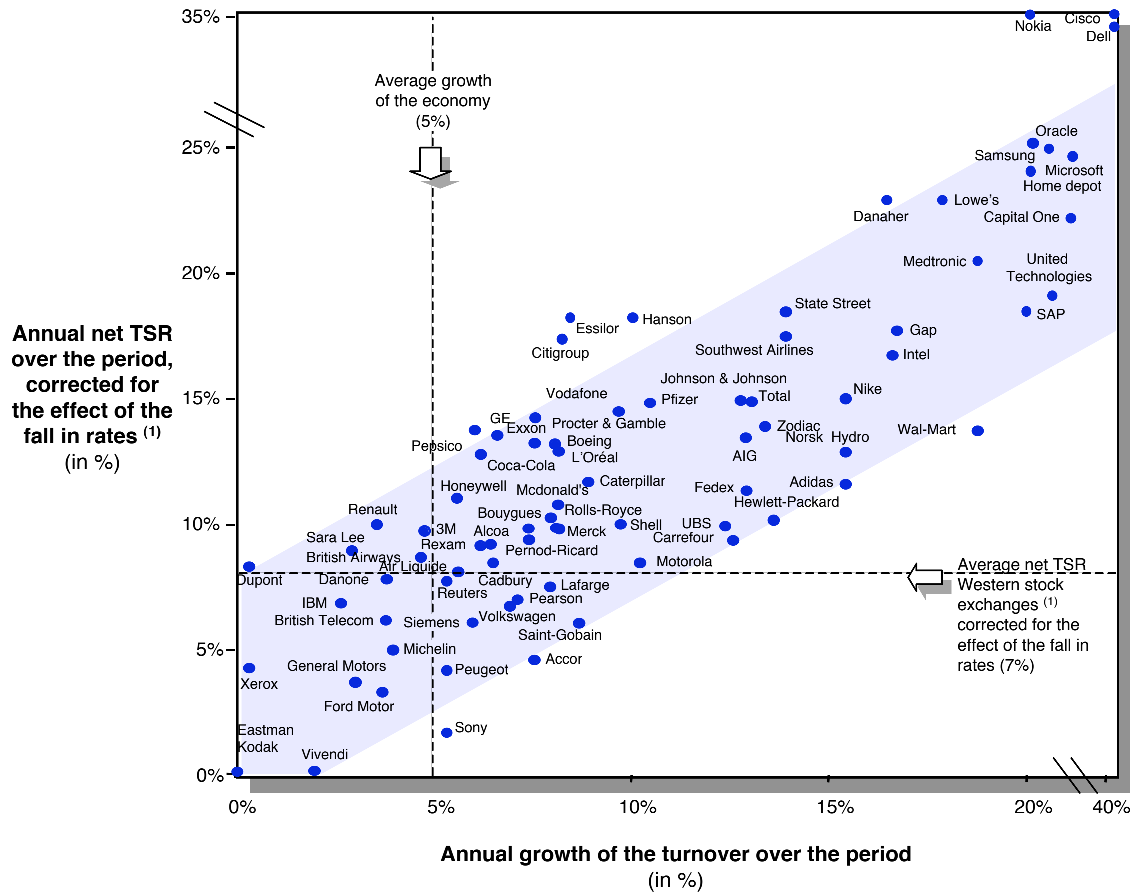
(2) The TSR (Total Shareholder Return) can be higher than the cost of capital only if the growth in the medium to long term is clearly higher than the average growth of the economy

- The potential concentration remains to be effected in the market: can one still gain market share and continue to grow by a significant degree while the market is maturing or is one already at the rate of maximum concentration?

