Five sources of value creation (and some benchmarks)

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There are five real sources of value creation.

(Profitable) Growth

Significantly accelerating a group's growth. This is one of the most significant sources of value creation. A group that is growing at only 3% per annum with a return on equity of 15% has a market value greater than its equity (about 2.3x) but it will only return the cost of capital to shareholders (say, for example, 8%).

A strategy that will enable the group to step change its growth to 10% per annum (with the same return) increases this market value to around 3x its equity. After the acceleration period, this value continues to increase steadily at 10% per annum (all other things being equal). The TSR[1] for the shareholder stands at 17% per annum during the acceleration phase (assuming that this phase lasts five years) and then remains steady at 11% per annum afterwards. This is one of the major issues facing large Western groups currently caught in stagnating markets. If instead of reaching a steady growth rate of 10% per annum the company manages to reach 15% per annum, the TSR for the shareholder will be 26% per annum during the acceleration phase and a steady 15% per annum afterwards.

Long-term growth. Long-term, profitable growth (triggered by significant long-term underlying market growth, plus organic market share gains in order to concentrate the industry and acquire or maintain profitable leadership, or a roll-out of the same business model country by country) is another significant source of value creation for shareholders. In a business which is growing at 15% per annum with a return on equity of 15%, the market value settles at around 4.4x the book value. For a shareholder who buys shares at market value, the annual return on investment is around 15%.

Acquisition of a fast growing business. Even if the acquisition price is high, this is also a strong source of value creation. A company which is growing at 15% per annum with a return on equity of 15% is expensive (around 4.4x its equity). But if the growth and profitability remain at the same high levels, the investment returns 15% per annum. For the shareholder who acquires the company, the profitability is paradoxically identical to that which results from organic growth (see above).

The number and size of possible acquisitions are limited, however. Large goodwill can in fact rapidly drain the company's free cash flow (or its borrowing power) while a self-financed organic growth model is theoretically infinite (as long as the market is not saturated and/or its concentration does not become unproductive or unacceptable).

Consolidation and creation of synergies

Consolidation of an established industry by organic market share gains. This is a riskier source of value creation. If it involves consolidating a market that is still growing strongly and is not very concentrated, the reasoning behind the previous case applies (see above, long-term growth).

If the market is mature, gains are often weaker. Cost gains resulting from market share gains and corresponding scale effects are partially offset by either commercial investments, or investments in products, or by the price reductions necessary to realise these market share gains. The more one

