

# The fourth dimension

by

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In economic and financial terms, profit is the remuneration of risk and risk is the consequence of change. The basic concepts for the strategy of a business have the structural sources of profit resting on three necessarily transient elements:

- *Competitive advantage*: for products and services that are more or less comparable, the company has structurally lower costs than its competitors, or greater market power which improves its conditions for sale or purchase;
- *Differentiation*: certain products or services are fundamentally different and are more attractive for some categories of customer; or else the company has a stronger brand providing it with a price premium; or it offers new products replacing others or fulfilling new needs and arriving on the market sooner than those of its competitors;
- *Growth*: for business activities in strong growth, the imbalance between supply and demand, as well as the investment needs, lead to price levels that generally guarantee the leaders higher margins than those that they generate in the mature markets.

These three foundations have shaped the strategic thought and action of the major European and North American groups over the last three decades.

They applied perfectly well on a level competitive playing field where developed countries (including Japan) represented about 75% of the global economy, the emerging countries forming only a marginal extension of this field or a place for the emergence of small competitors destabilising the whole system only at the edge (Taiwan, Korea etc.).

They were part of a framework where the competitors were fighting a battle with more or less equal weapons (payroll costs, social costs, retirement costs born by the companies or by the communities) and where the objective of the regulatory authorities was to ensure or to build market fluidity, genuine competition and uniformity of the pre-existing conditions in this competition.

The geographical dimension, with the corresponding strategies of segmentation or international expansion, only constituted a more or less critical growth element but no longer the major strategic element that it had represented in the 1960s (for American groups) and 1970s (for European and Japanese groups).

In this fairly homogeneous world, the evolution of the textile, clothing, toy industries, etc. over the last twenty years has been perceived only as an exception (except by those involved), corresponding to the normal fate of old industries, to be managed at best one can.

Compared with this uncomplicated view, everything has changed.

## **The world has doubled in size**

In five years, the world has doubled in size. Admittedly, the global economy has only grown by 30% in five years. But, in terms of prospects and strategic sphere, the world of 2015 including China, India, Brazil, Mexico and Indonesia as major constituents, will represent twice the world of the year 2000, and three times this same world if we reduce it to Europe, North America and Japan. And this new world is heterogeneous.

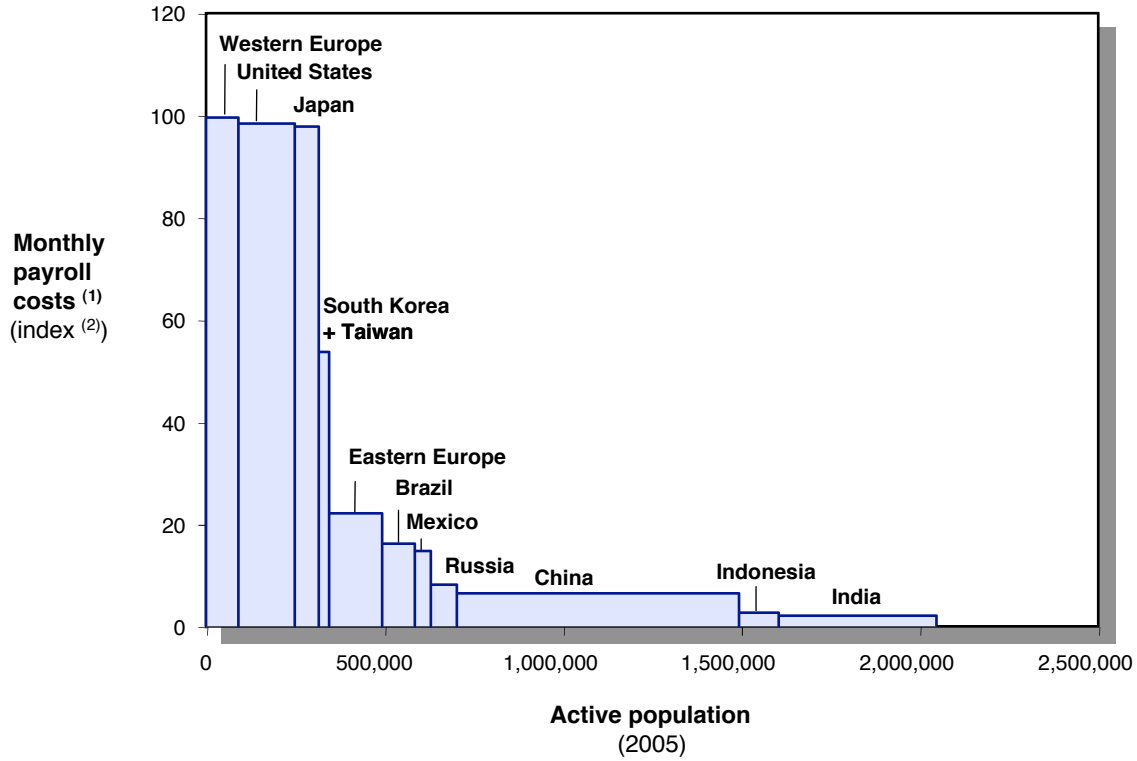
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The structural differences between geographies are not reducible in the medium term

