Why we must keep demanding 15% profitability

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In a world where the medium- and long-term growth of Western countries risks being low, at 1-2% a year, *and where consequently* companies will be less profitable, there is a great temptation to lower expectations of the minimum return required from a company or an investment. The cost of capital will be lower, the opportunities for obtaining higher profits will be fewer, and over-ambitious targets will discourage long-term investment and could undermine the future of a company.

However, this fails to take account of the fact that world growth, led by emerging nations, will remain strong, at 5-6% per annum, and that capital moves around. The cost of capital will not decrease in the long term. Western companies that settle for weaker profitability and growth will simply disappear in the long term, giving way to more ambitious Western competitors or emerging nations.

The recurring questions about the ability and the need to achieve sustained returns of 15% or more actually form part of a much wider debate – are we in it to win or just to take part? Should we resign ourselves to European decline or actively participate in world growth?

This is not a financial issue about covering the cost of capital - it is a strategic issue.

Market leaders still have profitability of over 15%

In a normal market, with economies of scale of around 10-20%[1], and at normal stages of consolidation, leading companies can in theory achieve EBIT[2] margins of between 20 and 35% of turnover, while second-tier companies will achieve 10 to 20%, and third-tier companies will barely break even.

In reality such gaps rarely occur because the leaders exploit this advantage to reinvest and consolidate their respective sectors. Some of the potential extra margin is in fact absorbed by increased costs - on improved product quality, greater technological innovation, better customer service, and increased spending on advertising - and some by lower prices. This gives the market leader a more competitive business model, and enables it to gain market share on competitors and to consolidate its sector. The leader then usually achieves EBIT margins of 10 to 20% and ROCE[3] (where turnover/CE[4] = 2x) of 20%, if not 40%.

In a number of well structured industries, where there are high barriers to entry, significant economies of scale and minimal value captured by customers or suppliers, it is apparent that ROCE is in fact often close to market share - 20% market share equates to 20% ROCE, and 30% market share to 30% ROCE (see Table 1).

Demanding returns of over 15% is not simply a matter of wanting to cover the cost of capital - which is now generally much lower than that anyway *- it is about demanding the profitability of a leader or co-leader.*

Much greater returns should even be required of non-growth businesses with 30-40% of market share.

[1] Reduction in costs of 10-20% for each doubling in size
[2] EBIT: earnings before interest and tax
[3] ROCE: EBIT/capital employed
[4] CE: capital employed

Conversely, logic suggests that such returns should not be required from businesses where the company has poor market share, or where the industry is poorly structured, with little or no economies of scale, no barriers to entry, and where major customers do capture value.

It is essential that this is done, however. Whilst it is clear that such returns cannot be achieved, demanding them results in very strong pressure being brought to bear on these businesses. Such businesses will be operated to their long-term detriment and therefore eventually to the point where the company will withdraw from them, or the management will be forced to redefine or even sell them. From a strategic point of view this is healthy pressure and it results in appropriate allocation of resources. Relaxing such demands is tantamount to accepting that the company will remain in businesses in which it has no long-term strategic or financial interest.

Apart from *temporary* events, such as product launches, business start-ups, or major gains of market share in new markets or regions, there are few exceptions. In fast growing businesses, more than anywhere else, leaders have high profitability, and this enables them to finance growth.

In times of crisis, reduced profit levels can be tolerated for a year or two, but rarely more.

A less harsh approach can only be justified in certain businesses with investments that cannot be capitalised, such as major marketing and publicity expenditure for mass-market consumer goods or perfumes, research and development costs for pharmaceuticals or semi-conductors, or software development for internet services and video games. In such cases companies need to reassess profit levels in the light of these investments, given that they must be charged off income, or to set appropriate profit demands accordingly.

Growing leading companies still have TSR[5] of more than 15%

ROCE of 15% usually equates to ROE[6] of 15-20%, making it possible to finance growth of at least 10%, whilst still maintaining dividend payments. However, there remains the challenge of seeking out industries and strategies that can maintain this rate.

