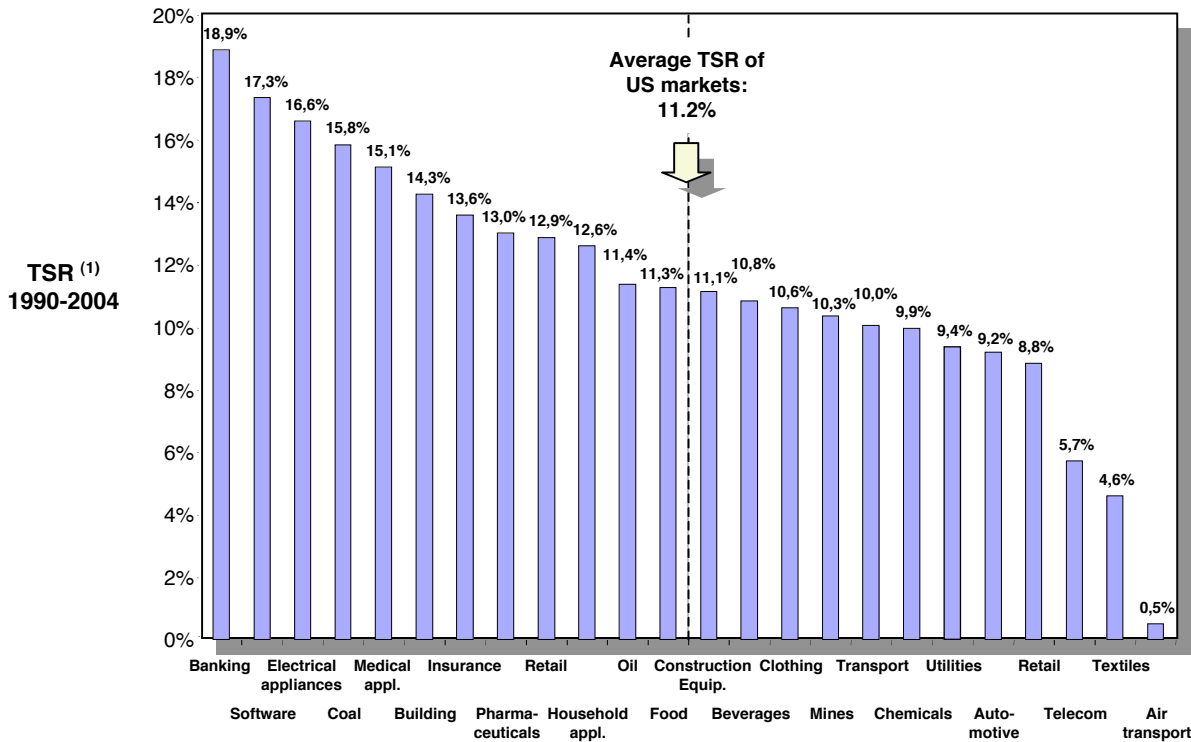


All businesses are not equal⁽¹⁾

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All businesses are not equal. Over a long period, certain businesses earn more for their shareholders in structural terms than others (cf. table 1). Growth and competitive structure are the two critical components of the value of a business.

- Table 1 -
 Over a given period, all business are not equally attractive



This hierarchy is still valid after taking into account the cost of capital in each industry

(1) Total Shareholder Return, including the appreciation of securities, distribution of dividends, buying up shares, distribution of free shares, capital increases (with hypothesis of reinvested dividends). Sample of 4,500 companies on the NYSE, AMEX and NASDAQ in 2005
 Source: CRSP University of Chicago, analyses by Estin & Co

(1) This article was written following requests from many readers of the article "Waves of value" of September 2006. It examines in detail the points made in the paragraph "All businesses are not equal" of this article. The reader interested in this subject can consult the article "Strategy vs. economy" in the X-HEC-ENA symposium of March 2005.

