The strategic trough

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Leading western companies are faced with a paradox. Although their strategies are probably aimed in the right direction, they are not producing results fast enough: growth is slow, and their value is scarcely increasing.

In most cases, they have achieved concentration in their European or North American markets, and their market share is large enough to produce significant cash flow. They have invested in emerging markets, where they have already achieved strong or growing positions. The problem is that these positions still represent only a small percentage of their global business portfolio. Emerging markets still represent a low volume, and hence even lower value.

It will take some years for these positions to reach significant size in many companies' overall business portfolio, when we consider emerging-country growth rates, up-selling on core markets with corresponding price increases, local currency revaluation, and time to bring market share in these countries up to levels achieved in mature markets.

Meanwhile, global growth resulting from these strategies remains low, and international companies are caught in a strategic trough from which few will emerge in the next five to ten years (see Table 1).

The paradox is that the trough is deepest for those companies that have been successful in their strategies of concentrating mature markets, where they hold a large slice of the market.

In contrast, smaller competitors in mature countries who are playing catch-up by investing in emerging countries have far higher growth rates, with valuations to match. And valuations for even the smaller emerging-country leaders are growing at an explosive pace, in some cases they are beginning to overtake their western competitors.

What can be done?

There are six strategies for tackling this paradox:

1. *Sit back and wait for the emerging-country growth strategy to produce results. Over a five-to-eight-year period, the portfolio will rebalance itself automatically, and the group's global growth as well as its value will correspondingly increase.*

   The logic of finance may appear wrong-headed and short-sighted. But the risks of this wait-and-see strategy are apparent: shareholder pressure and buyout risk, given the low share price, and problems in growing by acquisition in emerging countries, owing to increasing valuation differences. Transactions like Mittal-Arcelor will proliferate in coming years.

2. *Accelerate the pace of investment and market share gain in emerging countries to rebalance the business portfolio more rapidly and more definitively.*

   On paper, this is obviously the right strategy, especially if it results in local competitors being bought out before they can become too powerful.

   However, it presents several difficulties: the availability of suitable, ready acquisition targets; the inadequate profitability levels of certain unstructured markets in emerging countries, and the time that the structuring process is likely to take; the scale of entry-level markets in these countries relative to core markets that are not yet well-developed; quality and technology levels that are frequently not in line with the group's standards; the possible need to make fundamental changes in the business model and to downgrade the product to penetrate these markets and grow in them; the trade-off between spreading risk and focusing on particular countries as a faster route to competitiveness; and finally, the existence and adequacy of enough teams with sufficient expertise to develop these new markets.

Clarity and strategic focus, appropriate business models, and operational execution capability make all the difference.

3. *Redefine businesses in major developed countries to uncover new sources of growth above average growth in these countries' economies.*

   The figures often make this a "no-brainer" strategy, when you consider that 3% additional growth in 80% of business is worth as much as 10% additional growth in 20% of the business.

   Still, that 3% needs to be hunted down. Technological innovation, micro-segmentation and changing bases of competitiveness are factors traditionally used in this process of redefinition. All the prisms through which the company sees its customers, its markets and its technological, competitive and economic legitimacy, and which have served as the basis for all of its activities, must be completely re-examined.

   But not all companies can adopt the Apple model (growing at 33% per year since 2002 thanks to the iPod, online music and the rebound in laptop computers). The challenge is to move from fantasy to reality and to carefully separate out those activities that warrant a new approach, *with corresponding investment in them,* from those business activities that should continue to be operated as cash cows.

   The risk in not adopting this approach is that the company may overinvest in businesses with growth rates that will not change, no matter what steps are taken, whilst their operation becomes increasingly complex and costs rise, instead of maximising generation of cash flow.

4. *Reduce the proportion of no-growth activities in the portfolio*

   In cases where the preceding strategy is not suitable, this strategy should be considered.

   Withdrawing from no-growth businesses in which the company is not competitive always creates value. Withdrawing from a segment of the historic business in which the company is competitive and generates significant cash flow but which has no further growth potential is more difficult. The company's history, its culture, and the motivation of its personnel are all – legitimately – very strong barriers to this strategy.

   Yet, this strategy merits consideration, because although cash cows constitute significant, recurrent sources of financing, *they do not create value*. This strategy frees up significant resources for investment in fast-growing areas. It also reduces the proportion of no-growth businesses in the overall portfolio.

   It requires a *clear vision* of the company's development and its long-term outlook, as well as the ability to communicate this vision.

5. *Find new sources of diversification*

   Given the lack of growth in mature countries and the low impact of emerging-country growth on the global portfolio, the taboo of the last twenty years is likely to disappear. Most large western companies are *at the end of a growth cycle* in their original business lines, in mature countries. Growth is now found in the same business lines, but in emerging countries and in new lines of business in Europe and the United States.

