The magic of long-term growth

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Strategic theory has always differentiated between high-growth and low-growth businesses. It is a useful perspective, especially to anticipate investment needs as well as the ability to gain market shares and to change competitive structures. However, the most discriminating perspective as to value creation is not the magnitude of growth, *but its duration*.

Short vs. long-term growth

Short to mid-term growth (more than 8% to 10% per year for five to ten years) is based on leveraging a significant competitive advantage in a growing underlying market: a cost advantage, a new product or service, a new business model, a temporarily disruptive new technology, the outsourcing of production in countries with low factor costs, a strong umbrella brand…

It is based on significant, focused investments beyond what the normal growth of the market would require: market share gains; new production capacities; commercial and marketing investments to quickly develop new products or services; the penetration of new geographies; the acquisition of competitors...

Once identified and valued by investors, it leads to an increase in share price over two to three years, rarely more. The market quickly and strongly integrates the value created by the new strategy over the likely period of its implementation even before the associated profits have fully materialized.

A few years later, while the strategy continues to mature and to produce all its effects, the value of the company increases only little as those effects have been anticipated and are already included in the share price. The company generates significant cash flows but no longer creates value.

Long-term growth (more than 8% to 10% per year for 15 to 30 years) has a completely different impact on the financial performance of a company. *Financial markets never fully take it into account in its full-duration*–which is difficult to anticipate anyhow (you cannot blame investors for not valuing strong perpetual growth, even after discounting!). Each year, since the company has grown, and is offering the same prospects in terms of profitable growth, they update and increase their valuation.

Thus, dozens of companies see their stock price increase each year like the growth of their profits, and return far more than the cost of capital to their shareholders. Their financial performance evolves at odds with the traditional vision of pure and perfect financial markets which have incorporated all available information (see table 1).

Long-term value creation

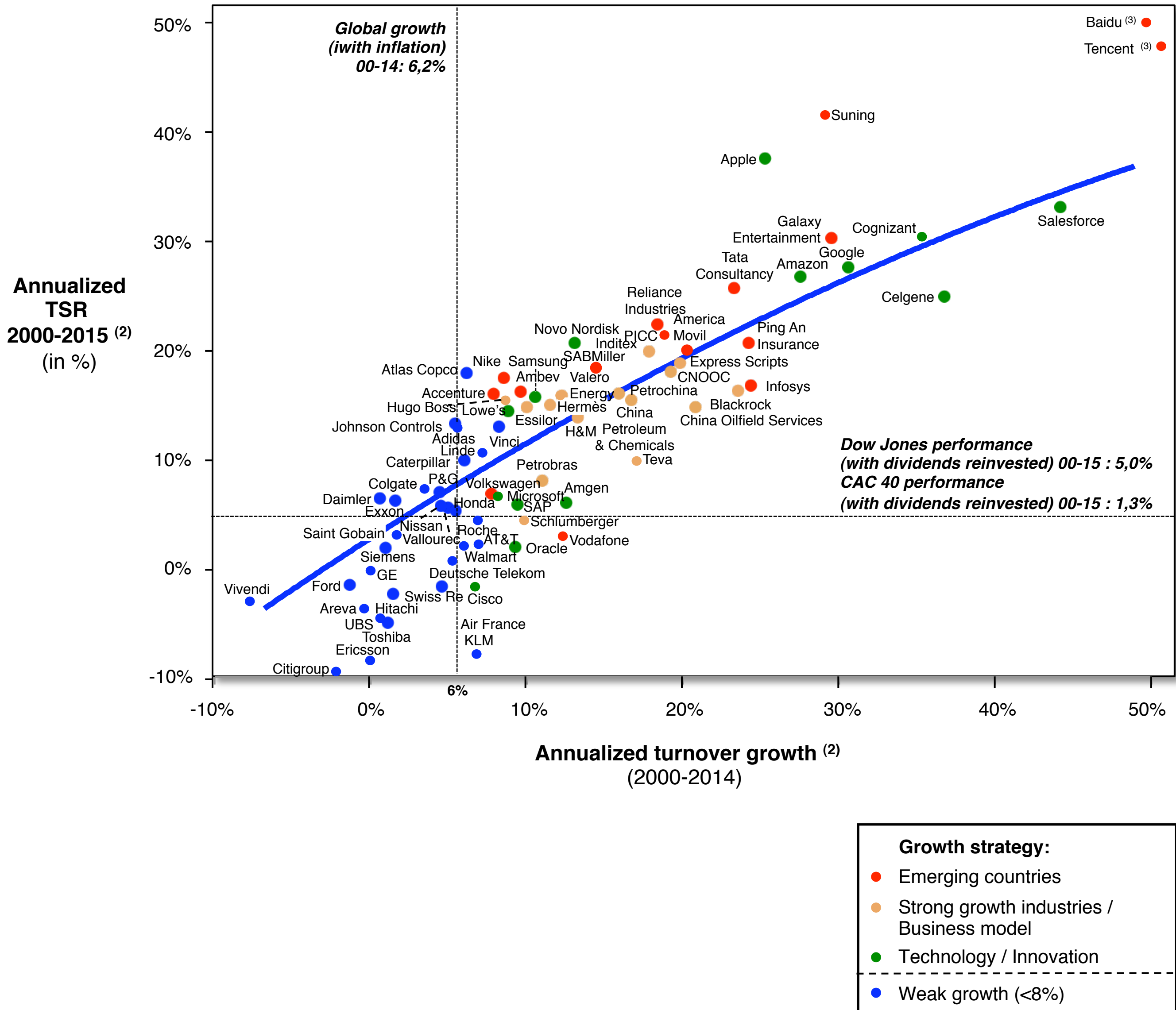
Long-term growth is magical. An investor may hop on the train at any point and get roughly the same TSR regardless of the timing of entry (notwithstanding short-term fluctuations, of course) provided that he does not invest too late, when growth is about to stop.

