Where does value come from?

By
Jean Estin
Chairman, Estin & Co

Over the last ten years and despite two economic and financial crises, the average annual TSR[1] of the Western Stock markets was 8% per year (with an average inflation of 2%). A sample of 250 major Western corporations[2] reached a TSR of 10% per year.

How was value created over this period?

The weight of the economy

The global growth rate has been 5% per year (3% for the Western countries). This growth - from which Western corporations profit in part - accounts for 40% of the average annual TSR of the Western Stock markets. The other 60% comes from the reduction in interest rates[3]. These decreased from 4% to 2% on average over the period for 10-year government bonds. Accordingly, price-earnings multiples for major public corporations increased from 16x to 19x between the end of 2005 and mid 2015.

These figures are the same as those observed over the previous fifteen years. In 2005, a study by Estin & Co[4] analysed the TSR of the companies of the main Western stock markets over the period 1990-2004 and over those 15 years the average annual TSR was 8%. The main 220 companies produced a TSR of 10%. Economic growth contributed a little less than 40% to this value creation, and the reduction in rates had contributed 60%.

In 25 years, more than half the value creation of Western stock markets has come from the continuous, massive reduction in interest rates. When these stop falling, all other things being equal, the value creation of Western companies will be divided by two. It will be equal or close to the share of global growth which Western companies will manage to capture.

Of this growth over the last ten years, emerging countries represented 54% (China alone was 25%). This share was only 25% over the period 1989-2004.

Let us draw a simple conclusion from this: without the growth of emerging countries and without the reduction in interest rates, the value creation of Western stock markets would have been almost zero between 2005 and 2015.

Choosing the right businesses and the right geographies

The study that Estin & Co conducted in 2005 presented a major learning. Between 1990 and 2004, classic leadership strategies within any individual business were only able to create value in industries with strong underlying growth (IT & software, financial services, FMCG, oil & gas products and services etc.). In poorly structured and low growth industries, the only strategies which succeeded in creating value were breakthrough strategies (new business models, new positioning, new products, new services etc.).

---

[1] TSR = Annualised Total Shareholder Return: the return on investment for the shareholder in terms of the sum of dividends, distributions of shares, value of the shares, …

[2] Sample of 250 large Western groups (North American, European and Japanese) representing the major market capitalisations.

[3] The dividend distribution component of the TSR has been completely offset by the de-rating caused by the lower growth rate

[4] See article "Economics versus Strategy" published in the March 2005 edition of « Colloque X-HEC-ENA »

The present study, which looks at the 2005-2015 period, confirms this observation, with three major additional ones:

- Choosing the right businesses is just as deciding as ever: there is no point in a leadership strategy in an industry with no growth and an already high level of concentration. However, the winning industries have changed over the last ten years—with a few exceptions. The winning industries of today are not the industries which won ten years ago (see table 1).
- Choosing the right countries has become just as deciding because an important share of global growth has come from emerging countries over the last ten years, which was not the case over the previous period (see table 2).
- Few companies manage to create 50% more value than the stock market over 25 years (which corresponds to a TSR of 15% p.a.) across economic cycles, differentiated growth rates and eventual substitutions between industries, and different growth rates between geographies (see table 4). How do these companies do it?

- Table 1 -

Total Shareholder Return (annualized TSR) (1)

	1989-2004	2005-2015
Digital	n.a.	29%
Biotechnology	n.a.	25%
Fashion and textiles	9%	19%
Luxury	n.a.	16%
Media	5%	14%
Consumer goods	14%	14%
Food and drink	11%	13%
Pharamaceutical and chemical	10%	13%
Asset management	n.a.	13%
Industrial	8%	12%
Automotive	5%	11%
Distribution	11%	9%
Telecommunications	6%	9%
IT et software	15%	8%
Medical equipment	n.a.	8%
Engineering et construction	4%	7%
Utilities	6%	7%
Air transport	1%	7%
Oil & Gas	12%	7%
Commodities	8%	6%
Hotels and tourism	n.a.	5%
Insurance	n.a.	2%
Banking	14%	1%
Sample average	**10%**	**10%**

(1) Sample of the main 220 Western companies in the period 1989-2004 (by market capitalization) and the main 250 over the period 2005-2015

Choosing the right businesses remains critical. The sectors which have performed the best over the last ten years have been those linked to the digital economy, with an annualized TSR of 29% (see table 1). At the other end of the scale, financial services have achieved an annualized TSR of 2% over the period, despite the fact that it had been one of the main growth sectors over the 1990-2004 period.

