



Worth Noting

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Worth Noting is the weekly management journal of research and conferences company L21. It is focused on management strategy issues of relevance to senior executives.

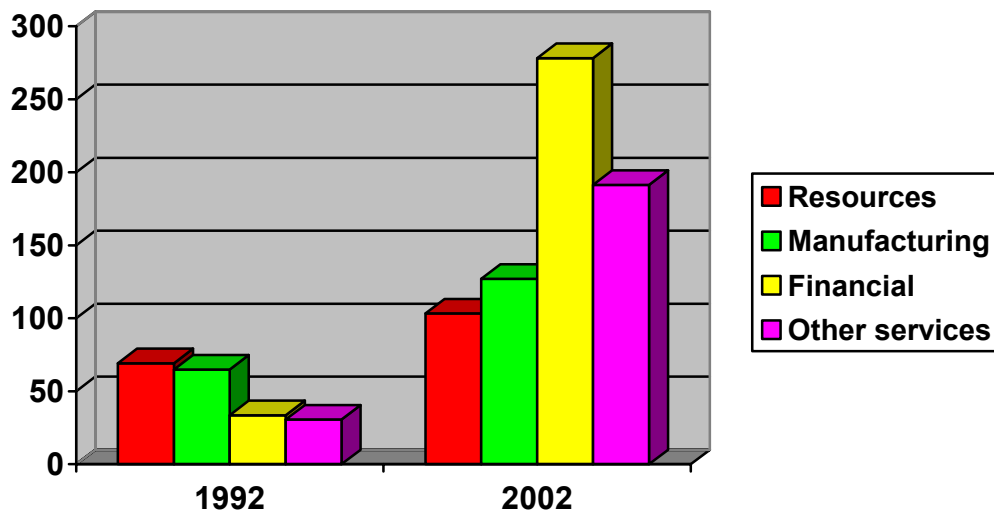
It is something of a cliché, but absolutely true, to suggest that change is all around us. In this issue of *Worth Noting*, we begin with a survey of changes to the broad composition of the ASX100 over the past decade and go on to look at two key factors which have helped leading Australian companies stay on top.

Changes in the Past Decade

The Market capitalisation of all listed companies in Australian increased from \$198 billion in 1992 to over \$700 billion in June 2002. Clearly, there has been significant growth in the size of the market across all major industries. This has been driven as much by new entrants as the growth of existing companies: 7 of the top 20 companies were listed in the past decade.

More interesting than absolute growth is the relative changes in sector weightings in the market over the past decade. The massive growth in the financial and services sector is noteworthy.

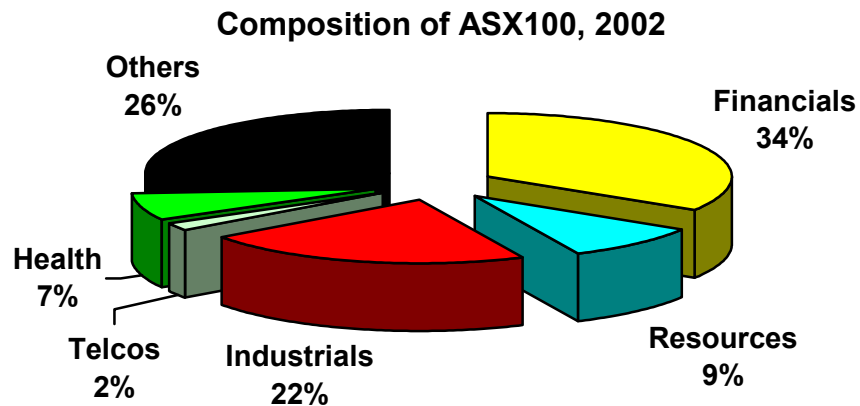
Market Capitalisation by Sector, \$B



Source: ASX Research

The size of the listed finance sector has increased by about 850% over the period, providing the main engine for the growth in overall market capitalisation. Resources comprised 35% and Finance only 17% of market capitalisation in 1992, by 2002 Resources comprised 14% of the market and Finance almost 40%.

This shift is broadly consistent with market changes in the developed world over the past ten years. What is unusual about the Australian experience is the size of the change. Finance has a far more dominant role here than in most other markets: 8 of the ASX 20 are Finance companies, and 34 of the ASX 100 are also from the sector. As an economy, we do a particularly good job of driving profits to finance companies.



