The cost of growth (2)
(and how to optimize it)

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Growth can quickly become dilutive if one is not careful. Large groups pursuing a strategy of shifting their business portfolio to high-growth emerging countries all meet four critical challenges, to varying degrees.

Four key challenges

- *Goodwill from acquisitions.* This reduces profitability in the short term and is higher for acquisitions of competitors that are already profitable and experiencing strong growth. The ability to carry out further acquisitions starting from these initial platforms or to rapidly improve competitiveness and growth of these first acquisitions through the acquiring group's expertise and products is critical in order to recoup this goodwill.
- *The cost of organic growth in emerging markets.* Annual growth of 15% in China looks like an attractive opportunity when you are struggling in mature European markets with growth below 2% per annum. However, it is often insufficient for becoming a market leader in the long term. Consolidating the market requires a growth of 25% to 30% per annum. The transitory strong investments needed to achieve this and to generate scale effects more quickly than competitors can be significant: price reductions ahead of cost reductions, investments in advertising and marketing, investments in sales networks, investments in production units and temporary overcapacities, investments in R&D to develop tailored products, etc.

  Profitability can therefore remain low for several years, despite the reduction in structural costs due to scale effects. This is not because the markets are unattractive, it is due to the transitory strong investments required in order to support strong growth and increase market share.
- *The cost of organic growth in mature markets.* It is difficult for an international group not to continue growing in its core sectors and regions when these still account for 60% to 80% of total revenues. Even in mature European and North American markets that are growing by 2-3% per annum, major Western corporations are aiming for annual growth of 5-6%, as growth in emerging markets alone is not sufficient to ensure a substantial increase in overall revenues, as companies are aiming at consolidating markets, and at remaining competitive, while also motivating their workforce.

  The cost of this growth, whose level is low in absolute terms yet double that of the underlying markets, is often dilutive due to growing complexity and the associated costs; diminishing returns on development projects; ongoing innovations in existing products rather than groundbreaking innovations, and high associated costs; as a consequence overall profitability is not sufficiently optimized. The cash flow that is needed in order to finance strong growth in emerging markets is no longer made available (table 1).

Note: This article is a follow-up to the article "The cost of growth" from January 2012.

Some groups are nevertheless managing to make their strategy profitable, whether through innovation, microsegmentation or differentiated growth in mature markets (McDonald's, Tesco, Legrand, Air Liquide, etc.). There are only a few such companies. In mature markets, absolute profit and cash flow growth no longer tends to follow revenue growth.

- *The growing importance of large emerging markets in the business portfolio*. These countries' contribution to revenues is no longer marginal and nor is their impact on results. Profitability often remains lower than the group average until competitive positions are fundamentally improved. An increased weighting for these countries in the business portfolio without a rapid improvement in profitability has a dilutive effect.

A number of large Western groups that have been pursuing strong growth strategies for five to ten years are thus gradually realizing that their growth model is dilutive (see table 3).

Six levers for accretive growth

Six levers can be used to optimize or mitigate the extra costs of growth described above.

- *Prioritizing*: it is difficult to invest in several growth areas at the same time and to reach competitive and profitable positions quickly, whilst continuing to invest in mature markets in order to grow faster than the underlying markets.

  It is better to expand in a limited number of high-growth markets and to become there a market leader *quickly*. Growth that is not focused or is not strong enough to reach there a competitive position will lead to damaging "back and forth" movements (see Carrefour's international strategy over the last forty years: in a number of countries, the group did not achieve sufficiently strong or rapid growth to become a market leader. Several years later, it was forced to withdraw; see table 2).

- *Reallocating resources across different businesses and countries*. No change in the business mix is possible without a major reallocation of resources (CAPEX, sales growth oriented OPEX, etc.). This idea is very hard to turn into reality in large groups. It requires major trade-offs at CAPEX level, but also fine-tuning at the level of OPEX. Traditional, mature activities often maintain high operating and development costs owing to inertia and strong structural profitability (which could be further enhanced). Conversely, businesses in high-growth markets suffer from chronic underinvestment.