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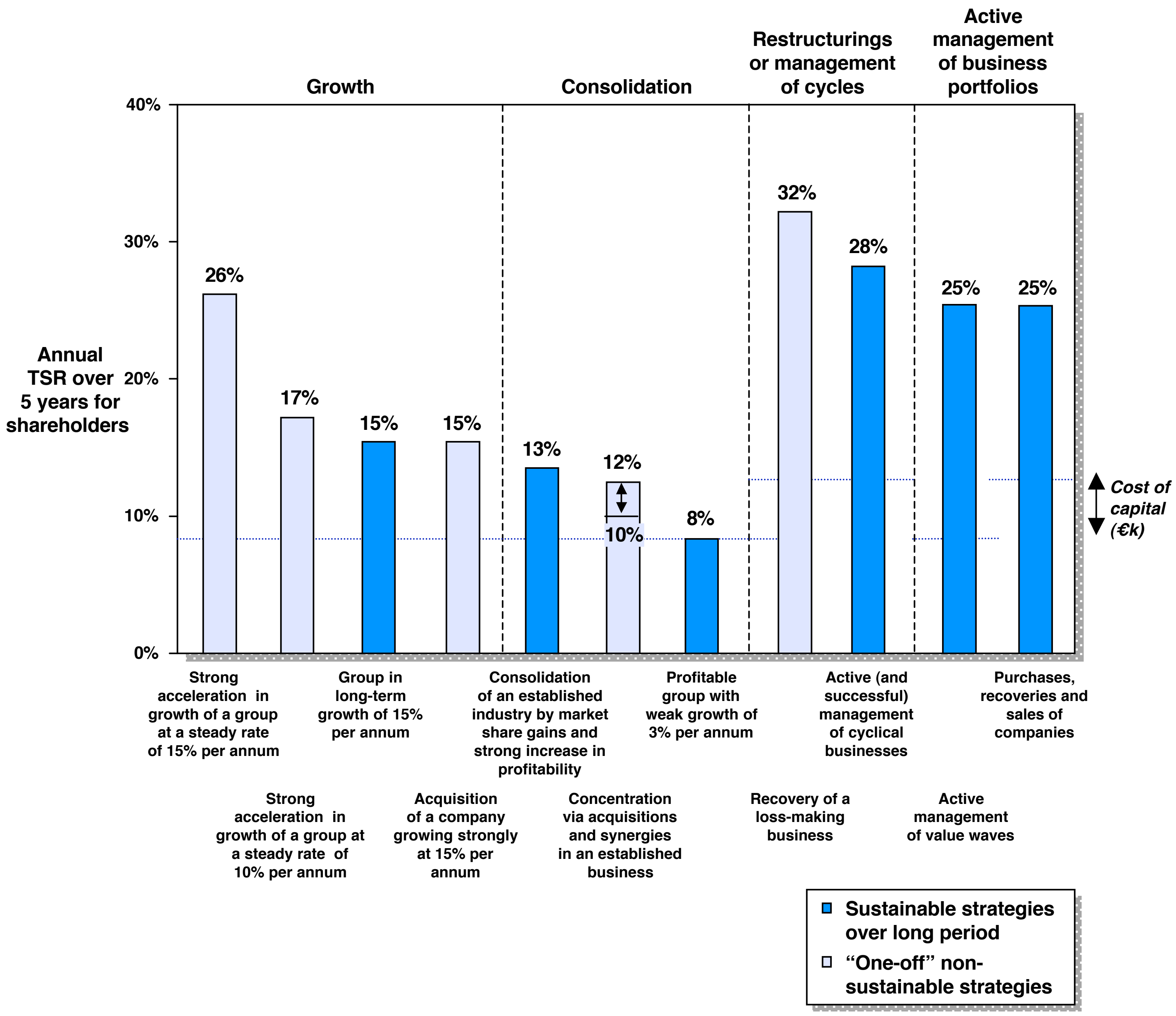
[1] TSR = Total Shareholder Return: total shareholder return compared to their investment at market value: dividends, bonus share distributions, share price appreciation, etc.

- Table 1 -

Value creation for shareholder by value creation type
(Averaged annual TSR over 5 years)

- Typical benchmarks -



achieves market share gains and concentrates the market, the more mature the market becomes, and the more these gains show decreasing returns (cost gains become less than the necessary price reductions). Improvement in margins and growth through consolidation are therefore structurally time-limited. A company which improves its return from 15% to 20% over a 10-year period and grows at 6% per annum in a market which is growing at 3% will have a market value which will go from 2.6x to 3.8x its equity in 10 years. Its shareholder will have a TSR of around 13% per annum throughout this consolidation period.

Concentration through acquisitions. Acquisition of a competitor and the rationalisations that follow can typically bring 20-30% synergies net of restructuring costs. But between a third and half of these gains are given back to the vendor as an acquisition premium. In industries where the clients have strong negotiating power, another portion of the gain (if not the whole amount) is given back to clients through price reductions.

In the best case scenario (synergies returning 20% of the acquisition price after factoring in all the mitigating impacts), and if there is weak market growth, the impact for the shareholder is around 6% above the cost of capital (and if one reckons on a period of three years to realise all the gains linked to the acquisition). The TSR during those three years is 14%. Beyond that, the shareholder still faces the weak growth of the business and a TSR equalling the cost of capital, but not more. Afterwards it is necessary to make another acquisition. If the net synergies are less than half (10% of the acquisition cost), the annual TSR over three years falls to 11%.

Corporate recoveries

Recovering a business. This is a significant source of value creation. But it is time-limited. A business which is growing weakly at 3% per annum and with a negative return of equity of -5% has a market value of around 0.5x its equity[2]. A recovery which brings it to a sustainable profitability of 10% increases its market value to 1.4x its equity. If the recovery is carried out within two years, the TSR is 77% per annum over these two years. After that it yields the cost of capital. Over a period of five years, the annual average TSR would then be 32%.