Source: ASX Research, L21 Analysis

Only 30 companies in the ASX100 in 1990 remain in the ASX100 today. As a recent Bain Consulting survey shows, names like David Jones and Burns Philip have fallen out of the index, companies such as TNT and BTR Nylex have been taken over and groups such as Adelaide Steamship have collapsed completely. On the other hand, recent floats have put companies like Commonwealth Bank and Macquarie Bank on the index and strong newcomers have included bold players such as Southcorp and Sonic Healthcare. This statistic certainly puts great pressure on CEOs to come up with the goods long-term. Consider this: only one company from the original Dow components still exists today: GE. Recent concerns notwithstanding, maybe some of the GE management adulation is justified after all.

In for the long haul ...

When steering a company to meet the future successfully, there are obviously factors at play that are beyond the control of executives. For example, the research above shows that broader trends in the structure of the Australian environment means that new sectors will emerge, others will rise and some will fall. Subsequently, macro trends will suit some and be at a disadvantage for others. A zinc company will struggle to reinvent itself as a bank (let alone an IT company).

Managers who are also leaders focus on those things that they have some control over: devising and implementing better strategy and minimising avoidable errors.

We frequently hear about the brilliant acquisition or the audacious launch of a new product. But as we all know, it is the patient accumulation of minor victories which adds up to long term success.

How many leading companies can boast about sustained growth over a 10 year period? Research by Bain Consulting shows that the number of top companies that can are alarmingly low. According to their research, only 1 in 10 companies succeed in becoming sustained value creators – growing revenues and profits at modest rates over a 10 year period whilst returning greater than their cost of equity to shareholders. Furthermore, when we look at the ASX100 companies, from 1990 to the present, only 7% achieved consistent growth over the nineties.

This statistic is even more alarming given that we are talking about a 10 year period that was the heart of the greatest economic boom over the past century. Also, Bain had defined sustained growth modestly at only inflation adjusted growth of only 5.5% per annum!

The lesson is that sustained growth even in good times is the exception for large firms and highly focused leadership is required to join the 10% of long-term value creators.

1. *Growth for Incumbents: More from the Core*

Research suggests that rather than through the continuous introduction of new services and products, or aggressive unfocused acquisitions, leading companies who succeed in building long-term value generally succeed at building and strengthening their core.

This sounds like just common sense but is much harder to work out in practice. First, what is the core? Merely looking at our balance sheet cannot tell us the answer because a business' core means more than just where most of its revenue comes from. The famous 80:20 principle rears its instructive head time and time again here.

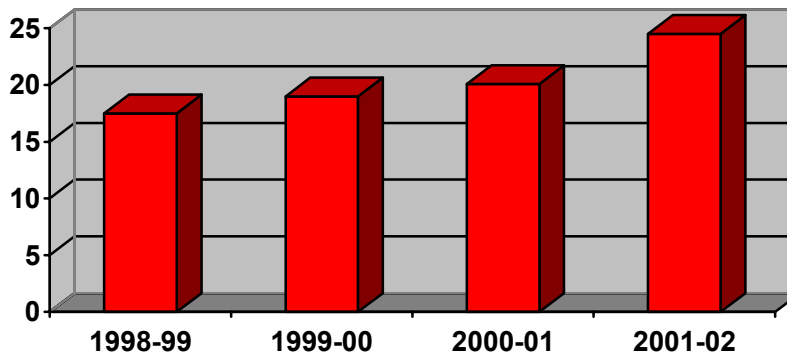
For instance, it means working out who are the most valuable customers (i.e., which 20% of customers supply 80% of the revenues), which are the most valuable products and services, which are the most important channels for supply and distribution, and which of the firm's characteristics gives that firm a distinct competitive advantage over rivals?

These questions, if answered accurately, allow companies to work out where cost cutting will be most effective; to whom, how and what we should be marketing; what should be outsourced and what should not; where our current and future competitors will most likely come from etc.

A prime example of a company and CEO that understands its core to tremendous results is Woolworths, and its head, Roger Corbett.

Woolworths ranks as one of Australia's most admired companies and Corbett as the second most admired business leader in Australia, according to BRW. It is not difficult to see why.