- *Reallocating resources across growth levers within the business*. Within a business, growth levers (R&D, advertising, prices, commercial intensity, functionality and services, etc.) are not necessarily the same in different countries, or for example in Europe, the US and China. Moreover, in high-growth emerging countries, the levers will evolve over time depending on the structure of the industry, distribution channels and customer sophistication. Consequently the investment mix (CAPEX and OPEX) should be reviewed regularly, with stronger and more differentiated investment than competitors, focused on the most relevant levers.

- *Adapting and differentiating business models*. At the same time, specific business models need to be created for emerging countries or even for certain regions within those countries (rural areas, etc.) so as to reduce costs and target high-growth customer segments in a way that is consistent with their purchasing power limits. New business models for growing niche markets in mature countries must be created. In view of the varying levels of development and structure in each country, nowadays a large international group can and should have several different business models, at least in the short term. The organization must be adapted to this increasing differentiation.

- *Expanding rooms for manœuvre*. Relocating production facilities to low-cost regions, relocating certain support functions (finance, IT) or development functions (R&D) to the same regions, clustering together certain support functions or outsourcing them, reducing complexity and the associated costs, optimizing the brand portfolio,

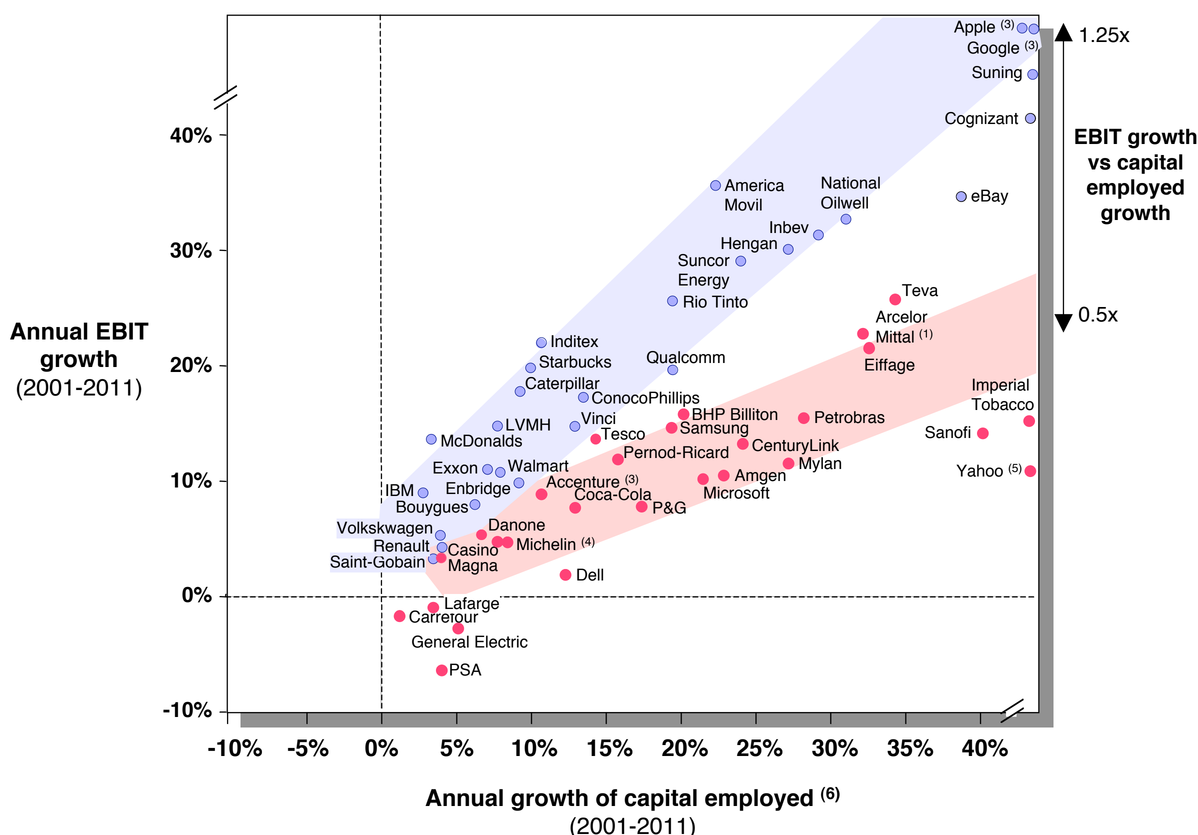
optimizing prices, etc. Potential efficiencies and savings need to be identified in order to boost EBIT by 1 to 3 percentage points and to finance the extra costs of growth.