   Today, diversification must be systematically explored. It still involves risk. The further away that the proposed areas are from the company's current business lines, the greater the challenge of strategic analysis to managers' intuition and appetites, investment bankers' ceaseless importuning, and investment fads that sweep along too many players at the same time.

6. *Continue to consolidate in mature markets*

Given the difficulty of growing in new markets, using new business models, there is a great temptation to continue to consolidate in mature markets by increasing market share or buying out smaller competitors and exploiting synergies.

This strategy is very clearly a path to a medium-term stalemate. Beyond instant value creation through synergies (provided they are actually tapped into), this merely amounts to increasing the weight of no-growth businesses and regions.

Nor is this any better in the short term. In most cases, above a certain market share, acquisitions or organic gains have only marginal impact on costs. Moreover, when markets are stagnant and customers themselves have achieved concentration, gains from cost reductions are often largely passed on to customers.

Thus, there are six strategies to alleviate the problem of inadequate growth given the structure of the portfolio of businesses and regions. Each of these strategies has its own corresponding risks:

- the risk of loss of operational flexibility and independence in the first case
- financial and operational risk in the second
- the risk of dilution of resources and sub-optimisation of cash flows in the third
- risk in connection with the transition of corporate identity in the fourth
- strategic, financial and operational risk in the fifth
- and finally, the risk of dilution of resources in the sixth.

Through strategic analysis, trade-offs can be established amongst these risks for every company, in its own context, with its own particular areas of expertise, resources and by-products of decisions, and an appropriate growth strategy mapped out. There are as many answers as companies, *with the fundamental choice being in favour of growth*. For, faced with these risks, there is only one certainty: a company which does not grow will not create increased value.

Positioning for the future

We are now well beyond simple strategies to improve competitiveness in well-understood businesses and regions. Significant transitions and even disruptions are necessary, and they will re-shuffle the deck.

But beyond this, the more basic question concerns active, carefully planned management of the business portfolio. For the last twenty years, companies have managed their portfolios with the single priority being competitiveness, whilst relegating to the back burner another consideration that fundamentally determines value: growth.

It takes at least five years to re-model a poorly structured business portfolio that offers little underlying growth. Many western companies will have difficulty finding their way out of the strategic stalemate described above for some years to come. They will remain vulnerable during this period, and their room to manoeuvre will be hampered by their low valuations (see Table 2).

A well-structured portfolio that can support high levels of profitable growth over the long term is constructed *prospectively*, by investing *regularly* in new, high-growth areas that will bear fruit in five to ten years.

The question is not just how to get out of the strategic trough. It is also how to avoid getting into it in the first place.

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Estin & Co is an international strategy consulting firm with offices in Paris, London, Geneva and Shanghai. The firm helps senior managers at large European and North American companies develop and implement growth strategies, and works with private equity funds to assess and value their investments.

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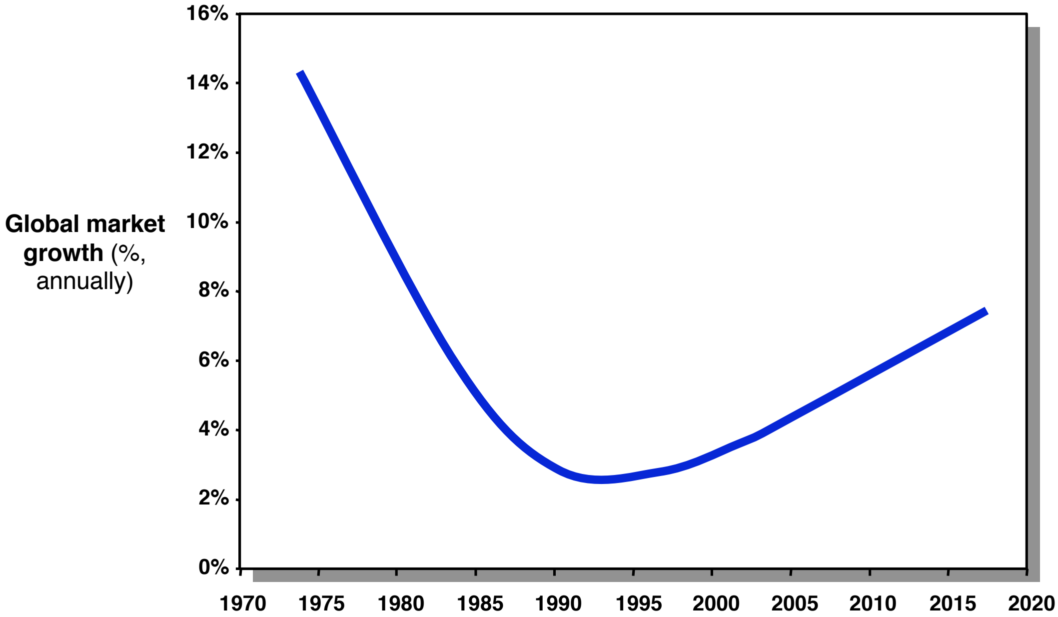
- Table 1 -