The growth of businesses driven by technological innovation, new consumption patterns, and the mass development of the middle class in emerging countries is of course a key part of value creation. However, the industry structure, the barriers to entry which protect them, the value to leadership and the ability of a leader to extract high margins and to finance the growth of the business are also highly important, just as the nature and impact of regulation which constrains them.

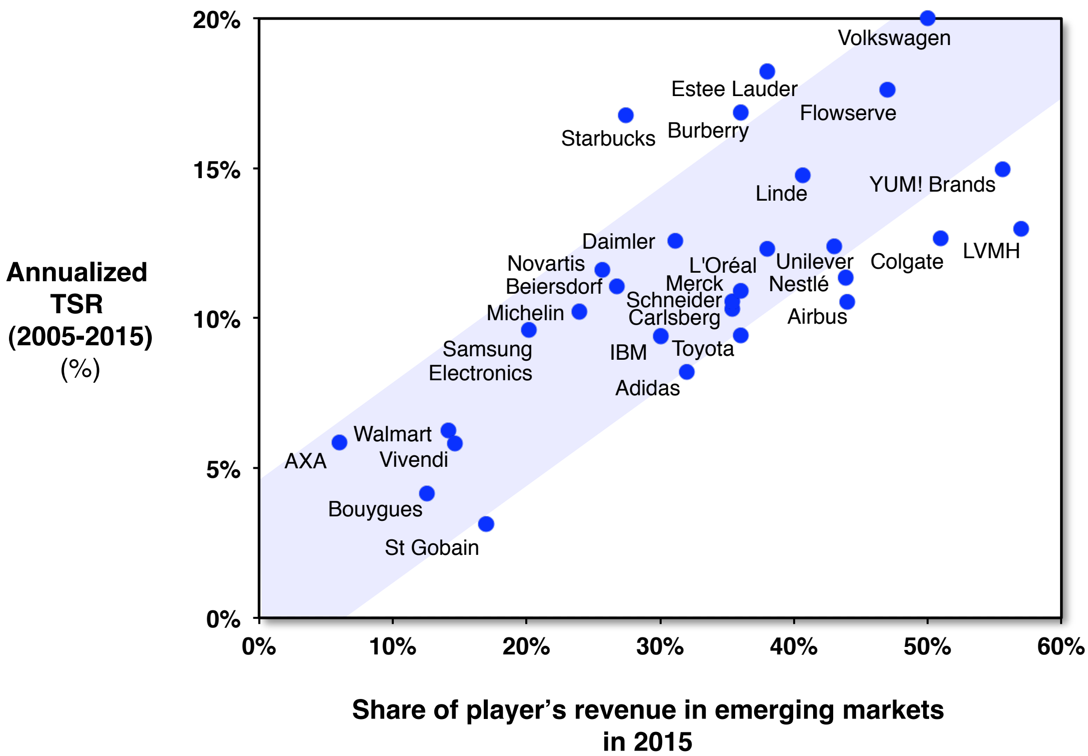
Choosing the right geographies has been a determining factor of success over the last ten years—a key difference from the 1989-2004 period. With the exception of digital sectors which have grown significantly in all countries, the value creation of large Western groups is statistically linked over the period to the percentage of their revenues coming from high growth geographies (see table 2).

As another simple conclusion, all that was needed to create value over this period was to be a leader in a segment of the digital economy, or a leader in China in (almost) any sector.

Conversely, large groups which were present in mature countries or industries did not create value over this period. Structurally they were not able to. What did the management teams do in order to escape this pitfall?

