The return of strategy

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Over the past 12 years and through the two major economic downturns of 2001-2002 and 2008-2009, shareholders have enjoyed little gain. TSR(1) for both the CAC 40 and the Dow Jones was 4% per annum, a far cry from the average long-term return on shares (7%) and only one point above the return on a cash investment over the same period. For many large western groups, their TSR was close to zero and for many of them, it was actually negative (see table 1).

The effect of these economic crises was, however, not the same for all. Several western market leaders generated an average TSR of 15 to 30% *per annum* over the period and through both crises. The main leaders in the emerging markets generated a TSR of 15 to 35% *per annum*.

So how have shareholders benefited in return for an annual 130 billion euros(2) spent on improving key processes and information systems_ on the modernisation of equipment and production technology; on acquisitions, market consolidations and restructuring to achieve synergies; on the regular re-vamping of product ranges and improvements in their functionality, if this investment has resulted in little or no positive return on their investment?

The reason, of course, is to stay ahead of the game. For leading companies, that means surviving economic downturns with a view to further consolidating their markets to the detriment of more vulnerable competitors. The weaker companies must try to survive increasingly violent downturns until they are finally forced out of business, in spite of any investments they may have made.

But how has their investment enabled some companies to do *far better* than their competitors; to respond differently to certain situations; to move into more structurally attractive areas; to detach themselves from what is happening to most of the western economy and, in some cases, even giving them the appearance of being immune to economic downturns?

When up to 80% of a company's cash flow is dedicated to simply doing what everyone else is doing (at the same pace – or worse, more slowly), that company is forcibly subjected to the effect of economic cycles and to the inevitable concentration of players within these cycles (government subsidised companies aside!). And if, despite the challenges, a company becomes a leader, its products or services inevitably become commoditised over the long term in mature markets.

All industries lose value over the long-term and the share of this value that a company holds can only be maintained or increased if the company's business strategy differs from that which prevails in the industry (more competitive, faster to market, more innovative or differentiated in some other way).

It's no use running away from the problem - a company has to win. The five 'golden years' from 2003-2007 masked this cold reality, as in every economic upturn. Which companies used their surplus cash flows during the good years to fundamentally change their competitive advantage, business model or product mix? Which will use the next growth cycle (2011-2014?) to once again address these parameters?

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(1) TSR: Total Shareholder Return: the shareholder's return on investment (dividends, bonus issues, capital gains, …); analysis carried out between 6 June 1997 and 6 June 2009.
(2) United States and Europe.

The economic world has now become very heterogeneous in growth terms. Core markets in emerging countries are growing by 10 to 20% every year, like the transient or long-gestation niche markets in western countries. Core markets in western countries are either not growing or losing value. Companies must therefore make much better choices and re-allocate key resources in order to grow.

In the coming years, global growth is likely to be as strong as it has been previously. However, it will not be in the same industries and geographic areas as currently.

Before and after the current economic downturn (and that of 2001-2002), the companies with the highest TSR are still the same (see table 1). They are the ones that are positioned in industries and/or geographic areas undergoing significant growth, or they have strategies and business models that enable their strong growth in mature industries, and they have the competitive edge and profitability that finances their growth.

For most western groups, a significant change in their growth trajectory and the creation of value will not be achieved by reinvesting the bulk of cash flow into their current type of business or market territory, even if they improve their competitive position or operations.

A company needs to return to the following recurring questions concerning its business strategy:

- Where are the sources of profitable transient or long-term growth to be found, taking into account the size of the group and its growth requirements? Within current business areas and market territories, perhaps by redefining certain business areas and strategies? By looking outside of the company? To what extent and with what legitimacy, competencies and risks can a company diversify?
- What factors do competitiveness and structural profitability depend on in current or new business areas in order to sustain and finance this growth? Does market share really have a value and is it therefore always necessary to strive for leadership? For how long, when we take into consideration the pace of technological and market development? Should companies remain in non-growth sectors and, if so, under what circumstances?
- How quickly can the necessary changes be developed and implemented within current business areas or within new ones? Do this ahead of your competitors, and you will come out on top. More slowly, and the best strategy in the world is worthless. With underlying markets growing at 20% per annum, you often also need to add on an extra 20% growth in market share to rapidly reach critical mass. Is it possible to grow at a rate of 40% every year in a new business area if your existing staff are accustomed to operating in markets with a growth rate of less than 5% per annum?
- Do the management team, reporting and motivational systems and corporate culture have the capability to manage both established and fast-growing activities side by side? Or does a bias in favour of one pose a threat to the successful management of the other?
- What should be done with cash cows that generate considerable income but do not grow? Is it better to sell them because they adversely affect the group's average growth figures or should you gradually 'milk' them to finance major developments in other sectors?
- What is the fundamental nature of the group and what capacity does it have to widen its horizons? Does it specialise in one business (in the widest sense), benefitting from sustained and geographically diverse growth? Is it a diversified group which regularly refreshes its portfolio according to value trends? Is it a financial holding company with neither active management of its portfolio of activities nor implementation of synergies between them? Is the directors' view of the fundamental nature of the group and its methods for creating value compatible with a growth strategy (see table 2)?
- Is the group's overall ambition in relation to growth, value creation and risk consistent with the responses to the previous six questions?

Decisions taken regarding investments and costs on a per activity and per territory basis are not only financial. When put together, they constitute the business strategy. When such decisions are utilised year after year to invest the bulk of cash flows generated from current activities using current business models to improve the business without really establishing a convincing lead over the competition (because all of the players make roughly the same investments to stay in the game), the strategy remains forcibly unchanged.

Every major economic downturn in the last fifty years has forced entrepreneurs to redefine their strategies.

The end of the first economic growth cycle following the Second World War and the development of anti-trust regulations in the US forced the large American companies to develop international diversification and growth strategies in the 1960s.

The two oil crises in the 1970s, the resulting slowdown in economic activity, and the emergence of Japanese competition made western groups realise the need to gain competitive advantage in their different business areas and thus to be more selective in their choice of investments. The resulting strong business portfolio management and priority given to leadership in one's area of expertise enabled clear industry leaders to emerge and eliminated the excesses of the previous cycle of diversification.

Rising interest rates at the start of the 1980s forced groups to introduce the time factor into their strategies, and to challenge leadership strategies that required major investment or long timescales to achieve profitability. The "value creation" approach enabled businesses to understand the important trade-offs between profitability and growth, the short and the long-term, profit levels and risk, while generally favouring, at the time, sound restructuring and short-term profitability.

The shockwave created by globalisation in the mid 1990s forced the large groups to separate out their production and marketing divisions and to specialise as much by stage in the added value process as by industry. It made companies reconsider the value of simply-defined leadership in terms of market share compared to other factors partly linked to locations and salary costs. The concurrent sharp fall in interest rates forced businesses to put long-term growth back at the top of the agenda.

With each major change to the economic context, businesses that did not adapt their strategies to the new macro-economic and competitive conditions went under.

The current economic crisis, as with that of 2001-2002, reveals the absence of growth *on average* in western countries but, on the other hand, the sustained dynamism of the emerging economies. *Growth remains necessary but it is becoming rare for western groups.*

The search for sources of profitable growth, both through diversification and the implementation of strategies and organisational changes that are adapted to benefit from that growth, has become the biggest strategic challenge for the large western groups. How can we discover these rare sources of growth before our competitors? How can a company benefit from them without paying over the odds? How can these opportunities be identified within existing areas of expertise? To what extent does a company diversify without risking dilution? How can one compete against the global strategies of the massive new Chinese and Indian competitors?

In order to grow, you need to make a conscious decision to do so. Sources of growth can always be found if they are sought out systematically (innovation, re-segmentation of businesses, new territories, new business areas, etc.) and if a substantial share of cash flow is dedicated to the process (see table 3).

The challenge is not to repeat the mistakes made at the end of the 1960s with regard to dilutive sector and territory diversification strategies. The further a business moves beyond the business lines or territories it has mastered in the past, the more essential it is to use objective analysis to supplement intuition.

Groups which constantly return to strategic management, have an approach that is always fresh and this results in the emergence of new "winners", at the expense of those groups that do not evolve.

In the face of the current economic crisis, businesses will fall into three categories:

Those that, with the economic recovery, will believe that they are once again creating value when in reality they will simply benefit from the new economic growth cycle. They will reinvest and grow stronger again in their current markets without making any major changes and without realising that they are increasing their dependence upon non-growth markets.

