Do pure players still have a future?

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No industry can grow faster than 8-12% per year in the long term. All products, technologies, business models, uses, etc… follow lifecycles of different lengths, sometimes as long as decades. After having grown strongly, their growth stabilises and then reverses, even disappearing to the gain of other products, technologies, business models and uses (see Table 1).

The hypermarkets and supermarkets in the United States have been through a growth period lasting 35 years from 1960 to 1995 (growing at a rate of 30% p.a. between 1980 and 1995). This is no longer a growing industry in either the United States or anywhere else in the west. The automotive industry grew strongly between 1930 and 1973 in the United States (at a rate of 8% per annum between 1960 and 1973). Since then, the American market has shrunk by -1% p.a. The number of new cars sold has been halved over the past 40 years. The financial services sector grew at around 9% p.a. from 1950 to 2000 in the United States, but has only grown at 3% since (in line with the average growth of the economy in value). The personal computers sector (in hardware) grew at 20% p.a. between the 1970s and 2010. Since then, it has shrunk by -2% p.a. (undergoing substitution by tablets and smartphones).

In the mature economies of the west, where the average real economic growth does not exceed 1% p.a.[1] and where many industries do not have significant potential to be consolidated, what is the future of the pure players, who, whilst they are theoretically much-loved by the financial markets, only manage to offer a TSR[2] of 4 to 6% to their shareholders, due to lack of significant growth?

Expand globally

The first response is to roll out products, technologies, business models… in different geographies, in particular in emerging countries. Even if hypermarkets are no longer growing in Western Europe or in the United States, they are at the beginning of their lifecycle in China, at the same point where western supermarkets were in the 1980s. The same goes for the automotive or insurance industries. The emerging countries remain a very strong source of growth for large western groups who are competitive. The share of revenue for this type of large groups that emerging countries[3] represent has increased from 20% to 29% in the last ten years for groups in the Dow Jones, from 15% to 34% in the Footsie 100, and from 16% to 23% in the CAC 40.

But the business models required in emerging countries are not always the same as those in the west. The price and value levels are different in the short term. Structural profitability levels in these highly competitive new markets are lower than in the concentrated markets in the west. The growth of the western groups will be less strong than the local competitors. And