10% is not the growth rate of a player from an emerging nation (the main Chinese leading companies are growing at 25-35% a year). It is the *normal growth rate* of a Western operator in moderate growth markets (5-6% in value per year) that is consolidating such markets (with annual company growth of 10%).

Growth of 10% per year, with ROE stable at 15-20% a year, generally produces a TSR of 15% per annum.

This level of growth becomes unattainable in overly mature markets - those growing at 1-3%, and in markets that are already heavily consolidated - where the leader has 40% market share, for example.

But it is a normal rate of growth for a company with a mix of businesses, that is growing in line with the average rate of the world economy, and that is consolidating the markets it operates in.

Demanding a TSR of 15% encourages a company to constantly update its business mix, in order to avoid overly mature markets, or markets that are already too consolidated, and to constantly seek out growth, by its choice of businesses and locations, and through its market leading strategies. Here again it is not simply a question of trying to cover the cost of capital and average stock market returns, which are much lower - *it is demanding the TSR of a growing leader*.

Leading companies that are no longer growing, or growing too slowly in comparison with the world economy average, will, in the long term, either disappear or be taken over (see Table 2). Even if they are highly profitable, their stock-market value will no longer increase, their

[5] TSR: Total Shareholder Return: the shareholders total return on initial investment (dividends, bonus issues, share profits etc) with dividends reinvested
[6] ROE: Net income after tax and financial costs/shareholder equity

room for manoeuvre will be reduced - making acquisitions more difficult - and their shareholders will lose patience.

A strategic objective

A target of 15% ROCE or ROE or TSR is not a mere financial objective. It is a strategic choice for the director of a major group who wants to distance the group from its competitors by its leadership strategies in all sectors, and by its choice of more attractive industries and geographical locations.

Contrary to popular belief, this is the most sustainable objective in the long term, as it ultimately depends on a mix of businesses and attractive locations, competitive positioning and sound strategies.

Pursuing any lesser objective turns leaders into followers, with reduced strategic and financial room for manoeuvre, limited market capitalisations, insufficient reinvestment capacity, and therefore positions and results which are not sustainable in the long term.

Companies that don't move forward go backwards.... and eventually disappear.