Those who will use their new-found room for manoeuvre to diversify without having a sound understanding of competitive gearing in their new markets, or who carry out prohibitively-priced acquisitions. These businesses will become targets for takeovers in future economic downturns.

Lastly, there will be a small number of winners, who will add new significant sources of profitable growth to their current business areas, whilst also strongly redefining the latter. This will not be possible without a clear vision of the nature of the group and an accurate understanding of its perimeters and of the value creation methods they decide to put into place (see table 2).

The role of Chairman of a large group is not that of a super Managing Director whose job it is to continuously improve the management of the group. It is an entrepreneurial role, where major allocations of resources, the activity mix and organisational structures are fundamentally challenged on a regular basis, with the objective of ensuring the business will evolve strongly in its economic and competitive environment.

Behind every successful group, there is a brilliant vision, brilliantly implemented. If this vision is not regularly refreshed, resources and energies will become diluted. Despite continuing to invest and working just as hard, advances are not made.

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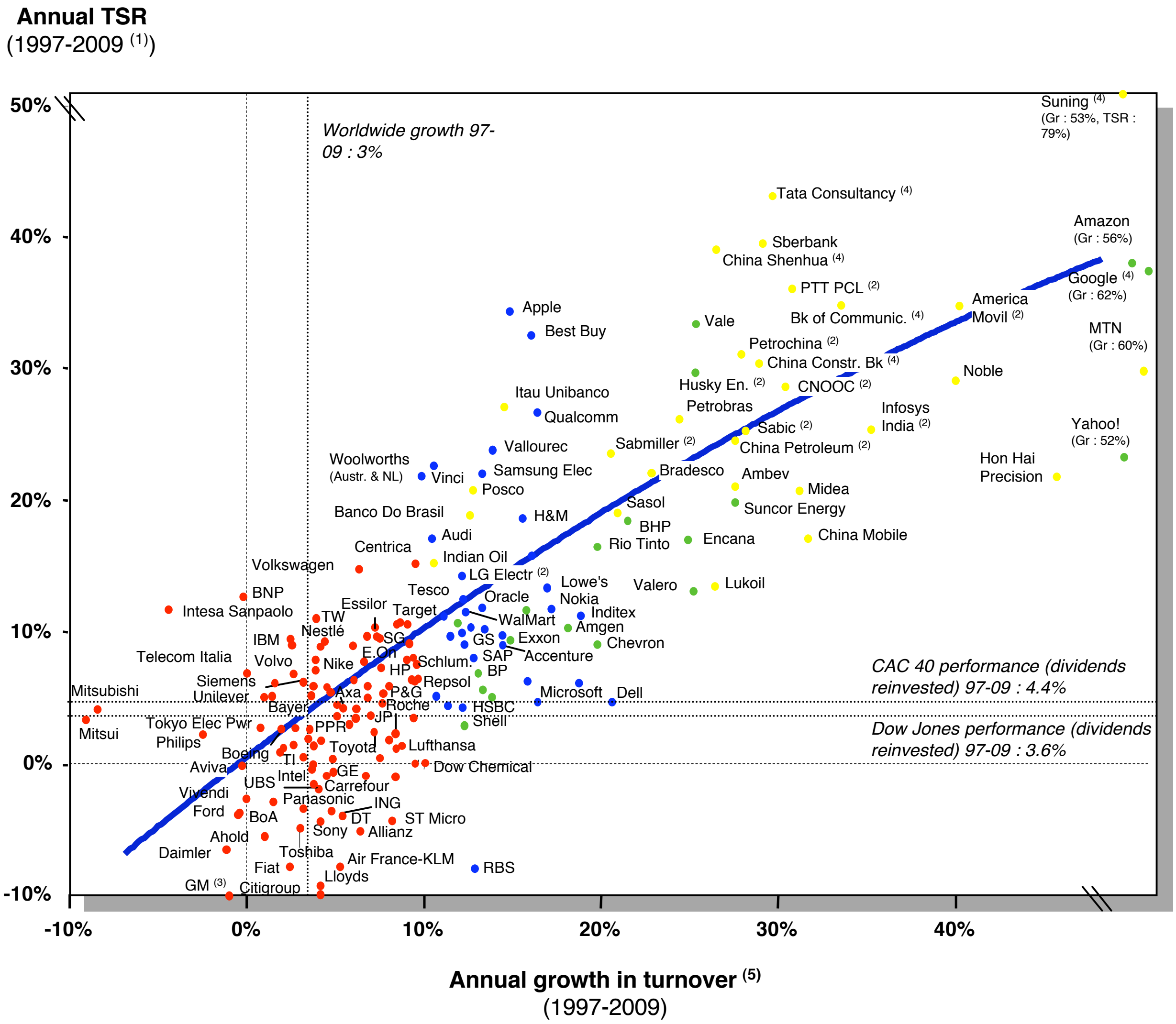
Estin & Co is an international strategy consulting firm with offices in Paris, London, Geneva and Shanghai. The firm assists CEOs and senior executives of large European and North American groups with strategic management and growth. The firm also works with private equity funds to assess and value their investments