The strategic trough

A global leader in a mass-market product may experience a "trough" in growth during the period in which emerging countries still represent a minor share of the company's global market or its portfolio of businesses



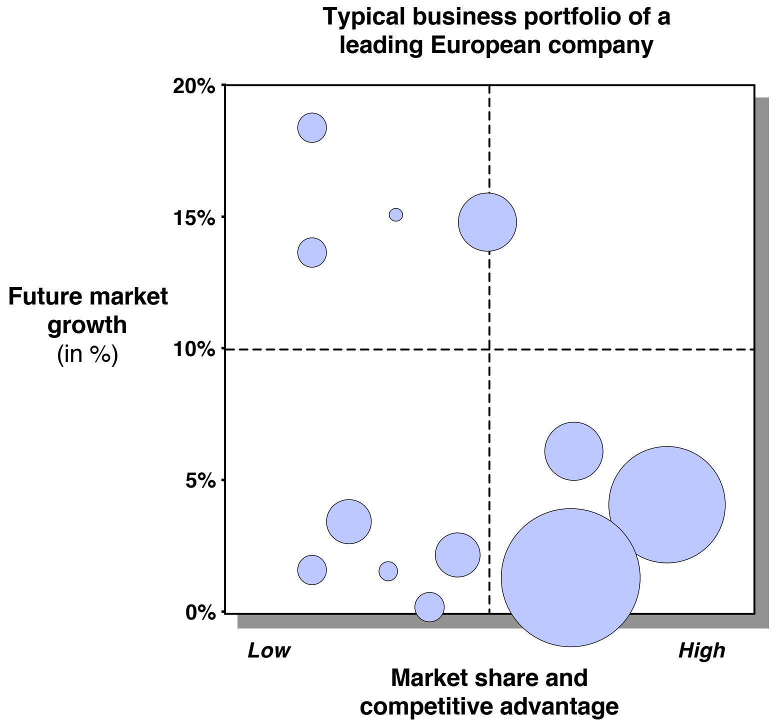
Example: disposable nappies

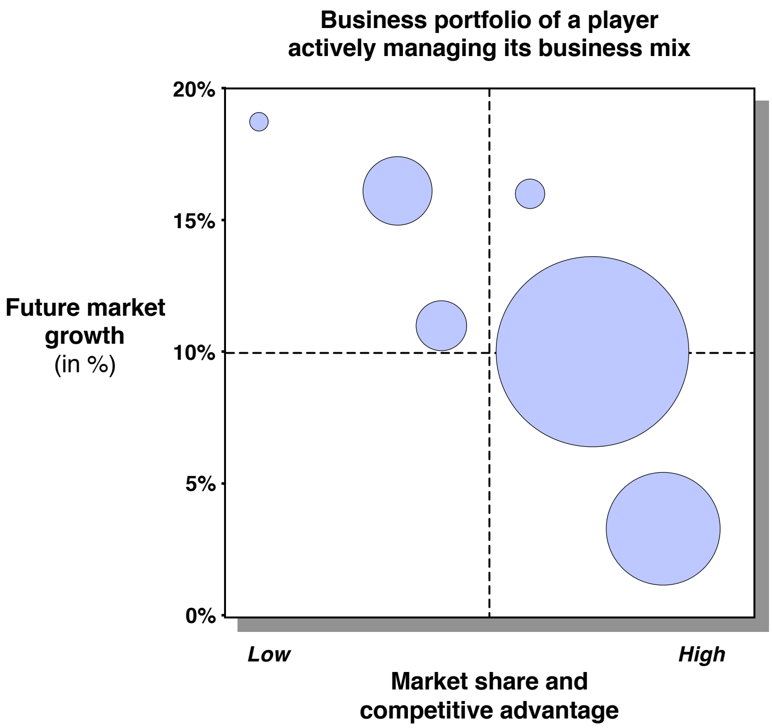
Product penetration rate				
Developed countries	50%	95%	98%	98%
Emerging countries	n.a.	n.a.	4%	20%
Market growth				
Developed countries	15%	3%	1%	1%
Emerging countries	n.a.	n.a.	55%	15%
Emerging countries' share	<1%	<1%	5%	35%

Source: Euromonitor, NPD, Estin & Co analysis and research reports

Many global leaders in mass-market consumer products (including Procter & Gamble, Unilever and Nestlé), mass-market retailing (such as Wal-Mart and Carrefour) and industries that are highly segmented in geographical terms (such as Bouygues) experience this phenomenon.

- Table 2 -


Typical business portfolio of a
leading European company
20%
15%
10%
5%
0%
Future market
growth
(in %)
Low
High
Market share and
competitive advantage


Business portfolio of a player
actively managing its business mix
20%
15%
10%
5%
0%
Future market
growth
(in %)
Low
High
Market share and
competitive advantage