- Figure 1 -

Payroll costs and active population



(1) Including social costs  
 (2) Salaries converted into Euros and then indexed  
 Source: International Labour Office, analysis Estin & Co

- Figure 2 -

Annual growth by geographical region  
 (2005-2010)

	Western Europe	US	China
Chemical	3%	0%	14%
Industrial equipment	7%	6%	14%
Utilities	3%	4%	8%
Automobile	2%	2%	22%
Retail electrical	3%	5%	10%
Clothing	0%	3%	6%
Food industry	2%	2%	9%
Pharmaceutics	6%	10%	12%
Banking	3%	4%	27%

Source: Datamonitor, analysis Estin & Co

## **The structural differences between geographies are not reducible in the medium term**

Whatever efforts the regulatory authorities make within Europe or at the global level, the globalisation of the economy creates, in a structural way and over a long term, huge differences for competition and attractiveness between geographies (see Figure 1). These differences are due, on the one hand, to the source of the goods produced and, on the other hand, to the relative rates of market growth:

- *Differences in payroll costs* (and social) from 1 to 5 (with Eastern Europe), from 1 to 10 (with China), and even 1 to 20 (with certain Chinese regions, with India, etc.). The *average* Chinese costs will not catch up with European costs in less than the next 40 or 50 years, whilst the productivity and quality will have caught up (or in some cases overtaken) those of Europe well before this date in many industries. And they will then be ‘replaced’ by the costs for other, less economically advanced Asiatic regions;
- *Differences in the rates of growth of markets* (from 1 to 5 or even 1 to 10 between Europe and China, within the same industries) (see Figure 2). The emerging countries will represent 45% of the global economy in 2015. More significantly, they will represent 55% of global economic growth over the period 2005-2015. For example, two thirds of global growth in luxury products will be in Asia, excluding Japan. More than 70% of the world’s new coal power stations will be built in China and India. In this sector, it is not by accident that the new state of the art technology (‘supercritical’) was developed by Chinese operatives<sup>1</sup>. To remain leader in one’s industry (including in terms of technology!), one must go where the growth is.

All of the differences arising from the effects of scale, technological advantages, price premiums linked to differentiation, differential growth in certain distribution channels or customer segments etc ... are now, and for the next two decades, of secondary importance compared with the economic groundswell created by these structural differences.

What is the value in being in the number one position in Europe (dearly won) with a 20% structural cost advantage over one’s European rivals (half of which is passed on to customers in the form of beneficial prices or commercial conditions) and in markets lacking growth, when Asiatic competitors have payroll costs ten times lower, domestic markets growing at 30% per year and for whom size will be close to or greater than that of Japan in ten years?

