Growing by developing a New Pillar

By
Jean Berg
Founding partner, Strategia Partners

Growth is the only way to create value in the long term.

A company that does not grow by more than 7.5% per year (i.e., a doubling of revenue every 10 years) loses its attractiveness and independence in the long term.

Companies that have experienced strong growth over many years often find themselves paradoxically facing with a growth challenge.

They have built up strong positions through a competitive and differentiated business model, enabling them to achieve high profitability and strong cash generation.

However, their growth is low: markets are often mature and slow-growing, and gaining market share is difficult and costly. One option is to develop new pillars.

Walmart: A 30-Year Model Becomes a Victim of Its Own Success

Walmart is an emblematic example of this situation. For 30 years, from 1970 to 2005, the Nashville-based company grew at a rate of over 30% p.a., dominating the U.S. market with a competitive model based on price, a broad product offering, and the impementation of unique operational excellence.

Walmart has deployed its strategy in a series of steps, nibbling away the U.S. territory by opening stores and gaining market share by refining its model. By 2005, it had captured about 25% of the grocery market with a revenue of 288 Bn€.

Since then, Walmart has experienced slow growth. Despite its expansion into Mexico and China, the company has not been able to return to historical growth levels. It remains a victim of incredible speed and scale, a lack of preparation for the end of American retail growth, and a reluctance to move beyond its traditional businesses.

The simple math of growth

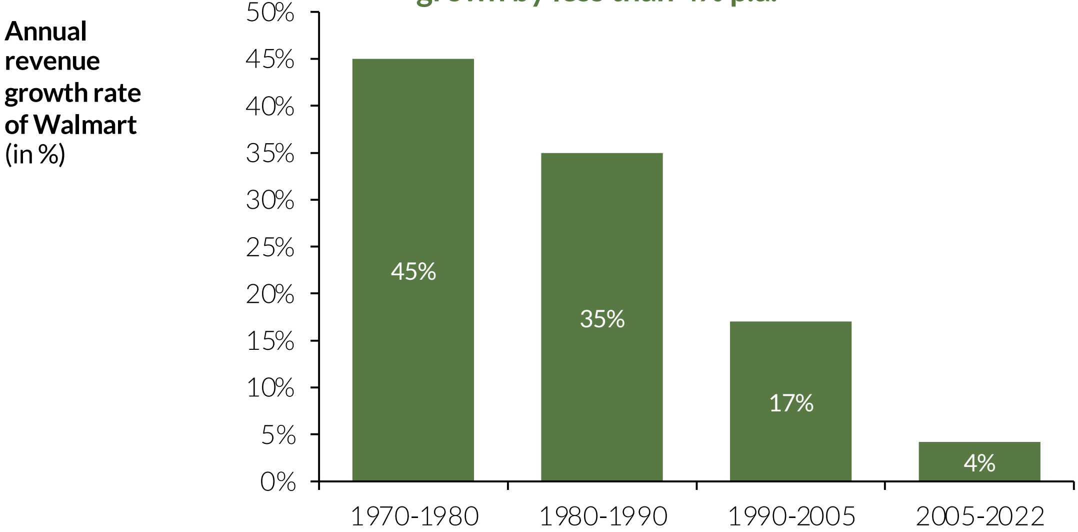
A company's growth is based on the simple mathematics of the growth potential of its various businesses.

In simple terms, large Western companies are typically positioned with 80% of their operations in businesses growing at 3% p.a., where they have concentrated and built up strong positions, and 20% in businesses growing at 10% p.a. Mathematically, overall growth is unlikely to exceed 4% to 5%.

To achieve growth, it's necessary to change the business portfolio. Developing a new pillar is one of the possible options for portfolio modification.

- Table 1 –

Walmart experienced strong growth until 2005. Since then, the group has grown by less than 4% p.a.



	1970-1980	1980-1990	1990-2005	2005-2022
Revenue End of periods (Bn $)	**1**	**26**	**288**	**574**
TSR (%) [1]		**39%**	**15%**	**7%**

(1) Total Shareholder Return: annual return for shareholders

Why building a new pillar?

What about developing adjacent businesses that are closer and better known than entirely new businesses? Isn't there a risk of spreading oneself too thinly in more complex businesses where there are no synergies?

There are three reasons to diversify rather than invest in adjacent industries.

Firstly, the scale of investment in adjacent businesses is insufficient relative to the stakes. A company with a value of 100 and a growth rate of only 5% p.a. must create an additional value of 40 to achieve a growth rate of 10% p.a.. Within 5 years, new activities must represent at least 25% of value and not a marginal share of total value.

This is what happened to Walmart after 2000, when its international expansion, especially in China, was not enought to shift the group's growth away from the U.S..

Secondly, value cannot be created in adjacent business. Value creation can come either from the concentrating of a business upstream or downstream, with the development of synergies (without these synergies being captured by customers), or from the long-term growth of these activities (which is possible but unlikely if the core business is no longer growing), or from transforming the industry by adding these activities.