In order to create long-term value with this type of strategy, you need to regularly identify businesses to restructure and sell them as soon as possible afterwards. A holding such as Hanson generated a TSR of 25% per annum over the 20-year period of 1970-1990 with such a strategy of acquiring loss-making companies, implementing a recovery and re-selling them after three to five years.

Management of cyclical assets

Managing cyclical businesses by entering and leaving them countercyclically. This is a strategy that can create significant value (and at the same time destroy a vast amount of it if the timing is wrong). It is difficult, if not impossible, for industrial businesses to execute this if they need a long-term strategy where assets cannot easily be separated from operations. It is possible in businesses where the underlying assets are modular and liquid (trucks, containers, ships, hotels, furniture, stocks, etc.) In a company lacking structural growth and where the seven-year cycles result in a return on equity of between -10% to +40% (within a given cycle), active management of part of the assets can result in an average additional TSR of 20% over and above the cost of capital, even if the sale or acquisition of the company takes place one year too early or one year too late.

Active management of business portfolios

Managing portfolios of businesses or geographies and ensuring they evolve over time. The main characteristic of all the sources of value creation is that they each have an optimal duration : *long-term* (15-20 years or more) when it involves, for example, profiting from growth and national then global consolidation of large industries; *average,* when it involves using or creating transitory waves of growth, of substitution, of modification of business models, of technological breakthroughs or competitive or economic advantages (5-10 years); *short* (24-30 months) when it involves restructuring businesses in "old" industries. Beyond these optimal time-frames they will not create value.

Anyone who is really focused on creating value therefore manages their business portfolio actively and explicitly by investing in new businesses or by getting rid of other older businesses according

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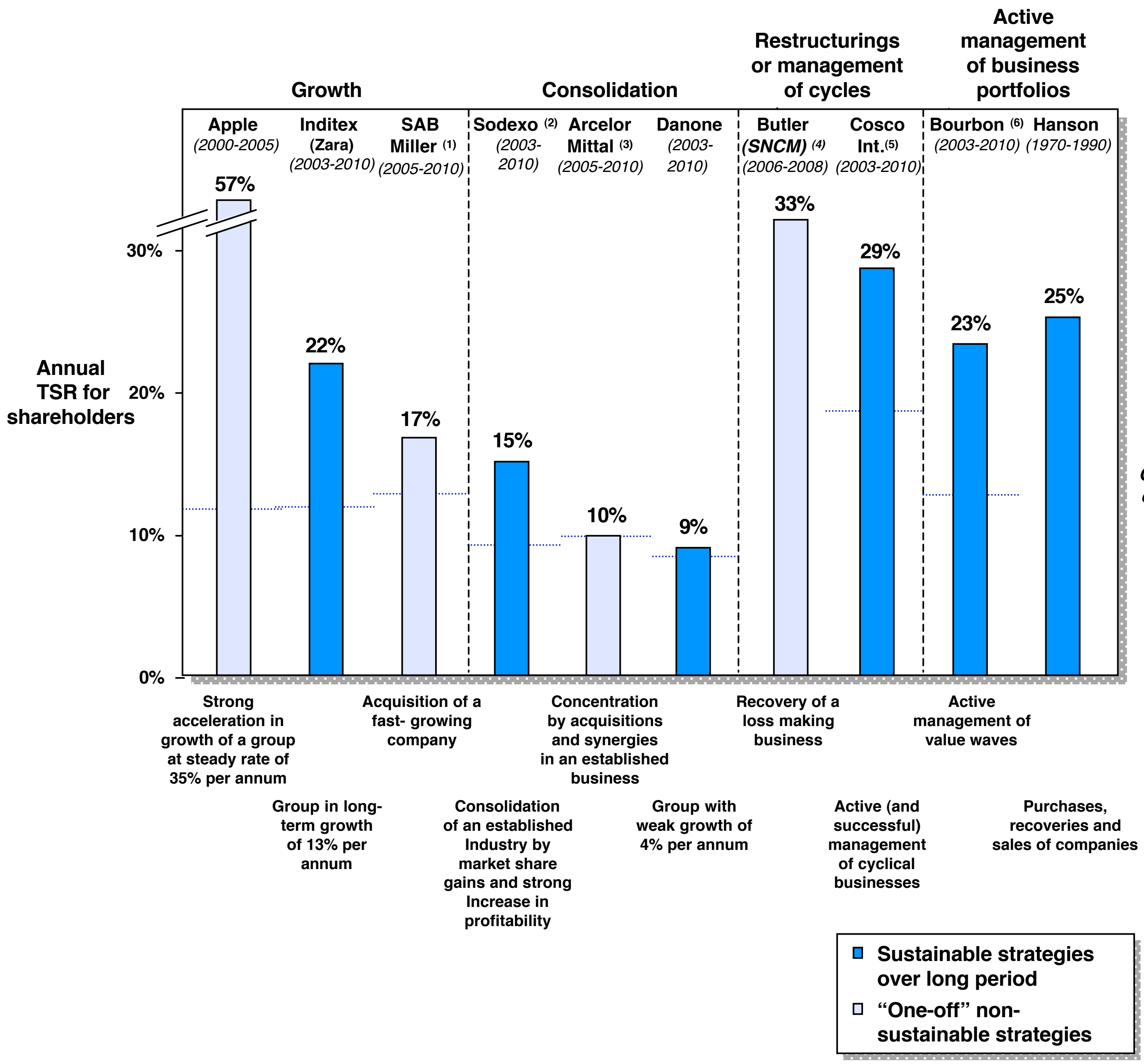
2 If the business is independent and listed on the stock exchange, its value cannot be negative.