Is it really better to conduct trench warfare to maintain and improve positions in Europe (and in the United States), where the value can only diminish over time, or a war of movement to acquire positions and competitors in the desired time in the big, strongly growing emerging markets?

Waves of destabilisation and of opportunities, industry by industry, linked to the rise in power of the large emerging countries will thus come one after another over the coming years.

The world over the next twenty years will probably look more like the heterogeneous economic world of the 1950s and 1960s (with differences in standard of living between the United States, Europe and Japan), or indeed the 1970s (with the emergence of Japan as a world player), than the world of the 1980s and 1990s. A significant difference with this world of the 1960s and 1970s is that Japan was an economy ‘closed’ to foreign investments. That is not the case for China and India today.

## **Today, localization is the fourth dimension for strategy (perhaps the most important)**

In this context, localization is again becoming the fourth major lever for strategy (and is perhaps the most important):

- Localization of the tools of production in order to benefit from the decisive cost advantages, well beyond the effects of scale, experience, ... in any products for which the costs for international transport are low;

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<sup>1</sup> The coal power stations with ‘supercritical’ technology represent state-of-the-art technology for semi-basic and basic electricity generation, nuclear being reserved for basic

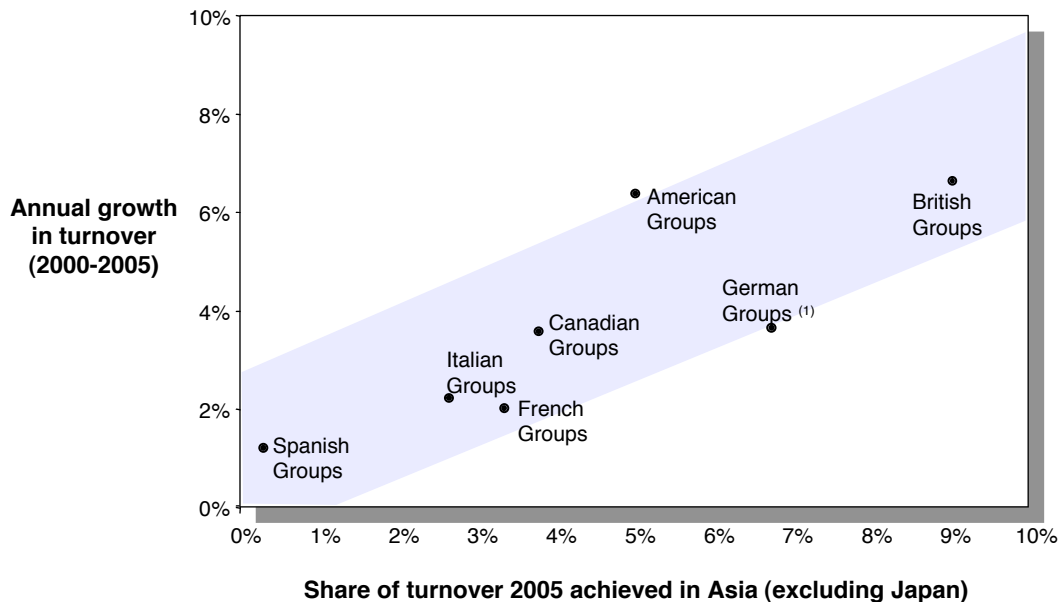
- Focus on the countries and regions in strong growth in order to best allocate commercial investments for the development of product ranges, marketing, image (this being true whatever the transport costs).

The challenge goes well beyond the simple question of geographical expansion. The mix of localization of the tools of production coupled with the geographical mix of commercial positions is the decisive variable for profitability and growth for businesses operating on a global scale. Where does one produce? Where does one sell? How does one make best use of the structural differences between geographies?