- *Finally, and most importantly, focusing management time on accretive factors*. Which accretive sources are contained in the growth model, organic or through acquisitions? (Generating manufacturing scale effects, better leverage of R&D expenses, better use of sales networks, transfer of products or technologies to new acquisitions, better market power, etc.) Are these exploited systematically and quickly?

- Table 3 -

Accretive growth vs dilutive growth (examples)

2001-2011



(1) Growth 2000-2011; (2) Growth 2003-2011; (3) Growth 2002-2011; (4) 2001-2010; (5) 2000-2010; (6) Fixed assets and working capital requirement (including goodwill)
Source: Bloomberg, Estin & Co annual reports, analyses and estimates

Over a period of ten years, the difference between dilutive growth and accretive growth in terms of the impact on value is significant (see table 3). *An accretive growth model does not simply involve replicating the coasting model with a few additional investments*. It is different by necessity and must be defined and tuned in advance. Otherwise, a cycle of stop and go will quickly emerge, which will destroy value: boost growth and accelerate investment to make up for lost time, followed by a slowdown in order to restore margins, then a boost, and finally a change of management.

Costs of growth and costs of coasting

All business is based on a mix of costs of growth (transitory additional costs required in order to grow and gain market share) and costs of coasting (structural costs of remaining in the market).

Costs of growth need to be optimized: prioritization, reallocation of resources between businesses, countries and levers, differentiation and adaptation of business models.

The costs of coasting must be competitive and as low as possible to ensure that there is adequate funding to finance growth: competitive costs for production, logistics and access to the customer, as well as for all general expenses, operating processes and support functions.

There can be no sustainable growth if the costs of coasting are not competitive and do not provide the necessary leeway for financing growth. Conversely, the costs of coasting will not be competitive in the long term if investment in growth does not result in a market leader position in the short term.

Groups that fail to distinguish carefully between these two types of costs for each area of business and each region and do not proactively change the cost mix will not achieve growth and will not be competitive.

A growth strategy that is accretive on balance at group level requires a clear differentiation of targets in terms of market share, profitability, growth and cash flow - *and thus cost and investment structures* - for each sector and country.

This requires a very strong focus: where are the real sources of long-term, profitable growth? What are the critical levers and resources necessary for becoming a market leader? What are the accretive factors? Are they the full focus of the group's resources and management 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 analyzing and improving the value of their investments.

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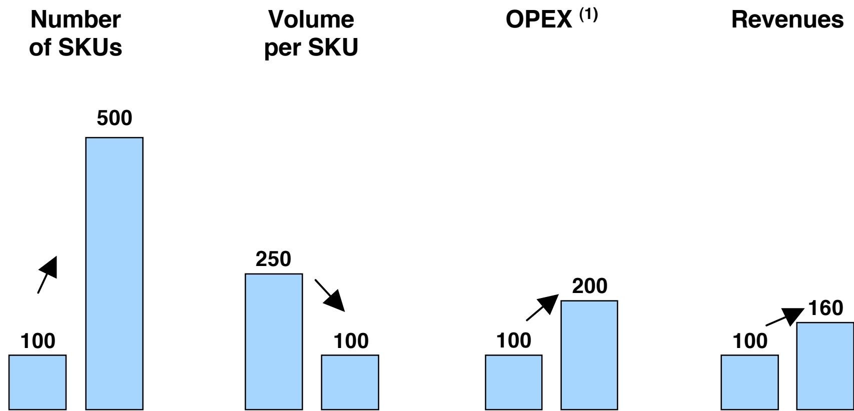
- Table 1 -

In mature markets, growth initiatives often lead to an increase in complexity costs