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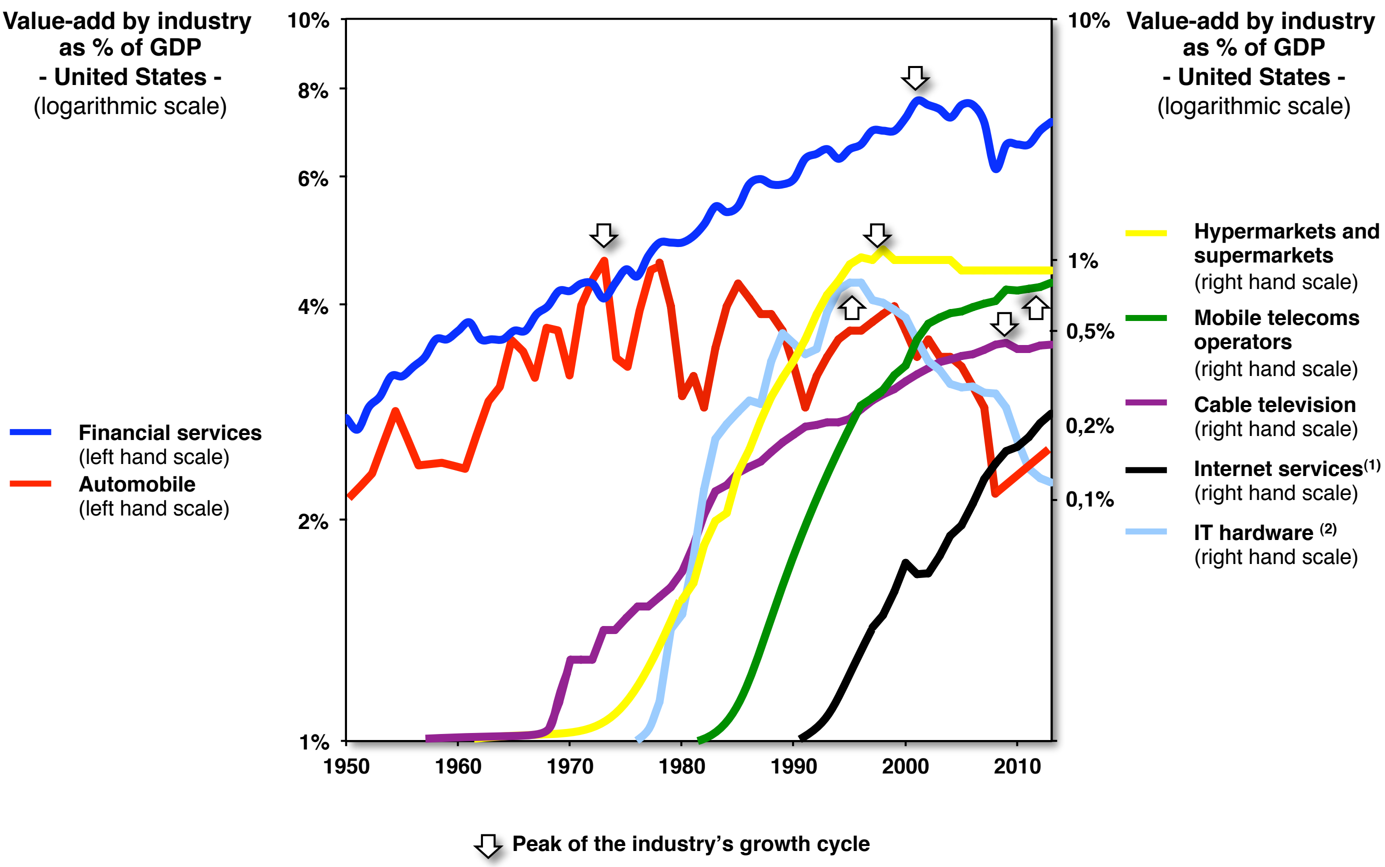
[1] Average GDP growth of the OECD in current dollars (nominal value) is -0,2% in 2012, 1,2% in 2013 and 1,4% in 2013.

[2] TSR = annualised Total Shareholder Return : shareholder's return on investment in terms of dividends, share distribution and share value

[3] Included in emerging countries: Africa, Asia ex Japan, Latin America. 2004 figures are the same perimeter as the 2014 figures in terms of companies included.

- Table 1 -

Growth of various industries over time
US - 1950-2014



Note : Different scales on the left and right hand side
(1) Excluding e-commerce
(2) Manufacture of computers, hard disks and et computer terminals (growth until 2011, this being less than the average of the economy 2006-11)
Source : BEA, Census Bureau, Estin & Co analyses and estimates

the revenue realised in emerging countries is not always significant enough to change the total growth of the group in the short and medium term.

More generally, and thinking further than emerging countries, geographic expansion necessitates a change in business model, and a prioritisation and focus of resources. There is no worse outcome than to invest strongly for ten years, only to establish a marginal position, which is not profitable in the medium term. Renault failed on two occasions in the United States in 1960 and 1980. However, LVMH, Hermès, Inditex, Nike, ... have all built long term growth of 10-15% p.a. based on systematic and well-executed geographic expansion in their industry.

Enlarge the scope of activity

Growth of the scope of the group's operating activities is a second response, which usually enables the group to continue to grow for a further few decades.

This growth of scope can be achieved through migration along the value chain. It can be done by successive covering of different product range levels, developing new product or service categories, developing in new categories of customers, markets and adjacent consumer uses.

Ecolab, today the leader for professional cleaning solutions (revenue 16 billion USD), grew at 11% p.a. for 25 years, between 1990 and 2014, with an annualised TSR of 18% (see tables 2 and 3). This growth was supported by successive enlargement in its operating activities. The business transformed from a niche position in the production of disinfectants for hotels and restaurants, into a global leader in cleaning solutions for multiple markets, successively developing different product and solution categories, different types of markets and consumer uses, different geographies and value chain positioning. In this way it has therefore completed a major growth in its operating perimeter every 5 to 10 years.