- Table 2 -

Examples of businesses by value creation type (Averaged annual TSR)

- Typical benchmarks -



Note: TSR calculated on 31/12 each year
(1) Acquisition of several companies in countries showing strong growth over the period 2005-2010; (2) Growth of 4% in a market growing at 3%, increase of 8 points in ROE over the period from 7% in 2003 to 15% in 2010; (3) Acquisitions mainly in Europe, USA and South America, acquisition of Arcelor in 2006, TSR of a Mittal then Arcelor-Mittal shareholder from 2006 onwards; (4) TSR averaged over 5 years, acquisition in 2006 and re-sale in 2008 to Veolia; (5) China Ocean Shipping Company, subsidiary specialising in boat trading businesses, shipping services and property investments; (6) Development in maritime services, then in the offshore sector following the gradual divestment of retail and food-industry businesses
Sources: Bloomberg, annual reports, Estin & Co analyses and estimates

to the optimal time-frames. *They will specialise in one method of value creation and will draw their conclusions accordingly regarding the time-frame for holding their investments and will not specialise (or not only) on one industry.*

Typical examples of active management of business portfolios leading to average long-term TSRs of 25% per annum are Bourbon for the management of growth and consolidation waves from 2000-2010 or Hanson (see above) for purchasing, recovery and successive re-sale of companies from 1970-1990 (see table 2).

These five sources of value creation are suitable for different industries, market cycles, management types and business situations.

There are nevertheless important choices to make. The large Western groups often have to choose between continuing to consolidate their markets in established countries and investing in new businesses or in strongly growing countries. Over and above all the specifics of each situation, the structural differences between growth strategies and consolidation strategies in established markets are significant (see above and tables 1 and 2).

The strategy that today consumes 50-80% of the investments of the large Western groups which have succeeded in established countries, namely managing cash cows without an in-depth reappraisal of portfolios of businesses or geographies, does not constitute a source of value creation for shareholders. A stagnant business with a return on equity of 25% does of course have a market value 4x greater than its equity. It generates essential funds to pay dividends and interest on debt or to finance other businesses experiencing strong growth. But for shareholders, this value will not increase any further and their TSR will be equal to the cost of capital.

Value creation is a result of a company's management team investing their time, and making effective choices in this area. Time taken to manage what's already there, as profitable as it may be, will not create value. It will simply maintain it. Creating value requires making thorough and regular changes to the trajectory, profitability and/or the business mix of the company, or alternatively identifying and capitalising on significant and long term growth trends.

How are you allocating your time?

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Estin & Co is an international strategy consultancy based in Paris, London, Geneva and Shanghai. The firm assists the boards of major European, North American and Asian groups in their growth strategies, and private equity funds in analysing and improving the value of their investments.

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