For instance, during the period of growth of General Electric between 1980 and 2000, an investor who would have bought a share in 1980 and kept it until 2000 would have had an annual TSR of 23%. If he had entered in 1985 and stayed until 2000, the TSR would have been the same. Between 1990 and 2000, it would have been 28%.

- Table 1 -

Only growth creates value over the long term

TSR and revenue growth – 2000-2015 (1) – Local currency



Note: extract from a sample of the 150 largest listed groups in terms of market capitalization, completed with key leaders by industry

TSR: Total Shareholder Return: return to the shareholder on his investment (dividends, distribution of free shares, stock market gains,...), with the assumption of dividends reinvested

(1) Start Date: 31/12/2000 or quotation date. End date: 30/09/15; (2) Local currency; (3) Baidu x = 76%, y = 49%; Tencent x = 55%, y = 60%

Sources: World Bank, Bloomberg, annual reports, IMF, Estin Co analysis and estimates

Similarly, an investor who would have invested in l'Oréal in 1977 would have had a TSR of 24% per year until 1999, 25% annually between 1985 and 1999 and 33% per year between 1990 and 1999.

Companies which manage to grow at 15% per year for 30 years are worth twelve times more at the end of the period than those which are growing at the rate of the world economy (6% per year). They change the world by the strength, the magnitude and the duration of the product and the service that they have developed and the value they provide to their customers. They secure their shareholders' retirement pensions. They offer long careers and rich achievements to their leaders and teams. They define management trends.

These long-term growths are not the preserve of a few exceptional companies. Out of the first 500 US-listed companies in 2015, one third had experienced significant growth (more than 10% per year) for over 15 years during the period 1980-2015 (see table 2; a few emblematic examples). How did they do it?

Levers

Long-term growth stories all share some of the following characteristics:

- An underlying market which grows above the average of the economy (1.4%[1] in the West and 6.2%[1] in emerging countries over the last ten years) thanks to the development of a major new product or service (automobiles in 1950-1980s, modern distribution in 1960-1990s, software in 1980-2000, smartphones in 2005-2015...).
- Or an innovation (technology, business model, positioning...) which leads to a major breakthrough within a large mass market or a sufficiently deep niche, with a superior quality or more competitive cost of the resulting product or service.
- A great resilience over time and across geographies of the product or service, even if it undergoes mutations and regular technological evolutions.
- A progressive and systematic roll-out of this product or service across different geographies, customer segments...
- A well structured activity with barriers to entry and a clear value to leadership which enables growth strategies and accretive acquisitions; investment levels by leaders above what is required by the growth of the market in order to concentrate it and generate better returns than competitors, allowing to self-finance growth.
- A market which is sufficiently large and deep for its concentration to require a long period of time and provide growth to leaders through market share gains (either organic or acquisition-based) far beyond the growth of the underlying market.
- A regular redefinition and extension of the business scope by leaders in order to break out from original niches which are too narrowly defined: entering new geographies, extending the range of products and services and moving to adjacent value-added steps.
- Or lastly, a regular diversification of activities and the active management of the corporate portfolio to regularly renew sources of growth and move away from businesses which no longer offer any prospect of development.

At first, these long-term growth strategies often rely on an innovation and/or a growing underlying market, but they quickly outreaches those early stages in magnitude and duration thanks to the concentration of the industry, the development of demand (in volume and value) and the extension of the business scope.

They require a regular redefinition of the strategic segmentation within an industry and/or changes in the mix of activities.