- Table 1 -

Annual growth and TSR of leading groups worldwide
1997-2009



Growth strategies:

- Emerging markets
- Strong growth sector
- Success of business model/technology innovation

- No significant growth (<10%)

- TSR -

Total Shareholder Return: the shareholder's annual return on investment (capital gain, dividends, bonus issues,…)

Note: sample of the 150 largest quoted groups worldwide made up of the main leaders by activity sector; TSR :
(1) June 1997-June 2009; (2) 2002-2009; (3) -25% of TSR; (4) 2004-2009 or 2005-2009, IPO dates; (5) Withdrawn from major acquisitions.
Source: Bloomberg, Annual reports, IMF, Estin & Co. analysis and calculations

- Table 2 -

What type of group and which value creation methods over a long period?

- Understanding value trends within business areas
- Identification and fast implementation of strategic and operational gearing
- Major changes to the activity mix over long or short periods

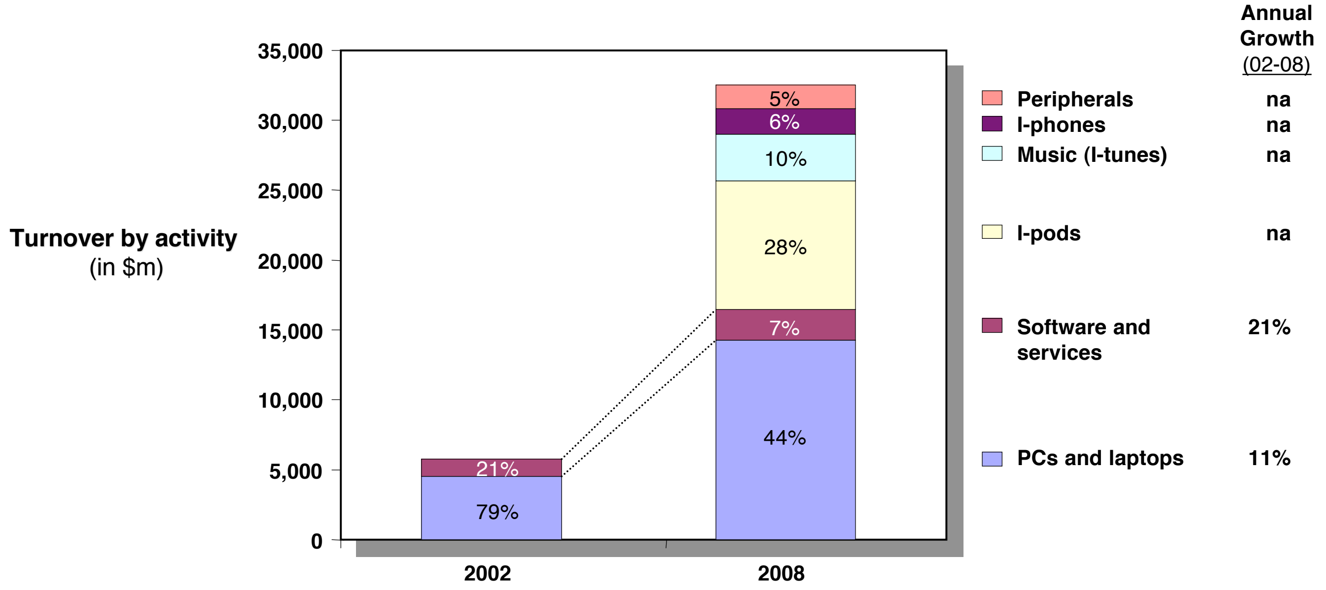
- Understanding value trends within business areas (over a long period)
- Implementation of synergies between activities
- Major changes to the activity mix over a long period