- Table 2 -

Exposure of large Western groups to emerging markets



Sources : Bloomberg, Estin & Co analyses and estimates

The comparison of the two periods has many lessons to teach us (see table 1). Few sectors manage to do better than the average economy over the long term. Some are cyclical by nature (oil & gas products and services with an reversion of the rising cycle in 2014), others are equipment businesses whose growth drivers stop being sufficient after ten to fifteen years (construction and infrastructure equipment) and yet others have to undergo significant restructuring after periods of expansion which were too rapid (financial services). Only certain sectors provide long term growth, coming from regular penetration of different segments of clientele and different countries at different stages of maturity (consumer goods).

Hence, global value creation in the Western world's has carried on over these 25 years despite economic and financial crises with constant new waves of growth, be it in new businesses, segments or geographies. *Some of these waves are short and others long*.

From a corporate strategy perspective, those results are of course fundamental. It is unrealistic to expect shareholder value creation with an exclusive focus on a narrowly defined, permanent perimeter of geographies and businesses. At any given time, there are few industries which are truly on a long term growth trend (of 15 years or more) within which it is worth the effort for a business to specialize. Certain sectors within consumer goods have allowed these types of strategies to succeed through successive penetration of new geographies. *Which businesses will allow this type of strategy to succeed over the next fifteen years?*

Choosing the right businesses, being able to roll them out by country, to re-define them and broaden their scope, to trade off between different business and countries according to their long term potential, to manage cyclical businesses, to re-define one's strategy when the long term growth trend of an industry comes to an end are all crucial, beyond one's strategies by business which may or may not be successful, and beyond skillful operational management.

Business strategies

Within the sector which has been the best performing (the digital industry), the business which has achieved the highest TSR over the period is Priceline (48% p.a., i.e. 1,5x the average sector TSR). Apple achieved an average TSR of 37%. On the opposite end of the scale, a number of businesses went bankrupt or had poor TSRs. As an illustrative example, eBay's TSR was only 6% over the period, and Yahoo's was 1%.

Within financial services—the industry which fared the worst overall—performance was extremely differentiated depending on the business (asset management versus insurance versus universal banking, etc.), the segment, the country, and the individual players within each segment and country (Allianz versus AIG, JP Morgan versus Citigroup or RBS, etc.).

Within all of these sectors, the difference between the top and the bottom performers over the period is at least 10 percentage points of TSR and for some players as much as 47! (See table 3).

Strategic choices in a given business and skillful operational management are always significant differentiators of performance, against the backdrop of the same industrial sector and macroeconomic environment. The value added of managers is in their strategic choices and their ability to run operations as much as their choices to change the business portfolio (see table 3).