Similarly, Apple has grown its revenue from 8 to 183 billion USD between 2000 and 2014 (25% growth p.a.) thanks to successive enlargements of its operating perimeter. It has proceeded from desktop and laptop computers (~85% of its revenue in 2001) to the iPod in 2001, online music in 2003, the iPhone in 2007, the iPad in 2010, and has progressively grown into retail (around 30% of its revenue in 2014). Five enlargements of its operating activity have taken place in 15 years, every 3 years on average. In 2014, computers represented less than 15% of Apple's revenue.

It is possible to see a large number of large groups maintain a growth rate of above 8 to 12% p.a., over decades, by changing their field of activity, in a logical sense according to their competences, their customer base, their reputation etc.

Every industry has segmented historically according to technological, industrial, commercial, geographic and other barriers, and also according to the strategic choices and financial means of the players present. The segmentation of these industries are not permanent because the economic or industrial barriers evolve. The ambitions and means of the players involved change. The re-segmentation of industries is itself a source of growth.

The rationale to grow into adjacent segments is an essential question to ask: is it a case of higher underlying growth, potential to consolidate with a value to this consolidation (scale effects, etc.), sharing of costs and revenues between segments.

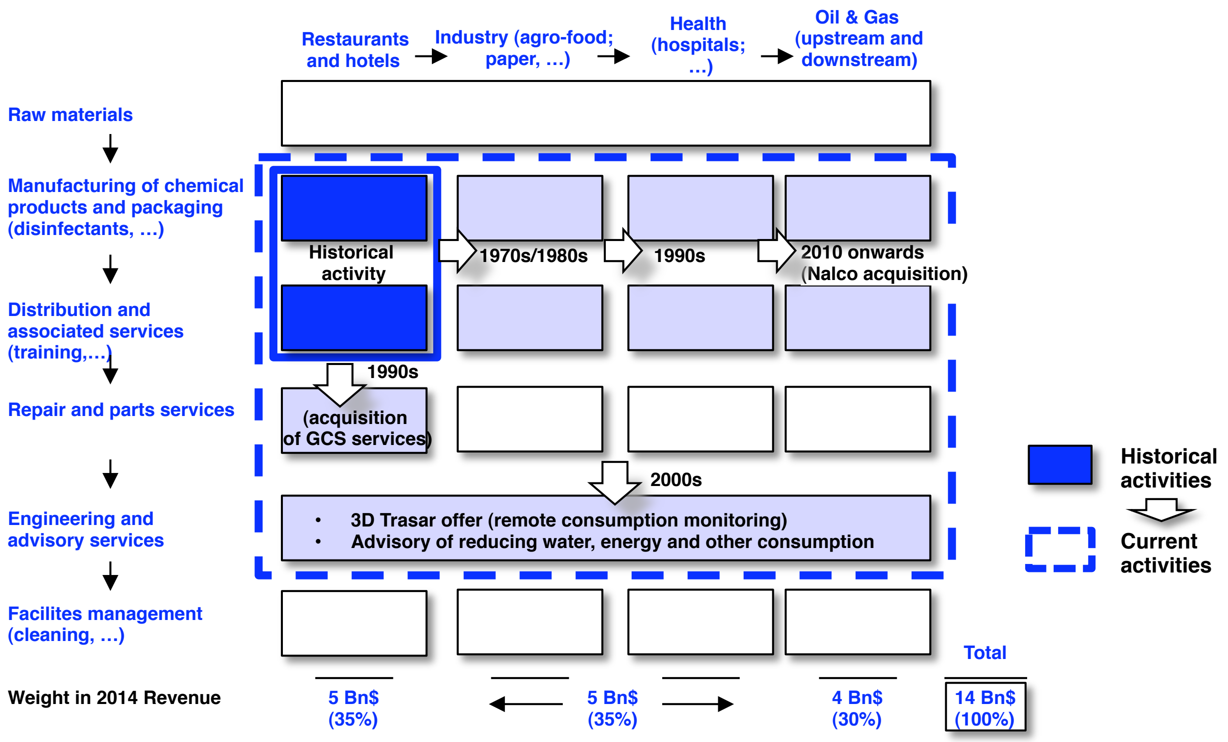
Beyond simple analysis, *it is essential to change perspective*: consider solutions rather than products, customers rather than markets, upstream or downstream positions in the value chain; will these changes not only help to grow the group, but also to find the highest value niches.