Example of a consumer goods company

2001-2011



Note : SKU = Stock Keeping Unit

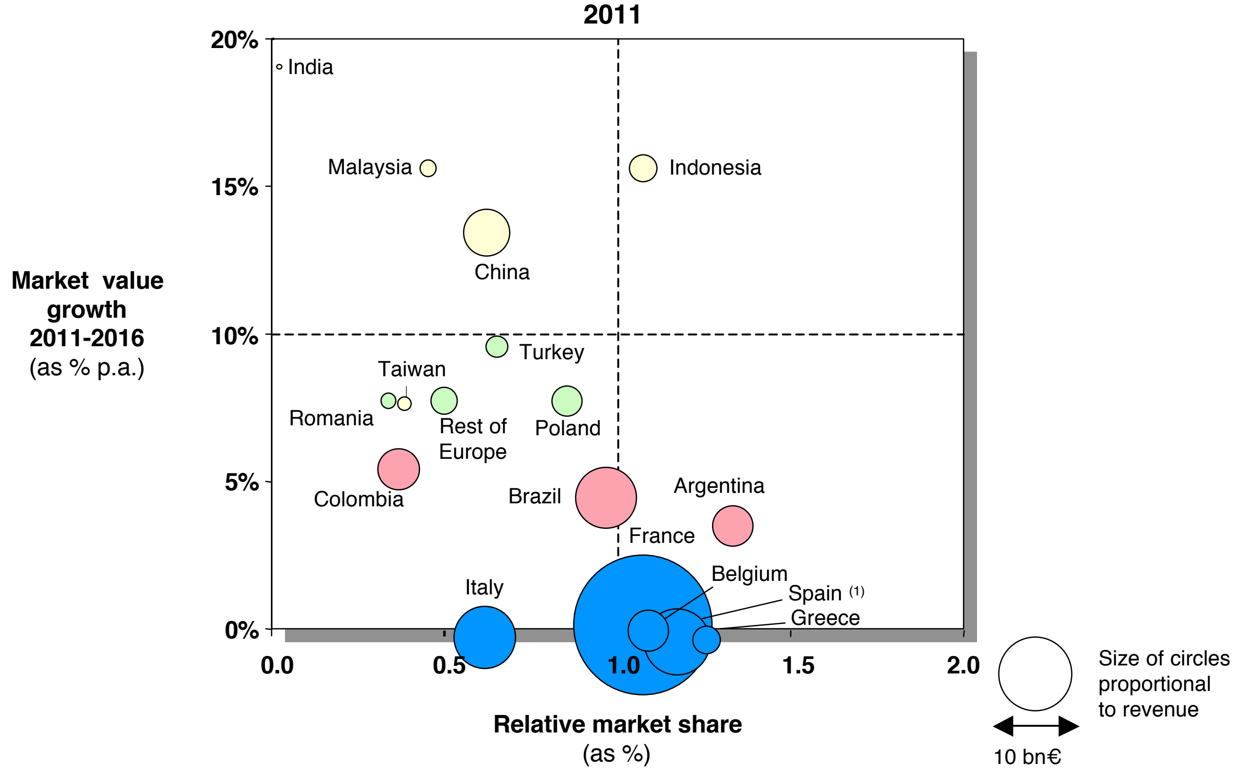
(1) Operating costs excluding COGS

- Table 2 -

Growth that is not focused will not allow to reach market-leading positions and will result in damaging "back and forth" movements

Example of Carrefour

- Simplified external view -



	Date of entry	Date of exit
UK	1972	1980
Spain	1973	-
Brazil	1975	-
Argentina	1982	-
USA	1988	1993
Portugal	1990	2010
Greece/Cyprus	1991	2012
Mexico	1994	2005
China	1995	-
South Korea	1996	2006
Hong Kong	1996	2000
Thailand	1996	2010 (2)
Singapore	1997	2012
Chile	1998	2003
Japan	2000	2005
Switzerland	2000	2007
Russia	2007	2009

(1) Including Dia (discounter); (2) Partial exit
Source: Estin & Co annual report, desk research, analyses and estimates