- Table 1 -

Annual compounded net TSR [(1)] and long-term growth

1988-2006



• "To create value" (to have a TSR higher than the cost of capital), it is necessary to grow long-term (in a profitable way) beyond the average growth of the economy

(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,…) less the natural TSR resulting from the structural fall of the interest rates over the period (between 2 and 4 points of annual TSR according to the financial markets of the various countries over the period considered); period considered: January 1, 1988 to December 31, 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

The great leaders grow on average 30 to 50% more quickly than the average growth of their market over the long term during the concentration of the industry. Once the train begins moving, there are only two questions:

- One is operational: to make sure that the whole of the organization works and invests around the few key levers of growth, that there is no dispersion of efforts to other tracks, and that these levers remain in force year after year with focus; and if these levers evolve, how does one adapt;

- The other is strategic: to anticipate, sufficiently in advance, all the components of the market, the economy, the competition, the technologies which could destroy these dynamics in the short, medium, or long term. Are there still two, five or ten years of strong growth ahead? Does one have the levers to modify this horizon? In the contrary case, is there another growth train waiting to start in the station?

- Table 2 -

Annual net TSR [3] achieved by the shareholder according to the date of his investment

	Average annual growth of turnover 1980-2006	- Net TSR depending on the period of entry [1] [3] -				
		1980 2006	1985 2006	1990 2006	1995 2006	2000 2006
Microsoft	29%	-	31% [4]	23%	17%	7%
Home Depot	29%	33%	27%	17%	13%	-2%
Gap	19%	25%	18%	13%	11%	-5%
L'Oréal	9%	18%	15%	16%	13%	-4%
Essilor	9%	17%	11%	17%	16%	15%
Procter & Gamble	9%	15%	14%	12%	12%	10%
Mc Donald	8%	14%	11%	11%	7%	5%
General Electric	7%	16%	14%	15%	13%	-3%
Coca-Cola	6%	15%	13%	9%	3%	-3%
3M	5%	11%	11%	10%	10%	5%
General Motors	3%	5%	3%	3%	0%	-4%
Goodyear	3%	5%	2%	5%	-6%	-1%
Eastman Kodak	1%	2%	1%	0%	-6%	-5%
Average annual growth of the economy	5%					
Average net TSR of the Western stock markets		8%	7%	7%	7%	0%

- **Strong growth of long duration, above the average growth of the economy, creates value for any shareholder, including those who get on the moving train**

(1) Annual TSR for a shareholder between the date of entry (period indicated) and the 31/12/2006
(2) Example: a shareholder having invested in Home Depot on January 1, 1980 achieved a compounded annual net TSR of 33% between the date of his investment and the 31/12/2006; his TSR would be 27% if he invested on January 1, 1985 and 17% if he invested on January 1, 1990
(3) The TSR are net. One withdraws from the gross TSR, the natural effect resulting from the fall in the interest rates over the period (between 2 and 5% of TSR according to the countries and the period considered in this table)
(4) From March 1986
Source: Bloomberg; analyses and estimates by Estin & Co

2. The replication of the activity model in other territories

All markets end up by maturing, every activity model ends up by eroding in a given territory, in the more or less long term. It can on the other hand be replicated identically or in a similar manner in other territories enjoying strong growth (products, geographies, segments of customers,…).

At what moment do growth investments within a territory begin to be wasted because the market does not valorise them any more? At what moment must they be reallocated to another territory with the corresponding organisational and managerial changes?

The classic example of this replication is that of the large international groups of mass consumption, mass distribution, fast food, the hotel trade, luxury products, etc… investing in and developing a concept in one country, then progressively replicating it universally country by country with the rise in power of new markets.

This replications depends on:

- The optimal sequence of development, territory by territory, according to their stage of development with respect to the product or of the service considered. Neither too early nor too late; neither too large, nor too small; one or two at a time and certainly not too many at the same time; such are the principles determining the selection and the sequencing of new territories which one seeks to develop;
- The balancing of the cash flows and the risks among the existing and maturing territories and new growth territories;
- The possible adjustment of the levers of the activity model to the new territories or the explicit avoidance of certain territories unsuited to the model.

How can one make sure that the activity model will function identically (without dilution of profitability) within a new territory? What must the relationships be among the various types of investment (R & D, rate of innovation, product quality, commercial, image, price, level of service, industrial or logistical plant, know how,…), its intensity, the timing necessary for the application of its full impact (typically between six months and three years) and the scope of this impact? How can one anticipate or test these relationships?

3. Management of the long-term business portfolio

No activity, no trade can grow ad infinitum. The great groups which grow strongly in the long-term are thus often diversified, with cash generated by some mature activities financing the development of new activities, with the whole contributing to ensure significant growth.