This is what Essilor successfully did in optics in the 2000s by investing in optical laboratories and acquiring 400 companies; what food ingredient manufacturer IFF did in 2018 by acquiring Frutarom, which specializes in fruit-based flavors and ingredients, for more than 6 Bn $.

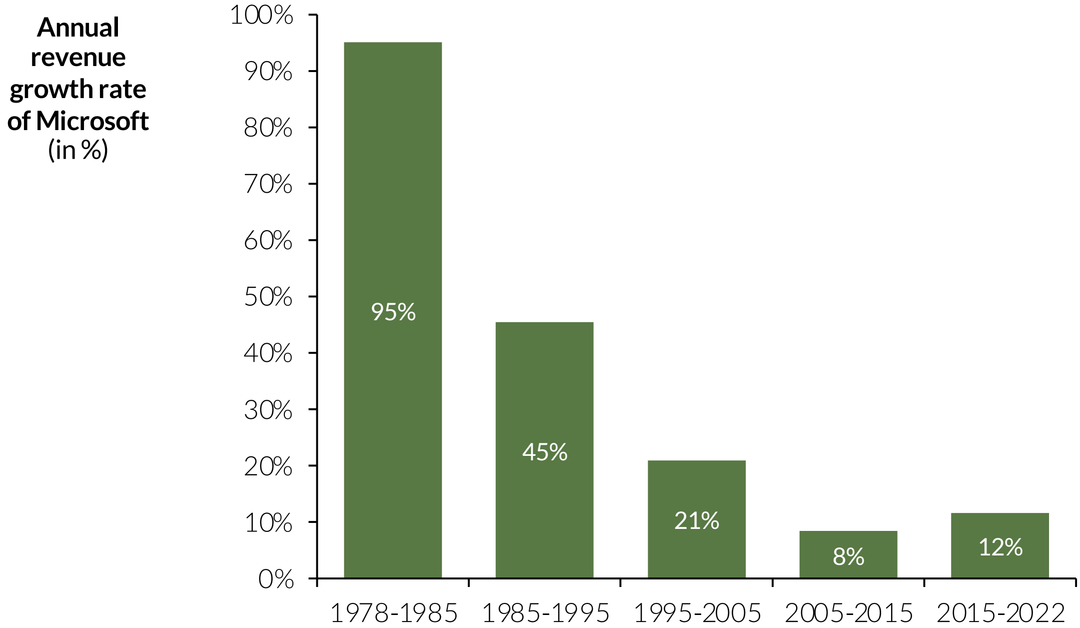
Finally, adjacent moves are too complex to execute. Adjacent businesses that are difficult to implement often run the risk of remaining dormant. This is the case for companies that want to invest upstream in rare mines to integrate the entire supply chain and secure supply, but where no mine is on the market. Or because the idea of downstream investment, particularly in distribution, may be attractive but complex or risky to execute.

How to develop a new pillar?

The development of a new pillar cannot be opportunistic and based on the expectation of a good deal. It must be built by aligning the ambition of developing a new pillar, defining its characteristics, and taking a proactive approach.

The ambition to develop a new pillar must be defined in terms of size and value. The new pillar must be of sufficient size, typically at least 25% of the company’s value in five years, to fulfill its expected role in the overall portfolio. This structures the type of pillar and precisely defines its framework.

- Table 2 –
Microsoft experienced strong growth until 2005. During 2005 and 2015, the company grew by less than 9% p.a. Since 2015, it has resumed growth



Revenue End of periods (Bn $)	**0,1**	**6**	**40**	**94**	**198**

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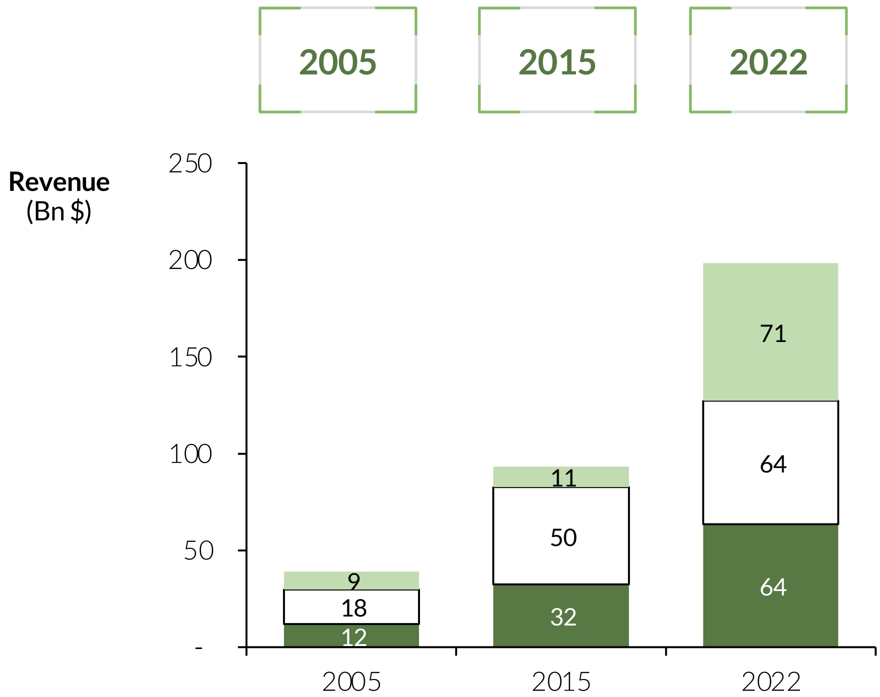
- Table 3 –
The development of Microsoft's Intelligent Cloud (IC) business has allowed the Group to regain momentum in growth and value creation