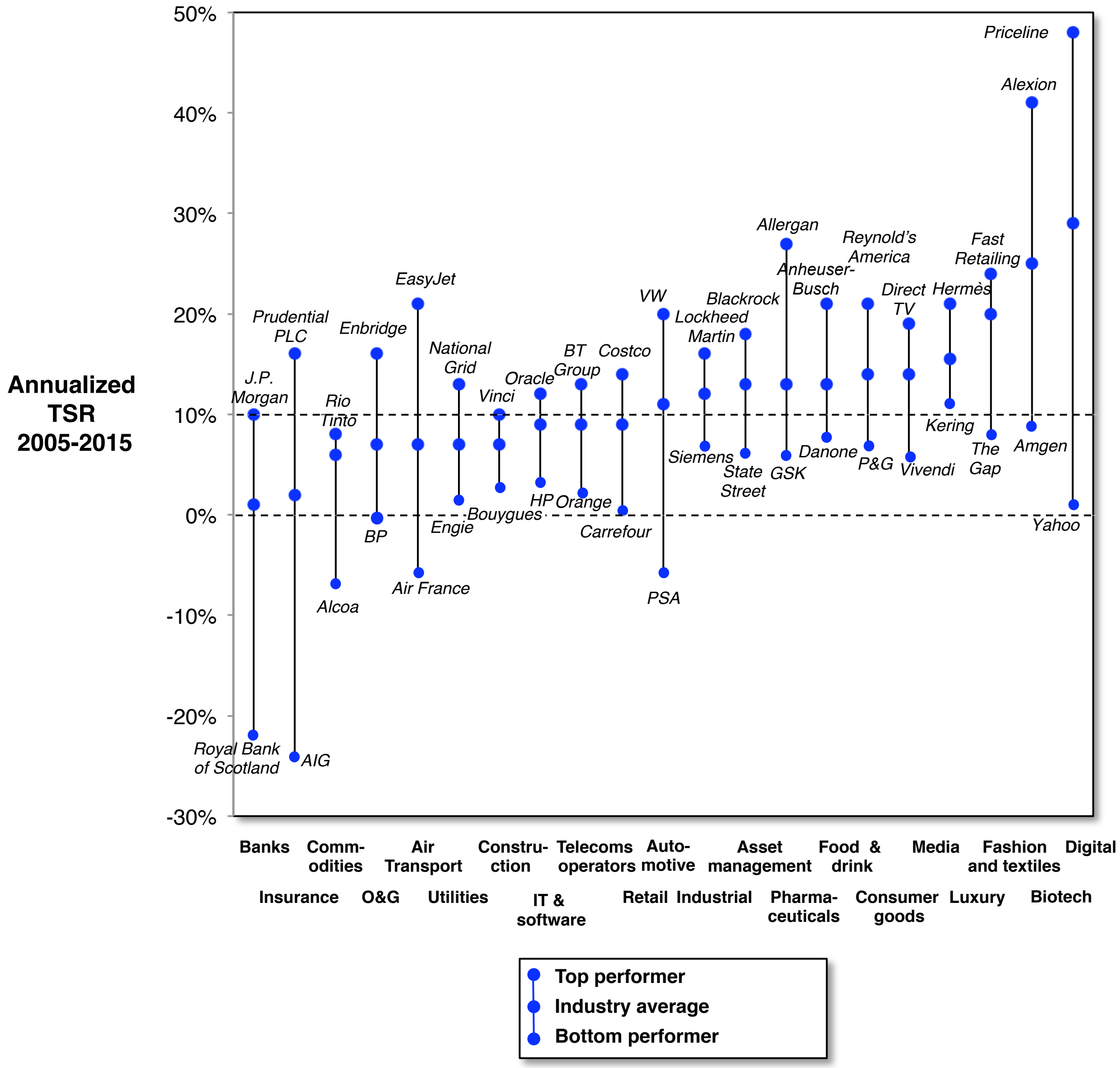
It is interesting to note that within the digital industry, the strongest performers (Priceline, Apple, etc.) are those who invented new products or services within either low cost segments (price comparison) or premium segments (iPads, smartphones, etc.). Within a traditionally low-return industry, air transport, the companies which developed new low cost operating models, easyJet and Ryanair, are the ones which have created shareholder value.

Within "attractive" industries (moderate to strong growth; sustainable segmentation axes; value to market share by segment), a large number of businesses managed to achieve total shareholder returns of 15% and above over the period—not just the leaders (digital and biotech businesses, luxury products, consumer goods, pharmacy, etc.).

However, in industries which are poorly structured, in decline or those which have suffered a significant downturn over the period, it is only the companies which have carried out breakthrough or niche strategies, as opposed to "classic" leadership strategies, which managed to achieve total shareholder returns above economic average over the period (easyJet or Ryanair in the airline industry, Enbridge in oil & gas equipment).

- Table 3 -

Total Shareholder Return (annualized TSR) (1)
(2005-2015)



(1) TSR = Annual Total Shareholder Return (15/07/2005 to 14/07/2015) calculated for a sample of 250 large Western companies
Sources : Bloomberg, Estin & Co

What to conclude?

In what has been a generally favourable context over the past ten years, breakthrough strategies (new operating models; new positioning; new products; new services) have enabled businesses to create value in all sectors, even those which have been the least supportive. However, these strategies are not necessarily sustainable. The businesses that implemented these strategies between 1990 and 2004 have not maintained their performance in the last decade (see table 4). *Breakthrough waves can be strong. But they are not necessarily long-lasting.*

- Table 4 -

Examples of companies whose total profitability for the shareholder was equal or superior to 15% p.a. over the period 2005-2015 and between 1989 and 2004