Among the various activities of the company, which are those which will ensure strong growth in 5 years, 10 years, 15 years? Does the group produce a growth significantly higher than the average of the *long-term* economy?

The stakes are of a different order that those in the preceding case. It is no longer a question of replicating a well-known activity model in new territories, but of enabling the coexistence of various trades and activity models, some mature or declining and others enjoying strong growth.

The competences, approaches, reflexes, cultures, differentiating levers, cost structures and capital intensities can be very different among the various trades and activity models...., How can one enable them to coexist?

Where should one place the cursor between a very decentralized organization of the holding type, without great synergies between the trades but with a strong respect for the cultures of each of them, and a highly integrated group with strong industrial or managerial divisions between the trades, free "to exploit" the dynamics of each of them?

How can one identify and make a sufficiently early start for certain growth trains so that they can take over *in time* and with sufficient scope, from other activities the development potential of which is exhausted?

4. Acquisitions

Within the context of a growth strategy, acquisitions fit into each of the three strategies summarized above. But logic, valorisation and the post-acquisition integration stakes are different according to the strategy adopted.

Acquisitions are used to continue the concentration of industry effectively within the context of strategy 1. The integration stakes are those of the implementation of potential synergies. The risk is often that in mature markets, where the value tends to migrate towards the end customer, that these acquisitions are more valuable to the seller than the purchaser.

They are also used as a starting platform in new territories in the context of strategy 2, when initial development would prove to be too difficult or too slow if it were carried out in an organic manner. The stakes are then to make sure that the acquired organization will be able to import the standard activity model of the company and can really be used by the latter as a springboard. In this situation, the true cash flows to be modelled are not those of the acquisition. They are those of the later developments facilitated by this acquisition.

They are also used as vehicles of migration or diversification towards new trades within the context of strategy 3. Insofar as the synergies are weak, then the price can only be justified if the future growth of the new trade is high over a long period, and that one has the financial resources to support or even accelerate it.

When an activity model is exhausted within a given territory or a trade matures, the organization is always a barrier to the continuation of growth by redeployments to other territories or trades. The culture and the management of a group must thus be able to anticipate and manage these potential brakes.

In the long run, the true barrier to growth for the great groups is not operational (the long-term replication of an activity model), or strategic (permanent re-allocation of the resources among territories, or among trades, to ensure growth). It is often cultural ("it is a new trade which one does not know"; "it is a new very risky geography"; "it is a new unprofitable distribution channel", "it is a new activity model too different from our current model"; …): it requires a leap over this barrier to capture the new source of growth; and it is the recognition of the fact that one is beginning to over-invest in the old that it becomes necessary to modify or redeploy the investments substantially.

It is also often analytical: this is the difficulty of rising above a qualitative and political debate, where the true stakes, investments, and risks are not truly quantified.

The true sources of growth are always there within the grasp of the groups. It is necessary to want to seize them and want to adapt, with all the consequences, to the new levers which they require.

A significant part of the "creation of value" effected by companies for their shareholders over the past twenty years (between 20 and 50% according to the periods and the financial markets) is only due to the structural fall in interest rates. One cannot assume that they will continue to decrease ad infinitum, especially in the context of a world economy in growth. One must thus return to fundamentals. *The only source of creation of value is profitable long-term growth which is clearly beyond the average growth of the economy.*

These are the never-ending stakes in the strategy of the great groups: to find, exploit and renew *in good time* the sources of profitable growth, while optimizing the investments and corresponding risks.

