What ambition?

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One of the critical roles of the board of directors and chairperson of a large group is to set the level of ambition for the company and its shareholders in terms of growth and TSR[1].

If the ambition is too high, the risks involved in achieving it can lead to losing independence; if it is too low, the resulting medium-term financial power of the group will make it vulnerable to attacks from competitors.

Without this calibration, it is difficult to establish a relevant strategy.

The traditional approach through portfolio management is a necessary but insufficient step; optimizing the portfolio and making use of existing growth sources leads to a rational allocation of resources, a better trade-off between profitability and growth and an improved TSR. However, for large Western groups in mature markets, this optimization rarely makes it possible to produce future growth and a TSR higher than 8-10% per year. Is there a need to go any further? Why? How far should a group go into looking for new businesses and extending the playing field? To what extent in the short and medium term?

Few companies challenge the boundaries in which they evolve, and which are only a consequence of past decisions. The dynamics of their industries and shareholder interest nevertheless demand a much deeper questioning than this optimization.

The ambition of shareholders for their business must be based on five perspectives:

The trajectory produced by a strong optimization of the business portfolio: as indicated above, this is only one of the elements of the equation, which is often insufficient.

The market capitalization and the historical TSR: a company which grows at a regular pace of 13% per annum and offers a TSR of 15% a year to its shareholders will undergo a significant de-rating if its new strategy yields growth of 8% per year, everything else being equal. One of the key challenges for successful groups is to maintain their medium-term and long-term strategic and financial path, at the same pace, as their size steadily increases. The difference between growth resulting from the optimization of existing businesses' and the one that is necessary in order to continue at the same pace determines the scale of expansions and new businesses to be developed.

Groups like Ecolab, Assa Abloy, Thermo Fisher, Medtronic, EssilorLuxottica... have grown by more than 10% per year over long periods by regularly expanding their playing field. Today, their revenue is a significant multiple of the current market size on which they narrowly operated 20 years ago.

The strategic and financial growth of direct and indirect competitors: a company must grow at least at a rate which allows it to concentrate the businesses in which it decides to invest. Its growth must therefore be greater than the one of its main direct competitors[2].

However, that is not enough. Some of its better-positioned competitors may operate in smaller, but very fast-growing markets. Hence, their TSR can be two to three times higher and their market value can quickly exceed the one of the company even if their size remains small. This situation is not sustainable in the long term. The company must grow at a pace which allows it

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[1] TSR = Total Shareholder Return: return for a shareholder on their investment (increase of the value of the security, distribution of dividends, distribution of bonus shares…).

[2] Leaders which concentrate an industry typically grow twice as fast as this one; for example, in an industry which grows at 5% per year, leaders must typically grow 10% per year minimum.

to remain among the frontrunners of its industry in terms of stock market value, or it will lose its room for maneuver and its independence in the medium term[3].

Financially sustainable growth: this is the fourth critical perspective. The profitability of the company, adjusted for debt leverage and after dividend distribution, determines the maximum sustainable growth. At current interest rates, a 15% ROCE with a leverage of D / E = 1 and a dividend distribution of 30% of profits can finance a yearly growth of 14%, everything else being equal[4].

If this growth rate is significantly lower than previously mentioned boundaries, the issue of the sustainable debt leverage, the capital structure, or the merger with another critical player of the industry becomes a strategic issue. AB InBev has managed to grow at over 15% a year for 25 years and to concentrate the beer industry through successive acquisitions but also by mergers.

The question of acquisition synergies is also critical. They are what make it possible to offset acquisition goodwill (all the more so when the company acquires high-growth targets) and to maintain profitability and financially sustainable growth.

Markets: they determine comparables for the shareholder. The average return (TSR) of worldwide stock exchanges is 10% per year for a shareholder (2010-2018). The average return of private equity funds worldwide is 17%. For a shareholder significantly committed in one company (as opposed to a diversified portfolio), it is normal to require TSRs of 15% or above. The reference to European stock markets only, which are increasingly disconnected from major global growth trends, is of course a major mistaken perspective[5].

These five perspectives are rarely aligned. Therefore, they will underline major strategic and financial issues. They lay out the parameters of the trade-off the board will have to make as regards *the TSR objective*, *the level and nature of acceptable risk, and the independence of the business*.

The organization and its skills are a variable which must be adjusted depending on those perspectives. If they are a constraint, the company no longer has room for maneuver to keep pace with the change needed within its industry.

In Western groups operating in mature businesses, taking into account those these five perspectives with different levels of ambition often produces *three strongly differentiated options*:

- An optimized “as is” option with a TSR around 4 to 6% per annum (given the slow growth of the underlying markets and despite all the operationally ambitious plans of the management); it is of course an insufficient objective in the medium and long term;
- A strong change in the business portfolio with a possible expansion of the playing field (often based on acquisitions and disposals), with a TSR of 8 to 10% per year;
- A strong concentration or transformation strategy with a major acquisition or merger and a change in the capital structure (with corresponding governance issues), allowing to reach a TSR of 12% to 15% per year.

Identifying these options and explicitly choosing of one of them is critical. This is the legitimate and relevant level of decision for shareholders. This is the level at which directions must be

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[3] A company which is growing at 5% per year with an ROCE of 15% (EBIT / Capital Employed) will have a Price-Earnings Ratio (PER) of 9x, whereas a company which grows at 20% a year with the same profitability will have a PER of 17x. Thus, a fast-growing player, even a small one, can develop additional room for maneuver to concentrate the industry. For example, in electronic payments, Adyen, a new comer in full-service e-commerce, grew at 80% per year between 2014 and 2018 from €0.2bn to €1.7bn; its 2019 PER is 65x and its market capitalization is €18bn. VeriFone, one of the traditional leaders of payment terminals, generated revenue of €1.6 billion in 2018 and grows at 2% per year; its 2019 PER is 13x and its market capitalization is €2 billion.

[4] Assumption: 25% tax rate and 3% cost of debt.

[5] The average TSR on European stock markets over 2010-2018 (with reinvested dividends) was 6% per annum, while the one of worldwide stock exchanges was 10% per annum (based on MSCI Europe vs. MSCI World indices).

given for the company's management, which can therefore work effectively on a strategy and avoid both self-censorship and unrealism in its ambition.

Some groups organize this dialogue between the company's management and its board of directors on a regular basis (every three to four years) in order to allow shareholders to make their trade-offs in a transparent and timely manner.

Without a clear and *clearly debated* objective regarding the ambition, it is difficult to have a meaningful dialogue between shareholders and the management of the company or between different blocks of shareholders. It is difficult to go beyond the narrow framework of the business portfolio, to integrate the industry's dynamics in a broad sense and to define a winning strategy both in the medium and long terms.

Companies which successfully grow on a regular basis at 12%, or 15% or more per year in the long term (with the resulting TSR) through different dynamics of markets and industries, changes in their business portfolios, through organic development or through major acquisitions, all have a strong common feature: *they chose it*.

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Estin & Co is an international strategy consulting firm based in Paris, London, Zurich, New York and Shanghai. The firm assists the management of major European, North American and Asian groups in their growth strategies, as well as private equity funds in the analysis and valuation of their investments.

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