Diversify and surf the waves of growth

The third option is to act according to the observations and introductory thought of this article: there is no value creation without profitable growth and no long term growth if one stays in the same industry in the long term, without redefining it.

- Table 2 -

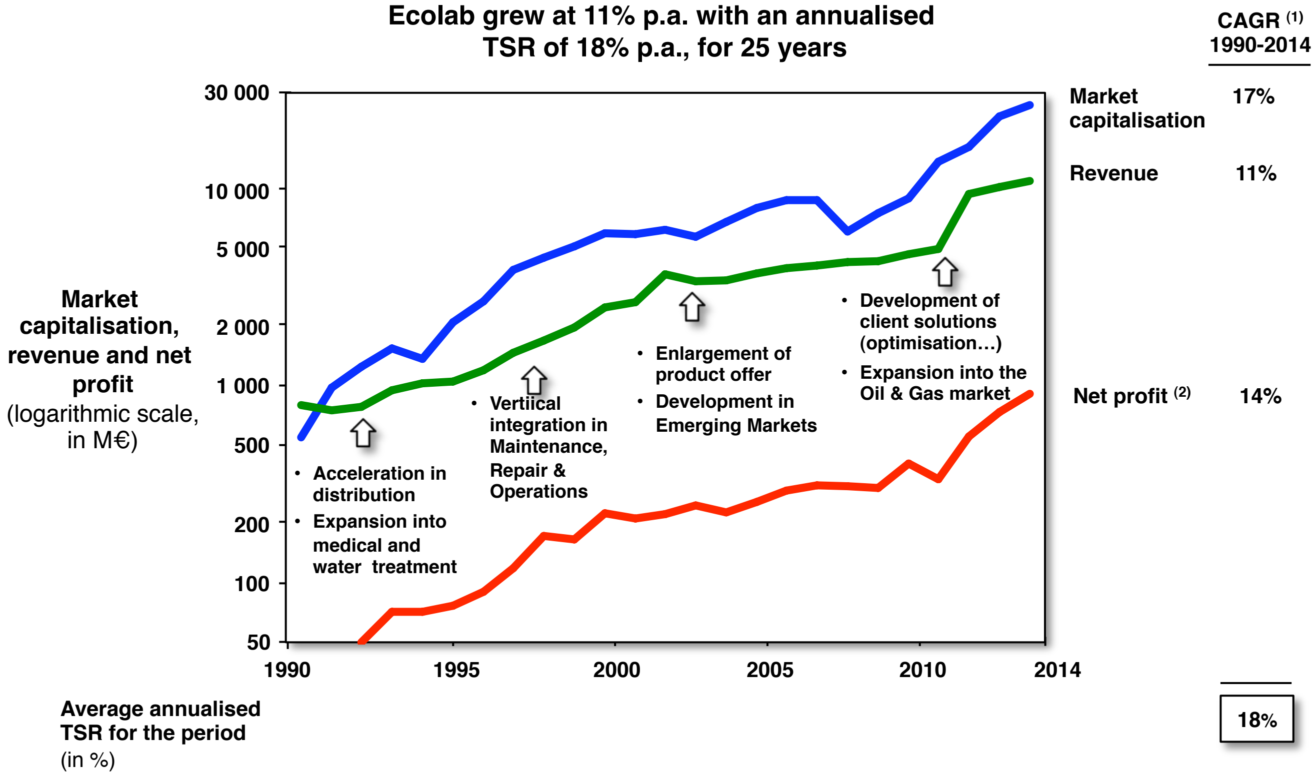
Ecolab 1970-2015
From an american producer of disinfectants for the restaurant industry to the global leader of cleanliness solutions for all end markets



Sources: Annual reports; Estin & Co analyses

- Table 3 -

Ecolab grew at 11% p.a. with an annualised TSR of 18% p.a., for 25 years



(1) Compound Annual Growth Rate; (2) Net profit inferior to 50M€ before 1993
Sources: Bloomberg, Estin & Co analyses

The long term future of a company is characterised either by a regular evolution, or even a transformation of its businesses, or by diversification. This diversification brings into place several co-existing activities at different stages of their lifecycle as part of one group, the mature activities generating cash to finance the new ones, which will bear fruit in the future. It is preferable, where possible, to share key technologies, know-how, culture etc. But it is not a determining factor. It is necessary to prioritise the search for real new sources of long term and profitable growth, rather than false synergies which bring no growth.