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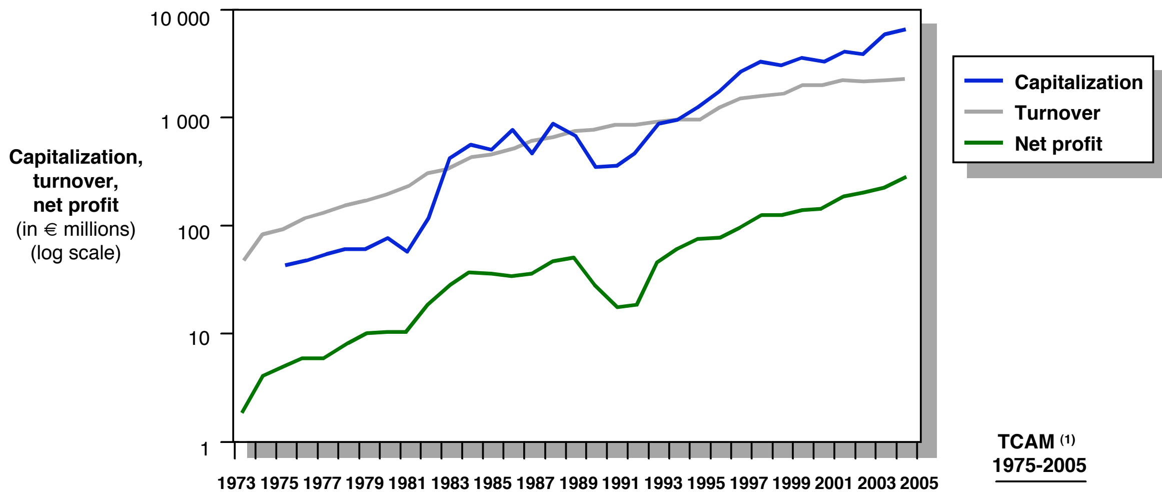
Estin & Co is an international consultancy in strategy based in Paris, London, Geneva and Shanghai. The cabinet assists the general management of great European and North-American groups in their growth strategies, as well as private equity funds in the analysis and valorisation of their investments.

- Table 3 -

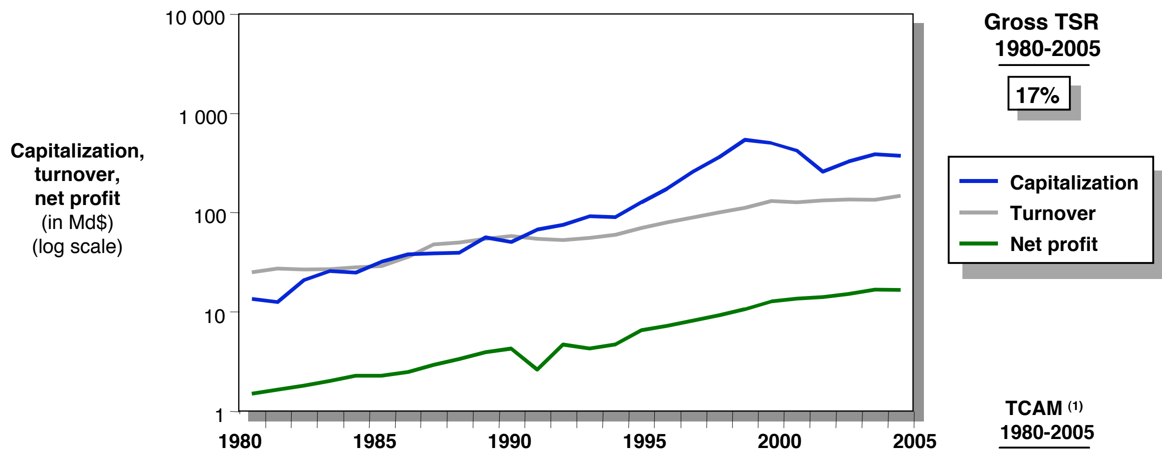
Essilor



	1975	2005	TCAM (1) 1975-2005
Capitalization (en M€)	46	6 905	18%
Turnover (in M€)	97	2 424	11%
Net profit (in M€)	5	287	14%

The stock exchange capitalization of Essilor increased more than a hundredfold in thirty years

General Electric



Gross TSR 1980-2005: 17%

	1980	2005	TCAM (1) 1980-2005
Capitaliszation (in Md$)	14	367	14%
Turnover (in Md$)	25	146	7%
Net profit (in Md$)	2	17	10%

The stock exchange capitalization of GE multiplied by 26 in 25 years

(1) AAGR = compounded annual average growth rate
Source: Essilor, Bloomberg; analyses and estimates by Estin & Co

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