The differences in competitiveness associated with the localization of the tools of production are clear. Those linked to the relative weight of the various geographies in the commercial portfolio are just as strong. Today, for example, in certain core market staple goods, profitabilities differ structurally between:

- The United States, with low profitabilities due to consumer behaviour, to the way in which core market products have become commonplace and to the strength of the supermarkets which grab a large share of the value;
- Western Europe, with strong profitability for the leaders due to the structures for consumption, to the value of innovation and differentiation and to the still significant strength of brands (with profitabilities greater by 5 to 10 points of ROCE on average compared with the United States);
- China with, according to the products, strong or weak profitabilities depending on whether purchasing power is adequate or not, on the development stage for the product on offer and on the rapidly changing organisation of competition and distribution.

**- Figure 3 -  
Global growth and share of income achieved  
in Asia, excluding Japan**



(1) Apart from the impact of the break-up of conglomerates  
Source: Analysis Estin & Co on a sample of 600 North American and European listed groups

Major global leaders having different weightings for these three regions in their portfolio have structurally different profitabilities for a similar mix of products and the same competitiveness for their tools of production.

In terms of growth, the impact of the geographical mix is equally clear. An analysis of 600 businesses quoted in North America and Europe shows the link between the proportion of their income achieved in Asia (excluding Japan) and their overall growth (see Figure 3). In a more detailed way, analysis by industrial sector illustrates the strategic directions and challenges for the major North American and European groups (see Figure 4).

**- Figure 4 -**  
**Proportion of 2005 income achieved in emerging countries in four specific sectors**

	Raw materials industry <sup>(1)</sup>	Manufacturing Industry <sup>(2)</sup>	Consumer goods	Financial sector
<b>English Groups</b>	25%	5%	8%	10%
<b>North American Groups</b>	15%	8%	10%	12%
<b>German Groups</b>	15%	14%	2%	5%
<b>French Groups</b>	11%	5%	8%	2%
<b>Italian Groups</b>	n.s	12%	n.s	n.s

(1) Chemicals, building materials, iron and steel

(2) Apart from capital goods

Source : Analyses Estin & Co on a sample of 300 quoted groups

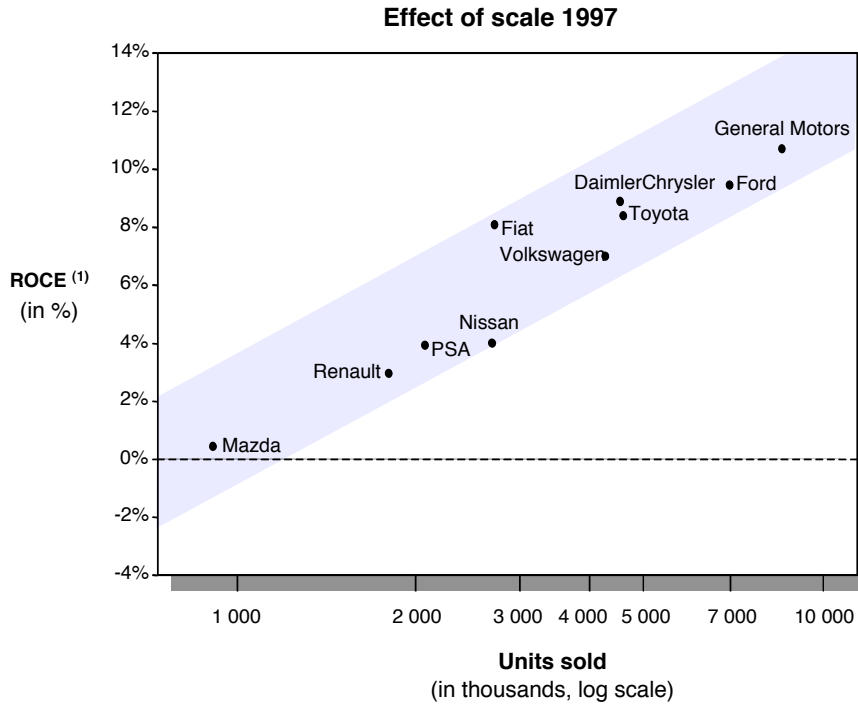
The challenge does not relate only to the differences in growth between continents. In numerous industries on a local dimension, the competitive structural differences and the dynamics of the market inside Europe are creating structurally different conditions for profitability. In electricity generation, for example, beyond the price rises linked to changes in the costs of oil and gas, investors today are interested in investing heavily in the Italian leaders rather than German, English or French leaders on account of the current inadequate generating capacity of the Italian power stations compared with the predicted growth in demand and the strong disparity in generating costs for the current power stations, propping up the market prices at high levels.