Diversification gets bad press. There is however no problem with it if the competitive factors and modes of value creation for each business have been made clear and are well understood. A number of large diversified groups, even conglomerates, fare better than pure players over the long term with TSRs above 15% p.a. over fifteen years (Hyundai, Keppel, Danaher, Jardine Matheson, etc.). They no longer define themselves as masters of a given field - even an enlarged one - but more as masters of a mode of value creation (long term and competitive growth, regular portfolio rotation, turnaround, build up strategies, LBOs, etc.).

The growth of General Electric under Jack Welch (9% p.a. between 1980 and 2000) was largely achieved by growth in financial services (an industry growing strongly in that period in the United States), rather than by development in its original industrial areas. Between 1980 and 2000 the share of financial services in the whole group's revenue grew from 12% to 50% and General Electric became the 10th largest provider of financial services in the United States in 2014 (in revenue terms). Over this period, the financial services arm of General Electric was responsible for 60% of its value creation.

It is not by chance that General Electric now wishes to exit financial services, an industry now without growth perspectives.

Roche also generated a TSR of 13% p.a. over 25 years through changing its mix of activities according to the fields which were growing, in a strategy of active portfolio management. It made a number of acquisitions to become leader of medical biotechnology, which now represents 50% of its revenue (in markets that are growing at 10% p.a.). Over the same period, the revenue share of its historic business of traditional pharmacy has decreased from 50% to 23% of its revenue, and its Perfumes and Aromas business, as well as its Vitamins and Fine Chemistry business have been sold.

On the other end of the scale, groups that do not hold sources of growth within their portfolio have not understood the role of activity diversification.

Change the paradigm

Over the last 30 years, the world of business has been dominated by two interlinked paradigms: the search for leadership within a given industry, and the appreciation of pure players – by financial markets. These two paradigms were based on a growing world economy[4] guaranteeing accretive growth. In that world, it is necessary to aim for leadership, and focus on prioritisation of resources, if one wants to be competitive, and profitable to grow faster than one's competitors.

However, in today's western world which is no longer growing, it is necessary first to look for new sources of growth to create value. Unequivocal focus on leadership is counterproductive. It casts a spell over the management of large groups and keeps them prisoner in their narrow box. What is the value of leadership without growth? When the market is no longer growing and the consolidation has been completed. There are no more sources of value creation for the profitable leader at this point, if he does not wish to change his business or modify the perimeter of his own.

CGE (Alcatel/Alsthom) was the foremost industrial group in France for 20 years, based on a large diversification of activities. Today, Alcatel is a pure player without growth, which finds itself forced to sell to Nokia. Its switch to a total focus on telecommunications in 1998 was probably short-termist even then, in the sense that the industry – which was at that point

[4] The United States' GDP grew at 3,3% p.a. (ex inflation) from 1970 to 2000 (7,8% p.a. with inflation). France's GDP grew by 2,8% p.a (ex-inflation) over the same period (8,5% p.a. with inflation).

growing – was close to its peak in western countries. Alcatel then was revealed to be severely constrained, in that it had not developed further routes to growth.

When one's current perimeter of activity no longer enables one to grow, it is necessary to redefine it or leave it. Activity redefinition is a major challenge for companies today.

In conclusion

There is no long term future (that is, growth and value creation) for western pure players who stay within their current scope of activity.

Long term growth requires regular redefinition of a group's activities, either on the edge of its historical activities, or far from them. Making this move is a risk. However value creation cannot exist without its counterpart.

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Estin & Co is an international strategy consulting firm based in Paris, London, Zurich and Shanghai. The firm assists management boards of large European and North American and Asian firms with their growth strategies, as well as private equity funds in the analysis and valuation of their investments.

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