Value Waves

by
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Over and above the strategies (good or bad) pursued in every industry, for the major groups (and investors) the issue is to determine why and how to choose one business rather than another, whether to have several or whether to be a "pure player", and when is the right time to diversify into a new industry because the current business portfolio no longer offers sufficient potential for increasing value.

The true added value of groups in fact depends on their ability to anticipate and respond to these issues rather than in determining a strategy for each of their component industries or in the mere financial or managerial control of these industries.

Not all businesses are of equal worth

"Give me a good management team and I can make any business profitable." This statement is clearly fallacious, as is the following: "All businesses are of equal worth as long as they are leaders in their sector with strong competitive positions.".

The rise in demand, the significance of entry barriers and the more or less attractive competition structure allowing *or preventing* leaders gaining high structural profitability, the potential for differentiation between competitors and the growing commoditisation of the industry, whether or not the value is taken up by customers, etc…, all of these make various industries more or less desirable in terms of their potential to create value with appropriate management and strategy.

Long term, sector or segment-based financial analyses of industries demonstrate that some activities either do not create value for their shareholders (air transport, metallurgy, textiles in Europe or the United States etc …) or create only a little (utilities, chemical etc …) as a whole, even for the leaders, while others, better structured or in full growth, are more attractive for the players that have built up strong market shares or defendable niche positions in them.

Why remain in clothing or basic textiles rather than investing in fashion and luxury goods when one is a European group? Why continue to invest in France or Germany rather than in China when one is in staple goods? Why continue to invest in telecommunications (except for niche positions) in Europe rather than in nuclear energy if one has large financial resources?

The barrier in skills and expertise is real at the level of operational teams. Strategically and financially speaking, it cannot exist for a major group that promises the creation of value to its shareholders.

The main added value for a group comes in deciding in which industries it is worth the trouble of investing financial and managerial resources or even simply staying, given their structural attraction.

There is nothing worse than the situations where, over ten or twenty years, good teams of directors expend their efforts on operational restructuring, strategic refocusing or consolidation of the industry through successive acquisitions, with the associated financial resources and human challenges, simply and *at best* to maintain the market price, whilst their industries are in structural decline or in the process of relocating or gradually being replaced by other services or technologies, … . They are running breathlessly in a negative sense, on a conveyor belt moving faster and faster.

- Figure 1 -

United-States - 1950 - 2005

Sectors significantly OUT-performing the financial market average (sample not exhaustive)

	1950s	1960s	1970s	1980s	1990s	2000s
	Metallurgy Aeronautics Electrical IT Automobile Pharmaceutics Hotels Publishing	Mining Construction IT Clothing Household appliances Publishing	Petroleum Mining Aeronautics Defense Capital goods Naval construction	Telecoms Pharmaceutics Food Supermarkets Publishing	Silicon chips IT Electrical Software Telecoms Banking	Petroleum Mining Aeronautics Defense Capital goods Naval construction Transport Fashion/luxury Banking
Difference per sector compared with market average TSR	+2 to+10%	+2 to+8%	+2 to+10%	+2 to+10%	+2 to+20%	+2 to+37%

Sectors significantly UNDER-performing the financial market average

	1950s	1960s	1970s	1980s	1990s	2000s
	Mining Utilities Transport Construction Food Textile Insurance	Metallurgy Chemical Utilities Telecoms Insurance	Chemical Utilities IT Household appliances Supermarkets	Mining Metallurgy Silicon chips IT Construction Capital goods Naval construction Aeronautics	Petroleum Chemical Metallurgy Utilities Transport Construction Capital goods Naval construction Automobile Food Clothing Textiles Hotels	Metallurgy Silicon chips IT Software Telecoms
Difference per sector compared with market average TSR	-2 to-7%	-2 to-7%	-2 to-6%	-2 to-15%	-2 to-10%	-2 to-16%

Note: Sample of 1,000 (1950) to 4,500 (2005) companies on the NYSE, AMEX and NASDAQ; over or under-performance defined as being at least two points higher or lower than the annual TSR representing the market average for the period; TSR includes the surplus on stocks, the distribution of dividends, share buybacks, distribution of free shares, additions to capital (assumed to be reinvested dividends); the average TSR for each sector is compared in each period with the average TSR of the financial markets for the period

Source: Bloomberg, Annual reports , University of Chicago, Analysis Estin & Co

There is no industry that creates value indefinitely

Moreover, the industries do not remain attractive forever. Analysis of the performances of the major groups and business sectors since 1950 in the United States and in Europe shows that *in the long term (beyond 10 to 20 years) and in a same geographical area, there is no industry that creates value, even for a leader* (see Figures 1 and 2) (except for a few shining exceptions).