A symbolic example of these disruptions is that of the car. The well-known scale effect by country and globally that has structured this industry over the course of the last thirty years (General Motors more profitable than Ford, itself more profitable than those following it, etc ... in an order close to that of the overall sizes) has disappeared, giving way to a localization effect (selection of final markets and production sites). The car manufacturers are today becoming more profitable if they sell and manufacture in Asia (excluding Japan) (see Figure 5).

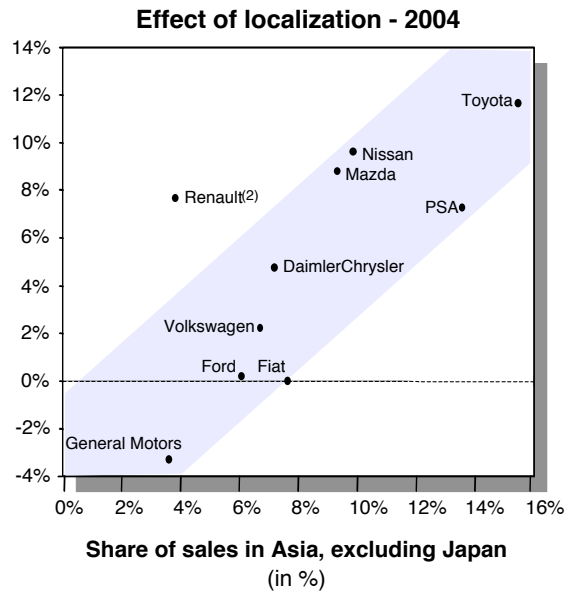
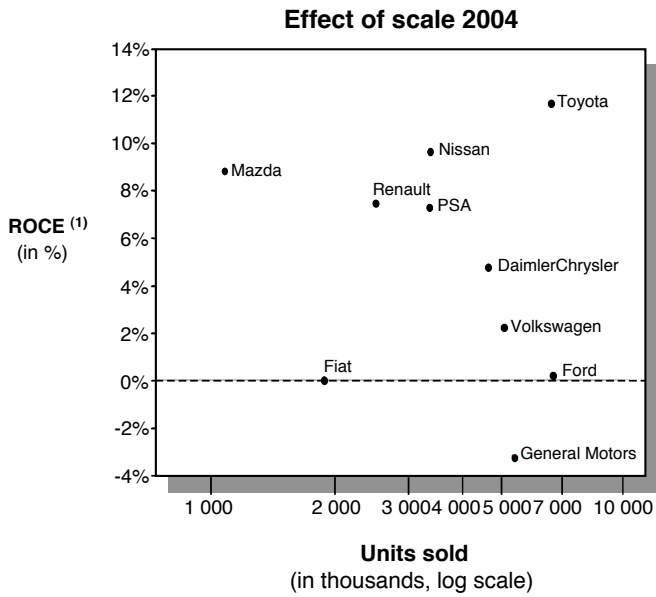
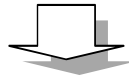
The Toyota model (stripping down of the value structure and subcontracting to companies and countries with low cost factors, strategy of growth in the emerging countries, etc) (16% of vehicles sold in Asia (excluding Japan) in 2004, 12% of ROCE) has finally got the upper hand over the General Motors model (strong integration of the value chain, scale effects countering high cost factors, pension costs in the US, defence of domestic market share, weakness of international position, etc) (less than 4% of vehicles sold in Asia (excluding Japan) in 2004, - 3% of ROCE).

