

Do the major western corporate groups still know how to grow?

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Three obvious facts

Obvious Fact One: in the long term, it is not possible to offer shareholders a TSR¹ in excess of the cost of capital if your business is not growing (profitably) at a rate significantly higher than the average for the world economy (approximately 5% per year).

A significant proportion of the management teams running major corporate groups continue to promise their shareholders value creation without setting themselves this minimum growth target or adjusting their business mix, geographic spread or strategies to sustain it. With the exception of necessarily transient readjustments, this amounts to a major contradiction.

Obvious Fact Two: industry-for-industry, Europe's leading companies are growing much more slowly than their US counterparts, which are themselves growing between 3 and 4 times slower than China's leading companies.

It would be wrong to consider these discrepancies as "normal", and the result solely of different market dynamics in the respective domestic markets. Given all the international markets to which products "travel", these are not inescapable.

These differences in growth rate reflect scale effects, cost reductions and differing medium-term investment capacity. Tomorrow's leaders are today's fastest-growing companies. In some sectors, Europe's major corporate groups are on their way to losing the game altogether, and within five to ten years, some Chinese groups will be more competitive than their European or American counterparts, *regardless of their cost base.*

Obvious Fact Three: for a corporate group to achieve annual growth of 5%, it must achieve at least 8% to 10% per year over a long period in its target strategic areas in order to offset the fact that its other activities or geographical locations are growing less strongly or are contracting.

Such growth is rarely linear. In business sectors or geographical locations where new vectors of growth are emerging, it is often necessary to grow at 30%, 50% or even 100% per year for between 3 and 10 years simply to keep pace with the market, and retain at least a chance of leading it in the long term.

In all the growth markets of China today, the local leaders are growing at between 30% and 100% per year. Very few of the western leaders in these same markets are growing at that rate.

How many western corporate groups still know how (or even want) to grow at 30% to 50% per year in selected business or geographical sectors with all the operational, managerial and human resources challenges posed by such growth (to say nothing of the financial risk)?

In many cases, and despite investing a lot of money and management time, those groups that grow too slowly in certain emerging countries can nevertheless find themselves forced to withdraw from the market, because their positions are still marginal and insufficiently profitable five or ten years down the line (cf. recent examples in superstore retailing, hotels, luxury goods and consumer goods).

¹ TSR: Total Shareholder Return: the total return investors receive on their investment (in the form of dividends, rights issues, share purchases, equity capital gains, etc.).

**- Table 1 -
Comparative annual growth rates
2002-2006**

	<u>European leader</u>	<u>US leader</u>	<u>Chinese leader</u>
Steel	Arcelor: + 13%⁽⁴⁾	US Steel: + 23%	Baoshan: + 47%
Cement	Lafarge: + 4%	M. Marietta Materials: + 8%	Anhui C. Cement: + 50%
Chemicals	BASF: + 13%	Dow: + 15%	Shijiazhuang: + 26%
Carbon fibre	-⁽²⁾	Zoltek: + 8%	Worldbest: new arrival
Semiconductors	Infineon: + 11 %	Intel: + 7%	Semiconductor MA: + 132%
Telecoms hardware	Alcatel-lucent: - 7%	Nortel: + 1%	Huawei: + 21% (3), ZTE: + 21%
Offshore oil drilling	-	Transocean: + 10%	China Oilfield S.: + 24%
Elec. equip. and products	Alstom Power: + 6%	GE Energy: + 15%⁽³⁾	Dongfang Elec.: + 37%
Automotive	Volkswagen: + 4%	General Motors: + 4%	Shanghai Automotive: + 58%
White goods	Electrolux: - 6%	Whirlpool: + 13%	Haier: + 14%, Midea: + 17%
Audiovisual hardware	-	Harman: + 15%	TCI Multimedia: + 24%
PC	-	HP: +13%	Lenovo: + 49% (1)

(1) Including incorporation of the IBM PC division; (2) European subsidiaries of Japanese leaders only; (3) 2004-2006 growth rate; (4) Prior to the merger with Mittal

N.B.: growth is expressed in the reporting currency of the company concerned (euro for European companies, dollars for US companies and renminbi for Chinese companies)

Source: Bloomberg and Estin & Co analyses

A strategic challenge

At the strategic level, growth is an apparently simple challenge. It is the result of investing more than your competitors (resource allocation), and the impact this investment has on revenue and profitability (better business model than your competitors as a result of its mix of special levers) as applied to the most favourable mix of business sectors, geographical markets and customers (strategic targeting).

This analysis is a simple one, and determines the maximum and optimum growth potential of a corporate group, but it is rarely conducted systematically. As a result, most groups under-optimize their growth or invest excessively to achieve a given level of growth.

In reality, the problem is a complex one:

- Few companies channel the majority of their investment into growth, often preferring to over-optimize their existing business
- Few companies adapt their business model to geographic sectors, product segments, customer segments or high-growth business lines
- Few companies make far-reaching changes to their portfolio of business sectors, geographic sectors and customer segments in order to position themselves structurally in growth markets.

Until internal cultural, political and strategic restrictions are removed, all the efforts at innovation, individual initiative encouragement policies, changes to organisations, people and processes, investment in production or products and growth-orientated motivational systems... are nothing more than empty gestures.