The problem is not only that of the cyclical industries (mining, chemical, construction, metallurgy etc). It is that of the big value waves created by the growth of new industries, technologies, forms of distribution, geographical markets, and the inevitable long-term saturation of demand in these sectors, geography by geography, or the replacement of certain business models by other, more successful ones.

The car manufacturing sector in the United States was very attractive in the 1950s and 1960s. Since 1970, it has had a TSR[1] regularly and significantly below the average for the financial markets. Within this sector, even the global leader General Motors has had a TSR lower than average for the financial markets since the second half of the 1980s, taking into account its business model and its geographical focus. The value has passed to other business models and geographical zones (see Toyota, Figure 2, and tomorrow the Chinese manufacturers?).

The strength of competitive advantages, the opportunities for differentiation and price premium, the exclusivity of products or technologies, … always in fact diminish in the long term in the face of maturing of demand, the diffusion of technologies, the emergence of new forms of more appropriate competition, the excessive growth in production capacities, the power of the supermarkets and large customers, the rise in strength of the countries with low cost factors or the implementation of new regulations.

Financial cycles can conceal this phenomenon for a time. The majority of the major groups and business sectors had very high TSRs in absolute terms during the 1980s and 1990s, thanks to the heavy fall in interest rates. After correction for the effect of this, a number of them would have had mediocre TSRs over this period which was already characterised by the rapid rise in power of Asia and growing over-capacities in Europe and the United States in several industries.

Groups that are seeking to maximise their value for their shareholders are therefore obliged to continually reallocate their resources into new industries, business sectors, technologies, geographies etc. in the medium and long term, or they will break up (voluntarily or not).

One must therefore know how to get out of mature industries when they are at their peak value for the group, given its mode of management (the investment funds would be able to take them back and create value with the managerial efficiency and additional financial levers in these industries), or carefully avoid over-investing in them by using their net cash flows to fund other activities with high potential.

At the same time, one must be able to promptly identify new value waves, where the skills of the group, its financial resources and its original strategy will give it a lever to be potentially more successful than other competitors and thus to invest more heavily.

There is a moment when management of the existing business portfolio, with its structural dynamic, is no longer sufficient to create value.

The groups that will prosper in the long term can therefore have trouble identifying themselves with a narrowly defined industry, business model or unique geography. They are necessarily diversified, the old industries and geographies coexisting with and funding the new.

The fact that the value moves in waves through industries, segments of them or geographies, thus explains and justifies the existence of diversified groups.

Significant development in the new strongly-growing geographies (China) to offset the unavoidable stagnation of value in staple goods businesses in Europe (Carrefour, Danone etc),

[1] TSR: Total shareholder return on their investment over a defined period

or the steady migration over a long period towards new industries, each time more attractive than the old ones, for example from construction to television, from television to mobile phones, and from mobile phones to nuclear (Bouygues), are examples of the strategic evolutions necessary to continue to create value for a group.

The strategy of systematic division by businesses and geographies followed by Procter & Gamble over a long period is a model of this type (see Figure 2).

Pulling out of an industry that has been the basis for the success of a group over a generation or, even without leaving it, migrating significantly to new industries is never easy. Cultural revolutions are a necessary condition for strategic changes.

The value of the Group Senior Management

The major diversified groups must therefore bring a supplementary value to the sum of the values of each of their component industries. Otherwise, it is difficult to justify the cost of the Group Senior Management, of the shared roles or of the various control and coordination costs that characterise them.

Besides, this is the reason why a number of holding companies and major diversified groups that add little value compared with the separate management of each of their industries suffer a significant down-rating (between 15% and 30%).

What values can a Group Senior Management add?

- Active management of the business portfolio: allocation of resources divided between activities or geographies; withdrawal from some; major developments in others with high potential; use of the cash generated by the "milk cows" or disposals to finance strategic developments;
- Purchase, sale, merger and swaps of businesses enabling the reconfiguration of one or more industries between players in such a way that they are more logically organised and made more strongly profitable;
- Heavy diversification, beyond the existing business portfolio, when necessary, to sustain growth and value;
- Purchase at a low price of businesses open to being heavily restructured operationally and strategically and systematic resale at the highest price after a few years;
- The lateral sharing of expertise (R&D, geographical presence, etc.) that is financially hard to sustain by a single industry; the provision of financial resources or of a capital sum not available for an isolated activity of insufficient size;
- The extreme financial lever on an activity with strong recurrent cash flow.

A Group Senior Management that does not make strong choices between activities when allocating resources, does not revolve its business portfolio over the short or the long term or does not make decisions on the diversification or switching of industries is not adding value when compared with the separate value of each of its managed businesses.

