Economic upturn: time to revisit your growth model?

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1. Issues raised by the upturn

Long-term value creation requires robust, sustained and profitable growth, but during economic downturns the markets sometimes turn their backs on growth companies. The recession that is now coming to an end has been no exception, and many growth stocks have been sold off heavily.

Now that the economy is emerging from recession the focus will once again be on growth. A strong growth model will once show itself to be the main source of value creation. However, tomorrow's growth models will not necessarily be the same as yesterday's. The emergence from a recession is a good time to revisit historical growth models and to either adjust them or leave them as they are.

2. The temporary triumph of defensives

During recessions investors begin to look sidelong at growth stocks, based on the following assumptions:

- Growth entails risk and, hence, the likelihood of weaker results, which will undermine the company's solidity;
- Growth entails capital expenditure, at a time when capex is being scaled back everywhere;
- Growth companies are generally geographically exposed, something that investors take a dim view of, even through a presence in emerging markets is one of the main levers of growth.

There is a reversal of investment logic. The market temporarily shuns companies that are solid over the long term, while continuing to find favour with companies that have limited long-term growth prospects but that are "defensive". The market bails out of China Mobile and rushes into France Telecom, for example.

Investment horizons shrink. Potential long-term investment returns become less important than solid short-term financial performances:

- *Heavy free cash flow:* France Telecom possesses highly profitable historical activities, such as fixed-line telephony, which generate heavy cash flow and allow it to fund its investments itself. The French incumbent operator generated 8 billion euros in free cash flow in 2008, up 2.5% on 2007.
- *Dividend payout maintained*: France Telecom paid out an interim dividend in the midst of the recession, in order to reassure investors on its solidity.
- *Further deleveraging*: France Telecom is continuing the deleveraging process that it began four years ago, with the goal of keeping its net debt/EBITDA ratio below 2. Even during the recession, France Telecom has managed to cut its debt from 38 billion to 36 billion euros.

3. Recessions change everything

The recession is slowly drawing to an end. Green shoots are already perceptible in certain sectors. Investment prospects are improving, and some geographical regions are even showing solid growth.

The value creation pricing mechanism will thus shift back to growth, with the focus, as usual, on the strength of the growth model.

Is there any reason to worry? Will companies with historically powerful growth models slide naturally back into a pattern of strong growth?

Recessions change everything, and this recession will be no exception.

Value chains are reorganising, players are disappearing, industries are consolidating, the internet is making greater inroads, competitors from emerging economies are even stronger, and so on and so forth.

Two factors will contribute to the coming upheavals.

The first is pressure from emerging economies, China in particular, which is now a given in almost all sectors. Chinese companies in all industries are outpacing most of their Western competitors. This is the prism through which historical growth models must be revisited. What can Western companies do to withstand such competition? Should they set up shop in China? What are their alternatives? How much time do they have?

The second factor is technological. Safety, traceability, energy savings, and other imperatives are helping sophisticated technologies find a place in many industries. The cost of developing, acquiring and rolling out these technologies is often so high that it can disrupt competitive balances or even transform entire industries. The transport sector, for example, has been deeply affected. It is a traditionally fragmented sector that is now consolidating around powerful leaders who are better equipped to integrate new technologies.

The growth models that prevailed prior to the recession will not necessarily create value after the recession. Historical models must be reviewed against the backdrop of recent developments, including pressure from emerging markets, the advent of structurally disruptive technologies and shifts in competitive landscapes.

4. How best to exploit the upturn?

Upturns are transitional periods. The growth stakes are huge when the economy begins to pick up again. Generally speaking, this is an opportunity to take stock precisely of the company's growth strategy.

Low-growth companies

Many companies will strive to show how they will exploit the first signs of recovery and how their strategies will allow them to fully benefit from it. Against this backdrop, companies without credible growth strategies are at a significant disadvantage. Their lack of growth prospects will once again be clear, once the cycle turns up, and concerns will once again arise over the mismatch between their strategy and the challenges posed by their industry.

Low-growth companies must reformulate their strategy in two ways. First, they must reshuffle their business portfolios. Chronic low-growth companies usually have placed too much emphasis on cash cows or deadweight businesses. They must reconfigure their business mixes for growth, even if that means taking out some profitable businesses, in order to develop other, more promising ones.

Second, they must specifically address the challenges from emerging markets, as well as threats to their existing business model.

High-growth companies

For growth pure players, on the other hand, this is an opportunity. Their priority must be to check that their growth strategies still work. Their strategies may have worked well in the previous cycle, but recessions change everything and bring with them new types of consumer behaviour, new low-cost models, and so on.

High-growth companies must therefore revisit their historical growth models to ensure that they are still relevant, and in particular to ensure that the assumptions underlying their growth strategies are still valid. Has the market changed? Will the internet continue to make inroads at the same pace? Have growth drivers been undermined by the recession? Are laggards still far behind?

Another challenge consists in timing the end of the recession as precisely as possible, in order to better calibrate one's investment strategy.

What comes next?

As the recession comes to an end, growth will resume its role as the main source of value creation. However, the recession has disrupted market balances, altered the competitive landscape, and given rise to new sources of leverage.

The recession will have had an impact on most growth models. Companies will still aim to stay one step ahead of the competition but will probably do so on the basis of different models. Now is the time to look closely at the changes that are disrupting historical growth models and, where necessary, to come up with new models that will ensure success during the coming upturn.

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Estin & Co is an international strategy consultancy based in Paris, London, Geneva and Shanghai. The consultancy assists the management of large European and North American groups in their growth strategies, and private equity funds in the analysis and valuation of their investments.