Woolworth's Sales Revenue (\$B)



Source: Company Reports

Woolworths has had a succession of CEOs (culminating in Corbett) and senior executives who know the business inside-out: from the packing shelf level to the top. This has allowed the management to identify how to improve the real core of the business – most notably from its implementation of operation Refresh which identified and improved the basic supply chain with \$1 billion invested on IT and process management. Through detailed understanding of the nuts and bolts of the business by senior management, the introduced reforms begun in 1999 delivered savings of \$368 million in 2000-01 and \$517 million in 2001-02. The plan is that improvements to the core supply chain will save the company about \$4 billion dollars between 2004-7, freeing up resources for expansion.

Second, acquisitions have generally been disciplined (i.e., focused on the core business). The main one has been of Franklins stores in 2001 for \$362 million and the successful integration of Franklins within Woolworths. Already, the acquisition has delivered sales of \$1.05 billion.

On the less successful side, Woolworth's' consumer electronics division covering Dick Smith and Tandy which it bought has been less successful with gross profit margins falling to 2.3%.

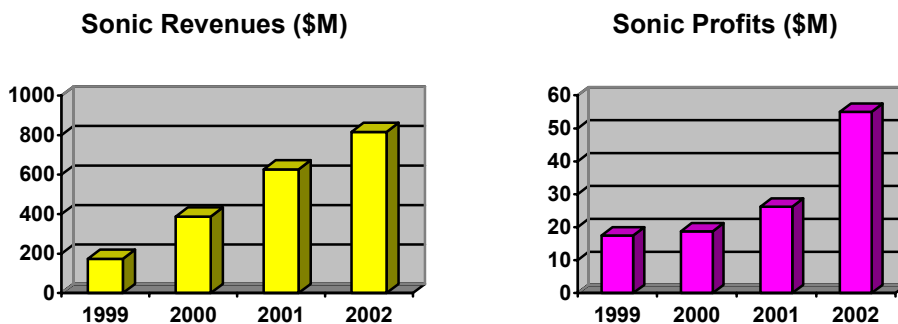
The principle: acquiring businesses whose core is compatible to our own means that we are more likely not only to have a strategic fit but also understand the business we are buying. Expanding around our core allows us to leverage of the strengths of our core business to greater effect. A Franklins acquisition, on this view, is more likely to be successful than a Dick Smith Electronics acquisition.

Third, Corbett claims that his legacy and future strategy is continual extraction of value from the core business – maintain sales growth of up to 10% and profit growth of over 10%. In other words, the strategy is continual realization of more of a core business' potential by isolating the 20% of products, suppliers, customers that deliver the bulk of the profits.

2. Growth for Upstarts: “Getting” the Future

Understanding the future is a hallmark of the new high achievers in the ASX100. These companies generally foresaw an opportunity which incumbents were too slow to capitalise upon.

A strong example is ASX100 company Sonic Healthcare. Sonic has achieved remarkable increases in revenues and profits as the snapshot below shows.

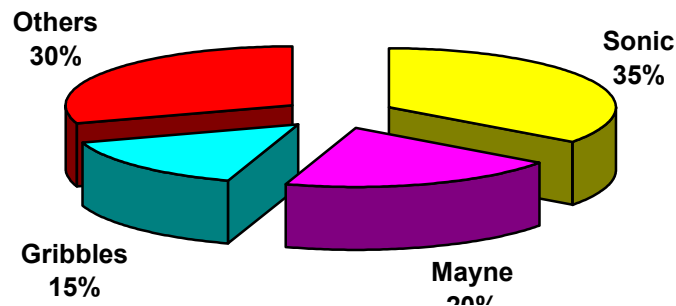


Source: Investorweb

Sonic has become the nation's leading radiology/pathology player. Its business model is essentially aimed at leveraging maximum network efficiencies through horizontal acquisitions while organic growth is gained from continual acquisitions of smaller operations that also serve to expand geographical coverage. In other words, Sonic employs a strategy developed to become a market leader in Australia in what is a fragmented market with many operators.

This goal seems to have been achieved – particularly in the pathology market as the charts below show.

Pathology Market Share, 2002



Source: Biotrends

Being a market leader is important but leveraging off leadership is really the name of the game.

For example, pathology lends itself to a satellitic operating structure where a centralized lab supports numerous sample collection outlets over a broad geographical region. Subsequently, Sonic's central processing model and its lab costs are already at the industry's best levels while turnaround and error rates have set new industry standards. While Sonic's revenues have jumped about \$200m each year since 1999, net profit has shown an incremental increase over the same period due to leadership leveraging in their processing model. Indeed, the disproportionate increase in net profit over revenue growth due to market leadership leveraging is remarkable and highlights extremely well the principle of exponential returns to market leadership.