In principle, the management of an industrial company will define the optimal strategy for its business as effectively as that of a group (with the given financial resources), and the financial markets will give a better value to a "stand alone" industry on the stock exchange rather than when it is within a group.

- Figure 2 -

Over- or under-performance of some major groups compared with the market (annual TSR for the group minus the annual TSR for the market)

	50-54	55-59	60-64	65-69	70-74	75-79	80-84	85-89	90-94	95-99	00-04
GM	10.9%	1.8%	8.2%	-8.3%	-5.4%	2.1%	1.1%	-10.0%	-5.4%	-7.0%	-6.4%
Toyota	-	-	-	-	-	-	-	+17.0%	+0.7%	+19.7%	-2.5%
IBM	0.2%	24.6%	2.6%	16.7%	-4.8%	-4.8%	4.2%	-21.0%	-10.2%	16.3%	-0.1%
Pan Am Corp.	1.8%	-6.8%	14.8%	-9.7%	-25.6%	6.7%	-20.1%	-29.9%	-	-	-
Delta Air Lines	-	-	37.4%	18.8%	4.4%	-9.7%	5.3%	-7.3%	-13.8%	-12.5%	-30.3%
Accor	-	-	-	10.5%	58.7%	-30,3%	8.8%	8,6%	-3,9%	-2,3%	0.2%
Exxon Mobil	13.0%	-4.2%	7.8%	-9.7%	10.8%	0.6%	5.4%	4.6%	-0.2%	-2.0%	8.5%
Air Liquide	-	-	-	-6.2%	10.3%	19.6%	8.3%	-8.0%	11.1%	-12.4%	9.7%
Dupont de Nemours	6.0%	-1.5%	0.5%	-19.5%	5.2%	-6.9%	-4.2%	5.8%	1.3%	-5.7%	-1.6%
Pfizer	-0.9%	9.6%	0.8%	11.3%	4.9%	-10.7%	5.5%	-5.1%	11.3%	12.%	-1.2%
Coca-Cola	-25.0%	-4.1%	16.5%	13.8%	-2.8%	-8.3%	4.4%	15.2%	14.5%	-8.4%	-3.8%
Procter&Gamble	-5.3%	2.3%	4.9%	1.9%	14.%	-16.7%	-0.7%	5.0%	5.5%	3.4%	3.3%
L'Oréal	-	-	-	28.0%	2.8%	-5.8%	22.2%	-1.7%	24.0%	12.4%	-0.9%
Carrefour	-	-	-	-	29.5%	5.8%	9.7%	7.8%	23.8%	10.7%	-11.2%
Wal Mart	-	-	-	-	-	32.2%	40.2%	18.0%	5.0%	19.1%	-3.6%
LVMH	-	-	-	-	-	-	29.1%	10.3%	2.8%	5.2%	-2.1%
Alcatel	-	-	-	-0.2%	4.7%	2.2%	-	-	1.5%	1.8%	-18.3%
Intel	-	-	-	-	-	34.8%	-4.5%	-6.1%	21.0%	32.4%	-9.3%
Microsoft	-	-	-	-	-	-	-	-	35.4%	45.2%	-11.3%
Dell	-	-	-	-	-	-	-	-	52.9%	112.7%	-2.7%
Verizon	-	-	-	-	-	-	-	10.4%	-6.4%	-2.8%	-3.8%
Vodafone	-	-	-	-	-	-	-	-	3.2%	34.9%	-10.9%
Telefonica	-	-	-	-	-	-	-	-	17.0%	23.7%	-5.0%
Average TSR of the North American markets	21.8%	14.7%	10.1%	7.0%	-4.0%	17.9%	15.0%	19.1%	9.2%	27.3%	-1.1%

Note: Annual TSR made up over the period includes the surplus on stocks, the distribution of dividends, share buybacks, distribution of free shares, additions to capital (assumed to be reinvested dividends). The TSRs of American companies are compared with the TSRs of the North American financial markets.The TSRs of European or Japanese companies are compared with the TSRs of their respective markets.

Source: Bloomberg, Annual reports , University of Chicago, Analysis Estin & Co

Besides, the major diversified holdings with ‘reference shareholding for the long term’ of the 1970-80s have disappeared (Générale de Belgique, etc) or have reconverted to investment funds (Paribas Affaires Industrielles, etc).

Whether or not there is proximity between the industries in the portfolio is not the defining issue for the creation of value, contrary to generally accepted thinking (and except in the case of certain shared skills). It is the ability to employ a mixture of strategic, financial and managerial skills *of a different nature* to those that are necessary for the management of a single line of business.

The added value of the Group Senior Management is measured quantitatively. This is, on the one hand, the size of the downgrade or the premium (rarer and weaker) compared with the value of each of the industries taken in isolation and, on the other hand, the steady growth in value over a long period (10 years or more).