		TSR[1] 1989-2004	Main characteristics of the adopted strategy	TSR[1] 2005-2015	Main characteristics of the adopted strategy and recent issues
Apple	Consumer electronics	10%	Follower in a growth market	37%	Innovation and move to premium alongside integration into retail
TJX Companies	Textiles distribution	21%	Discount positioning in mature markets	21%	Discount positioning in mature markets
Hermès	Luxury	19%[(4)]	Niche segment positioning	21%	Acceleration of in-place strategy and development into emerging markets
Volkswagen	Automotive	4%	Mid-range strategy in developed countries	20%	Acceleration of growth in emerging countries
Direct TV	Satellite TV	10%	Leader in a growth market	19%	Consolidation of the market
Blackrock	Asset management	35%[(3)]	Leader in a high growth market	18%	Leader in a high growth market
Essilor	Consumer goods	17%	Leader in a growth market	17%	Leader in a growth market/ extension into new markets and geographies
Prudential PLC	Insurance	10%	Investment in financial services	16%	Growth accleration in a certain number of emerging markets
Home Depot	Specialised retail	24%	Leader in a high growth market	14%	Leader in a growth market
L'Oréal	Cosmetics	16%	Leader in a growth market	13%	Leader in a growth market/development into emerging markets
BMW	Automotive	15%	Niche segment positioning	12%	Niche segment positioning
Southwest Airlines	Airlines	20%	Change in business model	9%	Competition from new entrants
Microsoft	Software	38%	Leader on a high growth market	8%	Substiution of traditional software by cloud solutions and of PCs by smartphones
Telefonica	Telecoms	20%	Positioning on a growth sector and carried by the growth in South America	6%	Economic slowdown of Latin America
Walmart	Retail	17%	Leader on a growth market	6%	Destabilised by e-commerce and insufficient exposure to emerging countries
Total	Oil & Gas	18%	Demand and price driven by emerging countries	4%	Oil & gas market crisis 2014-2015
General Electric	Industrial & Finance	15%	Portfolio strategy and growth of financial services	1%	Cycles and financial services crisis
Nokia	Telecoms equipment	37%	Change of portfolio of activities	-5%	Subsitution of standard mobile phones with smart phones
Dell	Computers	55%	Change in business model	Not listed (-12%)[(2)]	PC subsituted by tablets and smartphones
Citigroup	Banks	25%	Positioning on a high growth market	-18%	Cycles and financial services crisis

Notes
(1) TSR = Annual Total Shareholder Return (calculated over the period from 15/07/2005 to 14/07/2015 in local currency)
(2) The annualized TSR over the period from 15/07/2005 to 29/10/2013 is -11,9%
(3) Calculated from the date of the l'IPO (26/09/1999) to 31/12/2004
(4) Calculated from the date of the l'IPO (03/06/1993) to 31/12/2004
Sources: Bloomberg, Estin & Co analyses and estimates

Classic strategies based on growth and market share gain as a leader or a specialized number two or three have only created value in the best-structured industries or those which have experience strong growth. In those industries—and there are very few of them—which are on a strong growth trend, that type of strategy has allowed the companies which carried them out to produce strong TSRs over twenty years or more.

Classic strategies of effective management have only allowed companies not to founder.

Where does value come from?

The analysis of large Western companies over a ten year period leads to several conclusions.

Over a short period (less than 5 years), value comes from restructuring, temporary profit improvement, rebounds in cyclical markets, etc.

Over a medium-length period (less than 10-15 years), value comes from disruptive business models (new products, technologies, services, operating models, positioning, etc.).

Over a long period (20-25 years), value comes from leadership in attractive industries which are on a long term growth trend with a regular re-definition of these industries' frontiers (development of this industry in new geographies, extension of the industry into "nearby" products, clients or services, growth in the value add of the industry, organic or inorganic concentration of the industry, etc.). Alternatively, value can come from proactive management of a group's activity portfolio to regularly renew its sources of growth.

Choosing one's time horizons is to choose one's strategy.

September 2015

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.

ESTIN & CO

PARIS - LONDON - ZURICH - SHANGHAI

2nd Floor, Berkeley Square House, W1J 6BD, London
Tel.: 44 207 887 4595 - Fax: 44 207 887 7593 - E-Mail: Estin@estin.com