	Annual growth 2005-2015	Annual growth 2015-2022
Total	8%	12%
Intelligent cloud (IC)	2%	31%
More Personal Computing	11%	4%
Productivity & Business Processes	11%	10%

	2005		2015		2022
Net income (Bn$)	12		12		73
Annual growth		*0%*		*29%*	
PER (x)	24		31		28
Market capitalization (Bn$)	289		374		2 061
Annual growth		*3%*		*28%*	
Share price ($)	27		47		276
Annual growth		6%		29%	
Dividend yield		1%		1%	
TSR		7%		30%	

Microsoft is an emblematic example of this strategic approach.

For 30 years, from 1975 to 2005, the Redmont-based company grew at over 20% p.a., developing a competitive software model based on two major successes: operating system(MS-Dos, then Windows) and integrated office software (Office).

By 2005, the company had achieved over 60% market share in its two major segments, and revenues of 40 Bn$.

Microsoft's annual growth was 95% in its early years of its existence, 45% from 1985 to 1995, and 21% from 1995 to 2005. Its average total shareholder return (TSR) was over 20% before 2005 (Table 2).

The following decade was less successful. Microsoft's annual growth from 2005 to 2017 was 7%. Despite its efforts in portable media players (Zune), mobile phones (Windows Phone then Nokia), and tablets (Surface), the company did not return to historical growth levels. During this period, Microsoft remained the victim of the incredible success, in speed and scale in previous years (from 6 M$ to 40 Bn$ from 1985 to 2005), a lack of preparation for the end of the growth of its two flagship software products, and the difficulty of finding a significant new pillar of growth.

In 2014, Microsoft's new president defined the cloud as the company's strategic priority. Accelerating efforts in this segment enabled a return to a growth strategy that has materialized since 2017. This business has grown by nearly 20% p.a. and is now the leading pillar of the company. Overall, the company’s annual growth was 15% p.a. from 2015 to 2021, compared with 7% p.a. previously. Its TSR exceeded 40% (Table 3).

The characteristics of the pillar should leverage the appetite and capabilities of management or shareholders. This involves matching the type of the businesses to be developed: preferred value creation methods (long-term growth, consolidation, turnaround, etc.); positioning in the value chain; centralization or decentralization of decision making; homogeneity or diversity of business models within the company; level of customer concentration; level of supplier concentration; level of profitability; future growth prospects; volatility of the underlying industry; revenue exposure to emerging markets; and target shareholders.

Finally, a proactive approach is required to identify the pillars of diversification that match the previously defined ambition and criteria. This screening process of industries and companies allows us to focus on a limited number of growth and diversification options.

This is Kering’s strategy. The first wave of diversification into retail had a limited impact (TSR of 9% p.a. over the period 1985-1995); investments in retail activities came later when many of them were already close to maturity. The second wave had a significant impact (TSR of 15% p.a. over the period 1995-2018); the Group invested at a time when the luxury goods growth wave was and still is) strong and prolonged in both Western and emerging markets.

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To grow, it is necessary to modify the business portfolio.

The development of a new pillar is one possible option for portfolio modification.

KEY TAKEAWAYS

- Growth is the only way to create value in the long term.
- A company that does not grow by more than 7.5% per year (i.e., a doubling of revenue every 10 years) loses its attractiveness and independence in the long term.
- Paradoxically, successful companies are often victims of their own success: they have built up strong positions in low-growth markets and therefore have no further growth opportunities.
- Developing a new pillar is one way to accelerate the company's overall growth
- This move allows the company to break out of an overly constrained framework of industries where growth is either impossible or severely limited.
- It requires an approach that defines new businesses that are attractive in terms of growth or profitability, and at the right scale. It must also outline the characteristics of these new businesses.

What to conclude?

The development of a new pillar is an option to consider for companies that have successfully implemented their growth strategy and focus on their original business. It allows them to embark on a new growth adventure in a new business whose characteristics are close to those of management and the board.

It is more relevant than entering an adjacent business without potential. It enables a more selective approach and value creation at the right scale. As always, growth is a conscious choice that can’t be improvised.

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Contact : jean.berg@strategiapartners.com

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