Depending on the mix of skills and preferred levers employed from among those described above, the major diversified groups that truly create value over the long term rely on some very precise modes of management, limited in number.

- Figure 3 -

Over- or under-performance of some diversified groups
1950 - 2005
(Annual TSR of the group minus the average annual TSR of the market)

	50-54	55-59	60-64	65-69	70-74	75-79	80-84	85-89	90-94	95-99	00-04
ITT	8.0%	15.8%	1.3%	9.9%	-17.5%	1.3%	-3.7%	-1.4%	2.3%	-9.3%	22.9%
Hanson	-	-	-	-	-	2.8%	35.6%	9.6%	-2.7%	-7.2%	3.2%
General Electric	12.2%	5.1%	-8.6%	-8.0%	3.8%	-4.5%	7.9%	2.5%	3.7%	18.8%	-3.7%
Bouygues	-	-	-	-	18.4%	17.5%	33.3%	-14.4%	7.3%	33.2%	-5.2%
Wendel	-	-	-	2.4%	22.6%	-27.8%	24.1%	12.8%	0.7%	8.9%	11.2%
Average TSR of the North American markets	21.8%	14.7%	10.1%	7.0%	-4.0%	17.9%	15.0%	19.1%	9.2%	27.3%	-1.1%

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Source: Bloomberg, Annual reports , University of Chicago, Analysis Estin & Co

Management modes of the major diversified groups

ITT, General Electric, Hanson, Carlyle: all of these are emblematic diversified groups that have successively marked a decade or even two, since 1950, by offering TSRs[1] double (or better) those of the average financial markets over a long period (see Figure 3).

Each of these groups is based on a very specific business and value creation model, meeting the challenges of the relevant economic period as well as a given mix of activities and in reaction to the structural limits of the models of the pure players or of the less well-managed conglomerates of their time.

ITT (1960s and 1970s): diversification into all industries and all geographies to optimise growth whilst reducing risk: why remain in a single industry when anti-trust laws are limiting the positions achievable in each industry in the United States and one has a management model superior to the others (financial control)?

Hanson (1970s and 1980s): creation of value by the takeover and break up of badly run conglomerates in basic industries lacking growth; operational and strategic restructuring; liquidation of assets and refocusing on profitable core industries with strong net cash flows; resale at a higher price after a few years: why not systematically apply the same very effective restructuring formula to all similar situations?

General Electric (1980s and 1990s): development of international leaderships in each industry or total withdrawal, with optimised allocation of resources within the business portfolio: why remain in a single industry when one has a strategic management model which makes it possible to allocated resources rationally for growth whilst developing competitive and profitable positions, and this in a recurrent manner (strategic management of the business portfolio)?

Carlyle (1990s and 2000s): systematic purchase and resale of businesses with strong recurrent net cash flows with application of maximum operational and financial levers: what is the limit of the LBO model in environments with low interest rates? (The major investment funds are the conglomerates of today. They control groups of companies for which the total turnover, workforces and invested capital can reach the levels of those of General Electric. The very strong wave of reorientation at the end of the 1990s and from the start of the 2000s has paradoxically fed the growth of this new form of very diversified group).

Thus there are a few modes of management for the major diversified groups, each corresponding to a mix of activities and skills, to a type of value that the shareholder wants to create or even to a given economic period.

The first has today become obsolete, no longer creating sufficient value. The other three still function perfectly well as long as they are pursued to their logical end.

The third still today constitutes the classic management model for the major industrial groups, with more or less success according to whether or not strong choices are made between activities.

The second and fourth are limited to activities in weak or moderate growth, without serious risk of rupture and with limited needs for reinvestment. The second model extracts cash from the assets whilst the fourth from leverage. Both of these latter models are strongly challenging the third through the rapid rotation of the activities within the portfolio: why indeed remain permanently in certain industries once one has maximised their value?

Today, any diversified group must, in its management, emulate one of these latter three emblematic models, or a combination of them, if it wants to create value for its shareholders.

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[1] TSR : Total shareholder return on their investment over a defined period

The challenge

The problem is simple. Nevertheless, the continual return of conglomerates, successively valued and disparaged, interrupted or accompanied by long or short periods of development for the pure players, shows that few groups are finding effective solutions or know how to renew themselves over time.

For the major groups, the creation of value necessitates riding the waves by industries, segments, geographies, management levers,… . This is a war of movement.

Conversely, in each industry, the strength of a successful strategy is to be fully committed right up to the end, everywhere with persistence, over a given period (the longest possible), with great cohesion and motivation of teams, whilst knowing that, in the long term, its value strongly diminishes or disappears.

One must succeed in reconciling the two.

September 2006

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.