[1] During 2004/2014, GDP growth in volume (excluding inflation)

- Table 2 -

Iconic companies with long-term growth and high TSRs

	Period of strong growth	Length of growth	TSR p.a	Growth of turnover p.a.	Growth of Net Results p.a.	Comments
Dell	1988 - 2003	**15**	47%	40%	42%	• Growth of PCs with a disruptive low-cost model
Nokia	1992 - 2007	**15**	40%	20%	34%	• Growth of mobile phones with strong growth in emerging markets
Intel	1970 - 2000	**30**	35%[4]	43%	33%[4]	• Growth and consolidation of the semiconductors market
Walmart	1972 - 1999	**27**	30%	28%	28%	• Growth and consolidation of modern distribution in the USA then international development
H&M	1989 - 2014	**25**	28%	15%	26%	• Disruptive model of Fast Fashion with consolidation of occidental markets country by country
Home Depot	1981 - 2014	**33**	27%	25%	30%	• Growth and consolidation of DIY in the USA, then international development
Oracle	1986 - 2011	**25**	27%	25%	29%	• Growth and consolidation of databases with industry consolidation
Assa Abloy	1994 - 2014	**20**	26%	15%	28%	• Consolidation of market country by country with development of emerging markets
L'Oreal	1977 - 1999	**22**	24%	10%	14%	• Growth and globalization of cosmetic markets with market consolidation
Nike	1986 - 2014	**28**	23%	14%	17%	• Growth of sportswear market with development in emerging markets
General Electric	1980 - 2000	**20**	23%	9%	11%	• Growth of financial services in the 1980s and 90s
Coca-Cola	1978 - 1998	**20**	23%	7%	13%	• Strong growth and consolidation of the market in the United States and then international roll-out
Hermes	1984 - 2014	**30**	20%[5]	12%	17%[5]	• Growth and globalization of luxury market
TSMC	1994 - 2014	**20**	19%	20%	19%	• Growth and consolidation of the semiconductors market
Essilor	1975 - 2014	**39**	18%	11%	13%	• Growth with globalization and concentration of the optical market with regular extensions of the activity perimeter
Vodafone	1985 - 2004	**19**	18%	34%	34%	• Growth in the telecommunications market with consolidation country by country
Volkswagen	1996 - 2014	**18**	17%	8%	21%	• Strong growth in China and in the premium segment
Ecolab	1987 - 2014	**27**	16%	11%	14%	• Growth, globalization and regular redefinitions of the perimeter
SAP	1994 - 2014	**20**	15%	16%	17%	• Growth of databases with industry growth consolidation
Reckitt Benckiser	1988 - 2014	**26**	14%	8%	15%	• Growth and consolidation of the market and strong growth in emerging countries

(1) Each company is only reviewed during its strong period of long growth, for the length of this period, as well as the annual TSR, annual revenue and profits growth rates over this period. Immediate periods before and after are characterized by significantly lower growth and TSR (with some exceptions where the figures are not available for earlier periods); (2) Data in local currency; (3) The difference between the TSR and the growth rate of revenues and profits over the 80s to year 2000 is explained by a significant rerating due to the sharp decline of interest rates; (4) In 1986/2000 for the TSR and 1987/2000 for net income; (5) 1993-2014 for the TSR and net income

Sources: Bloomberg, analyses and estimates Estin & Co

Therefore, they require a regular challenge of the company's natural scope and purpose, its business mix and its corporate organization.

The growth of the underlying market or the development of the initial technology is just one lever among others. Companies which stop growing after 10 or 15 years because the technology and/or the initial underlying market have matured are prisoners of a narrow view.

Growing strongly in the long term requires successively activating many different levers over time.

Ambition

For investors, these periods of long-term growth are magical because they are the only ones to create value in the long term.

However, for the managers of the companies sustaining such growth, there is nothing magical. *Constant challenge and anticipation are the two engines of growth.* They have to fight the inertia of organizations and consensual thinking.

For most companies, competitiveness and growth for the next five years are already determined to a large extent by prior choices and investments (of a financial, industrial, marketing, technological, human or other nature). The question is to define what will allow to sustain strong growth (8 to 10% and more) beyond those 5 years. The answer is complex. To grow by 15% per year when the company has revenue of 5 billion euros requires generating an additional 1 billion euros of revenue every year. Five years later, when the company has revenue of 10 billion, an additional 2 billion euros needs to be generated annually.

Therefore, strategies to be developed today need to generate in five years and beyond growth amounting to about a third of the current size of the group every year.

In most cases, management teams are asked to design these strategies within the perimeter or in the close periphery of existing activities. The larger the company, the stronger its past growth, the stronger its former successes and its current valuation, and the more those approaches are bound to be disappoint. Necessarily, they only generate low additional growth and they cannot maintain high long-term TSRs.

The proper approach should be the opposite. First, the ambition should be set–at the CEO or board level–at a level sufficient to maintain the growth and the TSRs which are necessary beyond 5 years, in line with or beyond what has already been achieved. Then, the (often disruptive) strategies which are required for this ambition should be inferred (organic market share gains vs. large, game-changing acquisitions; marginal extensions at the periphery of current activities vs. development of new businesses), the risks involved should be assessed, *decisions taken*, and financial and human means for implementation mobilized.

What to conclude?

Battles are won or lost in the minds before they are fought on the ground[2]. Building a strategy in the context of a company as it is currently, with its size, its mix of activities and its business scope is tantamount to looking into the rearview mirror. Long-term growth results, above all, from regular changes of perspective on the natural battlefield of the group as well as from calculated and repeated risk-taking. It is primarily based on an explicit, thought-out and controlled *ambition*.

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

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[2] Sun Tzu

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