Growth

Businesses with sharp growth earn more on average for their shareholders than businesses with low growth, and for two reasons:

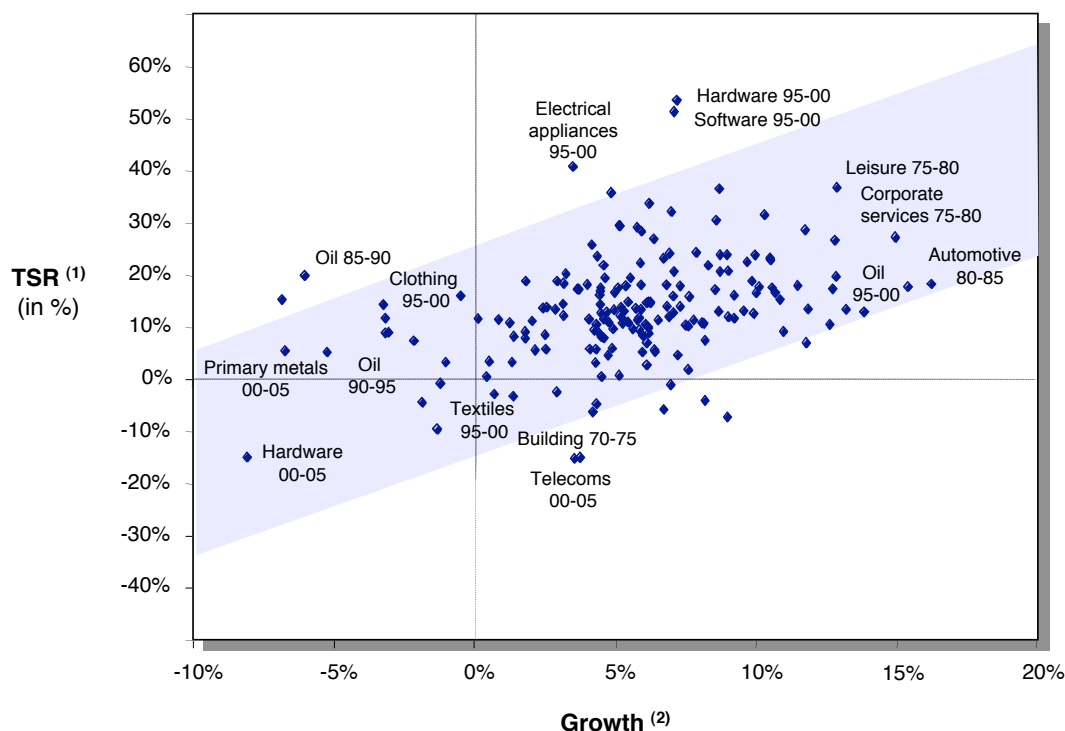
- The businesses with sharp growth generally offer (all things being equal) higher profitability rates and cash flows, not only for the leaders, but for all the players (high demand, prices still high, competitive fragmentation, etc.); for the leaders, the net cash flows of reinvestments are even often positive and high in spite of growth;
- The growth of these results and cash flows mechanically creates value for the players whose cost-effectiveness is higher than the cost of capital.

An analysis of 4,000 North American companies in 40 sectors between 1950 and 2005 shows that total shareholder return (TSR) is directly linked to growth (cf. table 2).

- Table 2 -

The growth of the sector is decisive for the creation of value

TSR and growth of 40 US sectors over 11 periods of 5 years (1950-2005)



(1) Total Shareholder Return, including the appreciation of securities, distribution of dividends, buying up shares, distribution of free shares, capital increases (with hypothesis of reinvested dividends). Average TSR over 5 years of each US sector. Sample of 1,000 companies in 1950 to 4,500 in 2005, on the NYSE, AMEX and NASDAQ; (2) Growth in average annual growth rate of turnover of the sector over 5 years
Source: CRSP University of Chicago, Bureau of Economic Analysis. Analyses by Estin & Co

Competitive structure

Certain businesses are "well" structured economically and in terms of competition: high barriers to market entry, significant effects of scale, a high value derived from leadership, technological advantages exclusive to certain players, and the ability to maintain high prices despite pressure from clients.

These businesses become highly concentrated over time and the leaders have high and constant levels of profitability.

Other businesses put lower barriers on entering the market; the effects of scale are very low beyond a critical mass that is also small in terms of the potential market; the technological innovations are rapidly accessible to all the competitors; and the margin is captured by clients whose negotiation power is considerable.