Portfolio management \ Implementation of synergies between activities	Weak	Strong
Active	Diversified holding company or group with active portfolio management	Diversified group with active portfolio management
Weak	Financial holding company with long-term holdings	Integrated diversified group that implements synergies between activities or Single-business group

- Understanding of value trends within business areas (over a long period)
- Acquisitions and management of businesses for long term growth

- Understanding value trends within business areas (over a long period)
- Implementation of synergies between and within business lines
- Maximum development of growth potential in each business line

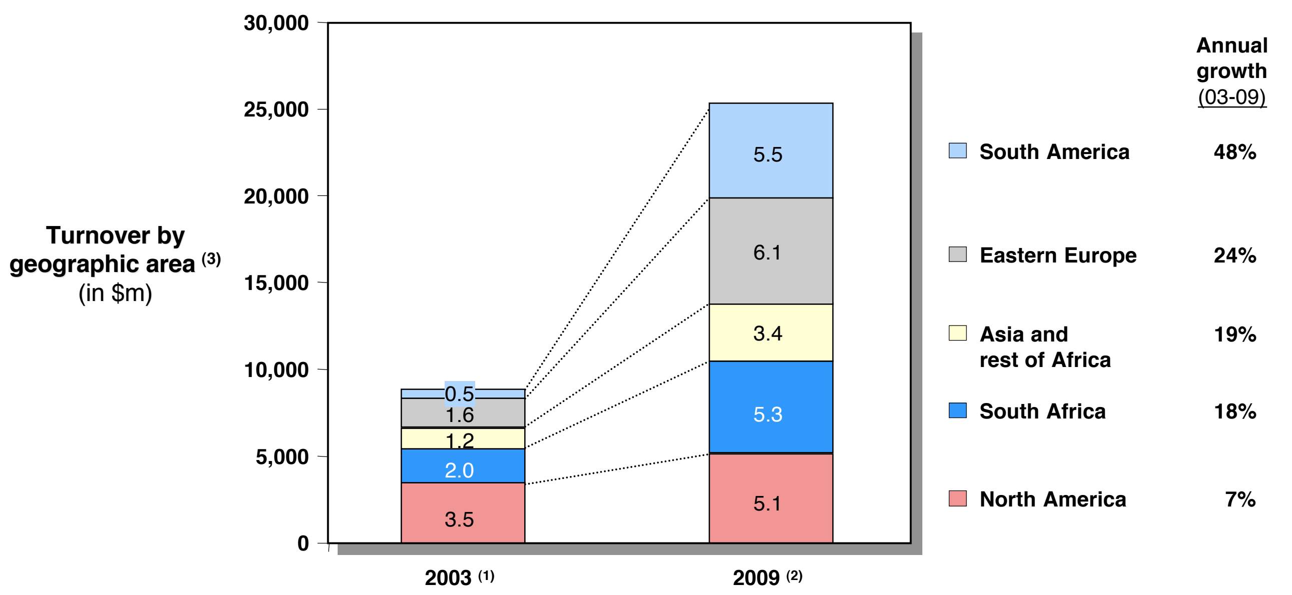
- Table 3 -
Growth of Apple through technology innovation and marketing



	2002	2008	
Turnover ($m)	**5,700**	**32,500**	**33%**

Sources: Annual reports, Bloomberg, Estin & Co. analysis and calculations

- Table 4 -
Growth of SAB Miller in the beer industry by development in emerging countries



	2003 (1)	2009 (2)	
Turnover ($m)	**8,831**	**25,340**	**19%**

(1) Year to 31/03/2003; (2) Year to 31/03/2009; (3) Group share.
Sources: Annual reports; Estin & Co. analysis and calculations