- Figure 5 -

In the automobile industry, the effect of scale has been superseded by the localization effect



(1) Return On Capital Employed = EBIT / Capital committed  
Source: Annual reports, analysis Estin & Co



(1) Return On Capital Employed = EBIT / Capital committed  
(2) For the volumes, impact of Renault Samsung in Korea only; for ROCE, impact of Nissan  
Source: Annual reports, analysis Estin & Co

## Some consequences

The implications of this change - clearly apparent - are significant:

- Strategies of defending market share, against a backdrop of prohibitively expensive production tools (payroll costs, social costs, retirement costs), are doomed to failure, whatever the levels of productivity and effects of scale (c.f. General Motors);
- Strategies of gaining market share and consolidation of an industry within mature markets (Europe, North America) to improve costs create less and less value. A large part of the cost savings arising from synergy through acquisitions or mergers is passed back to the customer. In the same way, most of the money invested in R&D and innovation at best makes it possible to maintain margins and retain market share but without increasing them;
- These consolidation strategies are vulnerable. In five years, the examples of sales of businesses of the European and North American leaders to competitors set up in more attractive and cost-competitive markets have multiplied (sale of the PC division of IBM to Lenovo, sale of the mobile phones division of Siemens to Ningbo Bird, sale of American International Steel to Mittal Steel, etc.);
- Given the respective dynamics of the markets, out of two major rivals, one European and the other Chinese or Indian, which one will buy the other in ten years time (or sooner), if the European remains confined to the markets of the mature countries?
- Strategies for gaining strength and differentiation in the mature countries are still possible. But these strategies for the development of new technology, for raising the range, for sophisticated differentiations in the developed countries must be compared with those for selling essential and staple goods in the major emerging countries. Where will it be best to allocate resources for R&D, marketing, investments under the brand, commercial networks, even acquisitions? Does one have the resources to do both?
- The companies that, at the same time, pursue strategies of consolidation or raising the range in Europe and in the United States on the one hand, and development in the emerging markets on the other hand, have to develop different business models, one for the differential strategy in the mature markets and the other for core market growth in the major emerging countries. The coexistence of both models within the same organisation is not apparent. And, in numerous businesses, the Europeans today no longer know how to design and develop competitive staple products intended for emerging markets.

Big decisions therefore have to be made concerning:

- *Business models*: must one apply the business model used in the developed countries to penetrate emerging markets at the top end of the range (whilst waiting for the market to rise in purchasing power and level of product range)? Or develop a new business model adapted to the core market in the emerging countries? (what similarities and differences are there compared with the 1960s in Europe and in the United States?);
- *Timing of penetration*: one can win or lose a lot of money in China and in India, depending on a good or bad match between the products and services being offered and the purchasing power of the intended targets, as well as the competitive structure. Should one take positions as quickly as possible? At what cost? Or take the risk of arriving too late when the acquisition targets would be too expensive?
- *Funding needs and investment priorities*: the ratio varies from 6 to 10-fold between the size of the market in China or in India today and what it will be in ten years. Will one have the resources for the commercial, industrial and R&D investments and working capital that will be necessary to build and maintain competitive market shares in such markets, beyond immediate acquisitions and purchases of market share (already expensive)? Will growth be self-financing through the margins achieved in

these markets or through those coming from positions built up in the mature markets? What geographies should one choose as a priority if one discovers that it would be too difficult to do everything?

Whatever their industry, the directors of the major European, North American and Japanese groups of the last three decades have developed their businesses by relying on an unprecedented wave of economic growth over these two continents and country. The next waves will be elsewhere. The new sources of profit (with their associated risks) will be caught up in these.

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*Estin & Co is an international consultancy in strategy based in Paris, London, Geneva and Shanghai. The firm assists the boards of major European and North American Groups in their growth strategies, as well as private equity funds in the analysis and value improvement of their investments.*