In these businesses, there are no structural differences of margins between the competitors, there is no value in being the leader, and profitability depends basically on long or short cycles of supply and demand.

Four typical situations

In terms of these two components, it is possible to distinguish between four typical situations (cf. table 3):

- *Businesses with high value in market share and sharp growth:*

A company must either invest heavily to obtain or maintain leadership by progressively concentrating the industry, or give up (making alliances, repositioning on niches, optimising liquidities, etc.). The worst solution is to continue investing heavily to maintain positions that are simply marginal.

Electrical appliances, luxury goods, spectacle lenses, and staple goods in countries with rapid growth are typical examples of these businesses.

- *Businesses with high value in market share and with low growth:*

When a company is a leader, it must optimise its investments and margins (no overinvestment, but also no loss of competitive positions). When a company is marginal, investing leads nowhere, so it must get out with optimum benefit or fundamentally change its business model.

Certain businesses in mature markets are in this latter situation. Numerous service activities, in which the local market share is the key factor in profitability, also enter into this category: the maintenance and repair of heating or cooling appliances, metrology, reading meters, etc.

- *Businesses with low value in market share and with sharp growth:*

Investments can be made opportunistically, on condition that one knows when to pull out in time before growth slackens and margins shrink.

The management of the investment in long and especially short cycles of offer and demand is crucial, more so than the development of market share (beyond a critical threshold).

These are often companies in regions with rapid growth (Asia, Eastern Europe, etc.). Businesses which elsewhere would have little potential for creating value benefit transitionally from an outsourcing surge or sharp growth in the local market: textile, certain types of industrial plant, etc. Also included are large cyclical industries during the ascending phase of the cycle (air transport, certain construction materials, paper, energy, etc.).

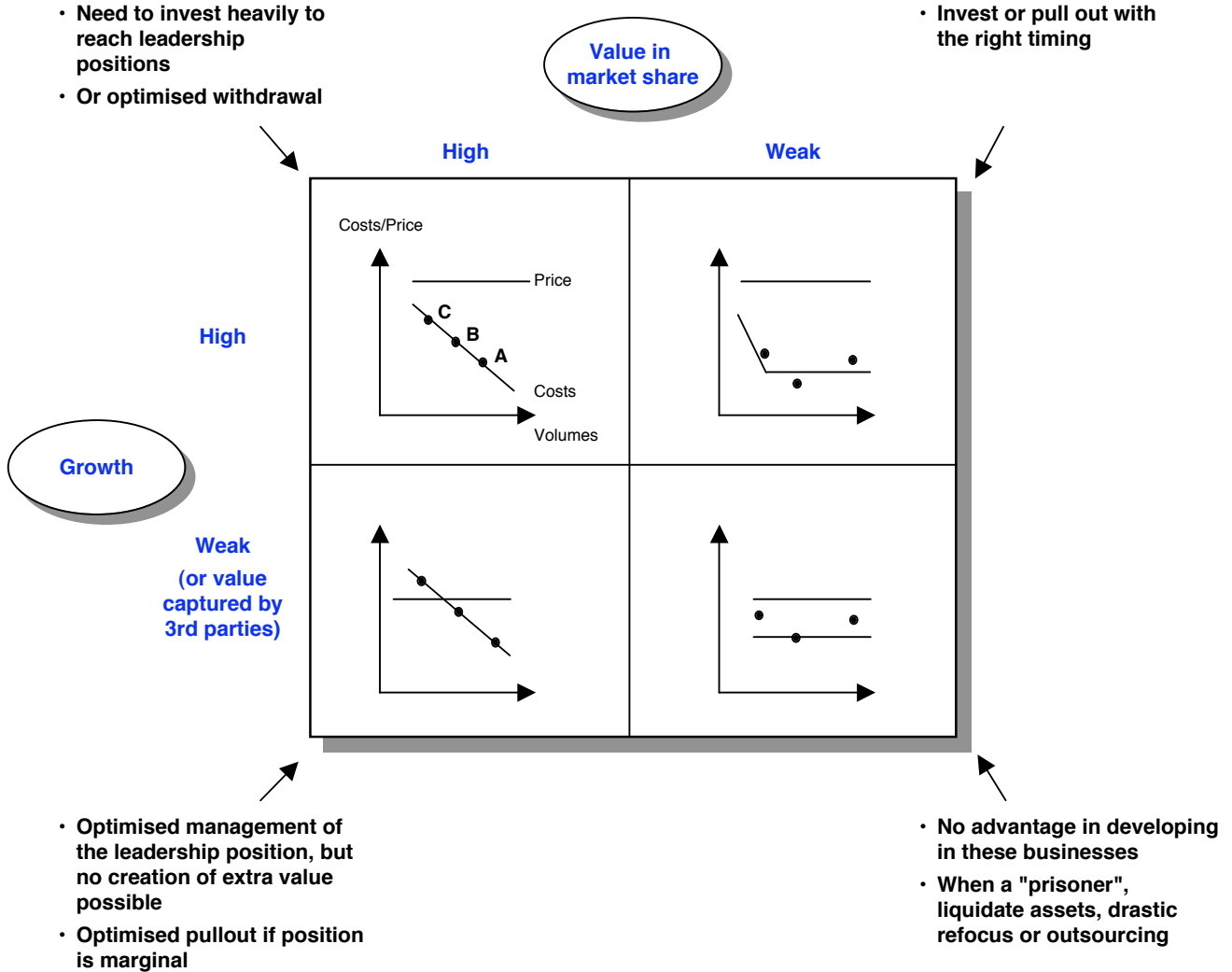
- *Businesses with low value in market share and with low growth:*