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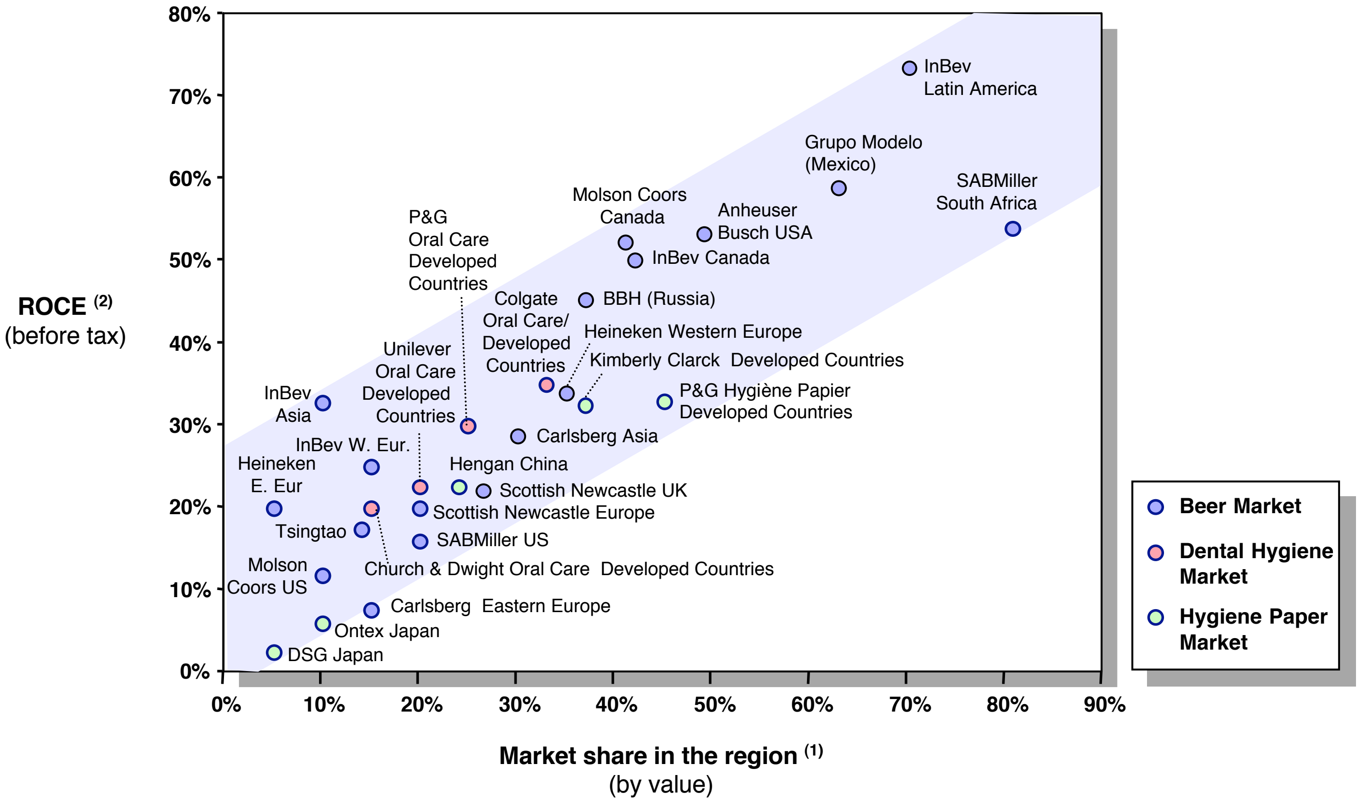
Estin & Co is an international strategy consulting firm operating in Paris, London, Geneva and Shanghai. The firm assists the CEOs and senior executives of European and North American corporations in the formulation of their growth strategies, and private equity funds in the analysis and valuation of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

- Table 1 -

Profitability and market share of mass-market leaders



(1) Average market share in the countries where the company has product distribution ; (2) ROCE = EBIT/Capital employed
Sources : Annual Reports, Reuters, analyses and forecasts Estin & Co

- Table 2 -

Major Western leading companies of the 1970s and 80s that disappeared in the 1990s or 2000s

(examples)

Company	Position in the 1970s or 80s	Year of sale, major split, bankruptcy or disappearance
Wyeth	American co-leader in pharmaceuticals	2009
Cadbury Schweppes	European co-leader in food	2008/2010
DMC	European leader in cotton textiles	2008
Corus	World's 5th largest steel maker	2007
Winterthur	European top 5 insurance company	2006
Steilmann	German leader in ready-to-wear	2006
CCF	French top 10 bank	2005
Marconi (ex GEC)	UK leader in telecoms equipment	2005
Arcelor	European steel industry leader	2006
Aventis	European co-leader in pharmaceuticals	2004
Pechiney	European leader in aluminium	2003
Moulinex	French co-leader in small electricals	2001
Union Carbide	Co-leader in pesticides and petrochemicals	2001
TWA	American top 5 in aviation	2001
LTV	Co-leader in aerospace and defence	2000
Rhône Poulenc	European top 5 in chemicals and pharmaceuticals	1999
Mobil	World's number 2 in oil exploration/production	1999
DEC	US number 2 in computing	1998
McDonnel Douglas	Number 3 aerospace manufacturer	1997
UAP	French number 1 insurance company	1996
PanAm	World leader in aviation	1991
Euromarché	French top 5 in mass-marketing	1991
Firestone	American co-leader in tyre manufacturing	1988