A financial challenge

All other things being equal (industry sector, geographical mix, financial leverage, etc.), strong growth causes a higher level of volatility in the business and its margins (and therefore in the cost of capital) than does weaker growth.

As an indication, 10% more growth results in approximately 0.2 points of additional beta.

Every pilot and airline passenger knows perfectly well that an aircraft vibrates more during a very steep takeoff than when cruising at altitude. In fast-growing markets, delays in implementation, errors in assessing the impact of investment, the time taken to adjust products or services, recruitment errors and similar blunders, are more frequent and more costly than in stable environments. Similarly, investor sentiment about the future growth of the market or the company can have an enormous effect on its share price.

This volatility is reduced when the business model is clearly defined and easily reproducible without significant adjustment from region to region and business sector to business sector, and is lent credibility by its track record and corporate communication.

It may be reduced when the people in charge are temporarily overrated and have a clear understanding of the group and what it does.

It is also reduced, of course, when the geographical region attracting the investment is well-known to the group as a result of experience in other business sectors.

The old management rule “*never invest unless you have a full understanding of two of the three traditional factors: business sector, people and geography*” should therefore be even more applicable to fast-growing markets. Where this rule cannot be met, there is a high risk of ending up with recurrent and costly “stop/go” policies (growth, restructuring, growth, and so on).

The financial risk also depends, quite naturally, on the relative scale of the new growth opportunity compared with the current size of the group. The sheer size of markets in China demands very significant increases in revenue and major investment from companies with an ambition to become competitive in a market core business. Variations in the wider economic climate can impact revenue and its associated margins very significantly in absolute terms.

It is clear then, that only the world’s major corporate groups are in a position today to invest in Chinese core markets without significantly increasing their overall risk level; and the same applies in all major emerging countries. Medium-sized companies are restricted to niche markets or tier-two countries, or alternatively, to accepting a very steep rise in their cost of capital.

A cultural and managerial challenge

In addition to the strategic and financial challenges, the other very real barrier to be removed is cultural.

Most major corporate groups in the West have spent the last 20 years operating in mature markets with growth below 5% per year in many cases. They have focused their efforts on restructuring and cost-cutting, redefining internal processes to reduce general and administrative costs, shedding assets to refocus their businesses, optimising their ranges and margins by micro-segmentation and product differentiation, and refreshing ranges to sustain demand and maintain price levels.

How many of these still know the answers to these questions:

- How do you manage 50% annual growth without major slippage of costs and margins? How do you open 100 sales outlets, fast food units or hotels *per year* in a new region, rather than 10 or 20?

- How do you adjust your internal development, design, decision-making, production and marketing processes, at the same time as reducing the time it takes to deliver a product or service to the end customer and growing at the right pace?
- How do you recruit, train and retain the people you need to keep up with this growth? And how do you grow strongly whilst maintaining quality and retaining skills despite a human resources turnover of over 30% per year?
- How do you design and produce core market products at low cost and with fewer features?
- How do you structure contracts and relationships with your suppliers of raw materials and energy to avoid them capturing the majority of the value created by growth? (In periods of high growth, value gradually migrates upwards through the industrial chain)
- To which reporting level do you assign the fast-growing entity to ensure fast decision-making, and what level of delegation do you grant it?
- How, in practical terms, do you remove the constraints that limit growth to between 8% and 15% per year under the normal group business model?

However, constraints are being removed.

Five years ago, even the combined capacity of all the merchant navy senior officer training schools in the world could not meet the explosion in demand generated by so many new ships entering service. One company set up its own training operation to by-pass this bottleneck.

The new hotel construction process is just too slow to cope with the exploding demand for hotel rooms in China, so the major players in the market are converting existing offices, factories, etc. in order to grow at 100% per year.

In the world of semiconductors, a single R&D team isn't enough to get products to market fast enough to match the speed of the new product cycle. The result is lost market share every other cycle. Having two R&D teams working almost in parallel, but one slightly ahead of the other, has allowed one company to grow faster than its competitors.

Return to the future

This return to the future (western corporate groups have already faced the same challenge in the US and Europe in the 1950s and 60s, and in Japan in the 1970s and 80s) is proving difficult today. The teams and the techniques they have used to maximise margins over the last 15 years are simply not capable of doubling the size of the business every year in a new area of business or new country, whilst containing costs and risks.

But in all the world's major industries, this "return" is necessary if we assume that, given the likely significant and normal ups and downs of the market, growth in Asia will continue to drive world growth over the long term.

As with any major change, the questions for senior management are simple:

- Is the actual or target growth rate of my group high enough to achieve my value targets and ensure my future competitiveness?
- What should it be and can I support it financially?
- What are the major structural decisions that will allow me to achieve my objectives? Which internal constraints and limitations must I remove?

Answering these questions objectively is the first step on the long path to growth. Once on it, (profitable) long-term growth will rely, as it does in other areas of business, on the traditional application of experience (in all its systematic, codifiable and reproducible aspects).

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Estin & Co is an international strategy consulting firm operating in Paris, London, Geneva and Shanghai. The firm assists CEOs and senior executives of European and North American corporations in the formulation and implementation of growth strategies, and private equity funds in the analysis and valuation of their investments.

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