To be avoided!

When a company inherits this situation and is a "prisoner" there (because the exit costs are often very high: welfare costs, environmental costs), it must optimise: liquefy assets; manage cycles and investments; fine optimisation of the mix of clientele, products and geographies with given capacity; yield management; outsourcing to restore a cost advantage when this is possible; major changes in the business model with focus on certain niches. Market share has no value beyond often low critical masses.

Textile, ordinary clothing, and chemicals outside of niches are examples of such businesses.

**- Table 3 -
Four very different situations**



NB: In the above simplified diagram, each dot corresponds to a competitor

The dynamics

All businesses evolve over time, over a more or less long period. Growth tends to slow down or even disappear (maturing of markets, substitution of products and technologies, changes in customer expectations, etc.). The competitive advantages and the barriers to entry also tend to diminish or disappear. Businesses that are very attractive at the outset, and with expensively acquired competitive positions, can become poor creators of value five, ten or fifteen years later on.

These evolutions must be anticipated and managed.

What are the implications?

These strategic situations and dynamics are well known. They occur over time in most industries, though at naturally more detailed segmentation levels than the few examples mentioned in the tables. They also appear in the financial statistics over a long period: businesses that are "well" structured and growing earn more for their shareholders, including after taking into account the cost of capital, than businesses that are "badly" structured, stagnating, or forced to abandon or substitute large swathes of their basic components (cf. table 1).

This does not mean that the strategies of businesses or their operational management are not important. In all businesses, including the most difficult, there will be at least one profitable company, temporarily or constantly. But the economic and competitive dynamics described above put great pressure on the nature and the result of these strategies, as well as on the number of competitors that can be profitable (and with positive net cash flow) over a long period. These dynamics get the better of the talent of managements, their strategic or tactical inventiveness, and the operational miracles that they are capable of producing from day to day.

Hence, the choice of businesses is also as important as the good or bad strategy that they adopt or the quality of the operational management that they develop.

For a management team in a business sector with few possibilities of diversifying and reallocating resources, this question is not very relevant. But for a large group with many possibilities of allocating resources, it is crucial.

For these large groups, the choice of business sectors, the large-scale reallocation of resources between them, the development of new types of business over time, or the abandonment of historical businesses, are fundamental factors in the creation of value.

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Estin & Co is an international consultancy in strategy base in Paris, London, Geneva and Shanghai. The consultancy assists the managements of large European and North American groups in their growth strategies, as well as private equity funds in analysing and enhancing de their investments.