



# Worth Noting

The Fortnightly Journal of L21 Management Consultants

Issue 2, September 10, 2001

*Worth Noting is the fortnightly journal of L21 Management Consultants. The aim of the publication is to provide our clients and associates with insights of relevance to their business. It will be distributed every second Monday.*

*Worth Noting* will focus on the three key practice areas of L21, namely:

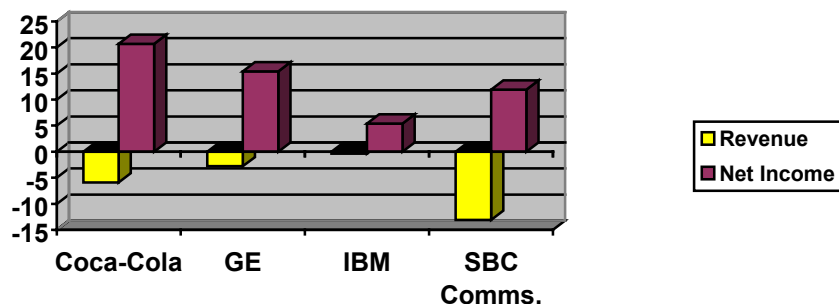
- Strategy
- Growth
- Business Development

Practice Area: Growth

## Earnings Growth on Flat or Declining Revenues

Readers of the last edition of *Worth Noting* will recall that we highlighted the performance of Dow stocks that had increased earnings in the June 2001 quarter despite declining revenues. Of the thirty Dow components, four had managed to increase earnings on falling revenues: GE, IBM, SBC Communications and Coca-Cola.

Revenue and Net Income Growth, selected Dow components, June quarter 2001/2000 (%)



Source: Hoover's, Company Reports

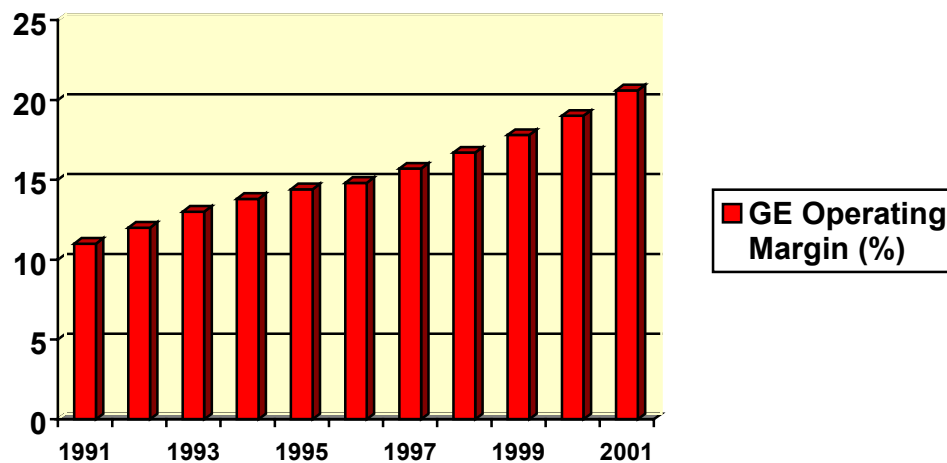
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This issue of the journal will focus on the strategies employed by these four companies.

## General Electric

GE is not only the world's most valuable company, it is also the most diversified large corporation in the world. From building power plants to creating television programs, from financing consumer loans to manufacturing aircraft engines, the company's activities touch on scores of sectors in the global economy.

GE's capacity to raise earnings on falling revenue is driven by its continual expansion in operating margins. For more than a century until 1990, the company had struggled to raise operating margins above 10%. In 1991 CEO Jack Welch set a goal of achieving 15% operating margin by 1995. As it turned out this goal was not quite met, but the margin focus set off a decade of truly remarkable results.



Source: Company reports, 2001 result June quarter

Little wonder that the company's stock price increased by more than 700% during the same period.

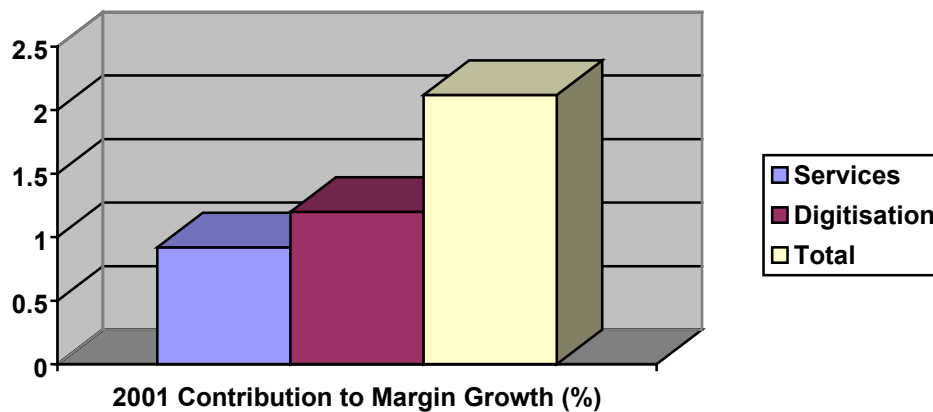
Jack Welch has focused the company on four key initiatives in recent years: Globalisation, Six Sigma quality, Services, and Digitisation.

GE has an inherent advantage in pursuing the benefits of globalisation: 313,000 employees in over 100 countries. The company's procurement processes are all global – right down to the procurement of labour. GE Capital, for instance, currently has over 5,000 Associates based in India who provide round-the-clock service to clients all over the world.

The June 2001 results make clear the success of the company's increasing focus on digitisation and services in increasing margins. For GE, digitization

is about eliminating middle-men. The company is gradually deleting wholesalers, record keepers, administrators and so on from its processes by moving its processes to digital. In the services area, GE is lifting overall company margins by earning a greater proportion of its revenues from its two key services divisions: Technical Products and Services and GE Capital.

By breaking down the company's operating profit by segment, we have produced an estimate of how GE will again grow operating margins in the 2001 year.



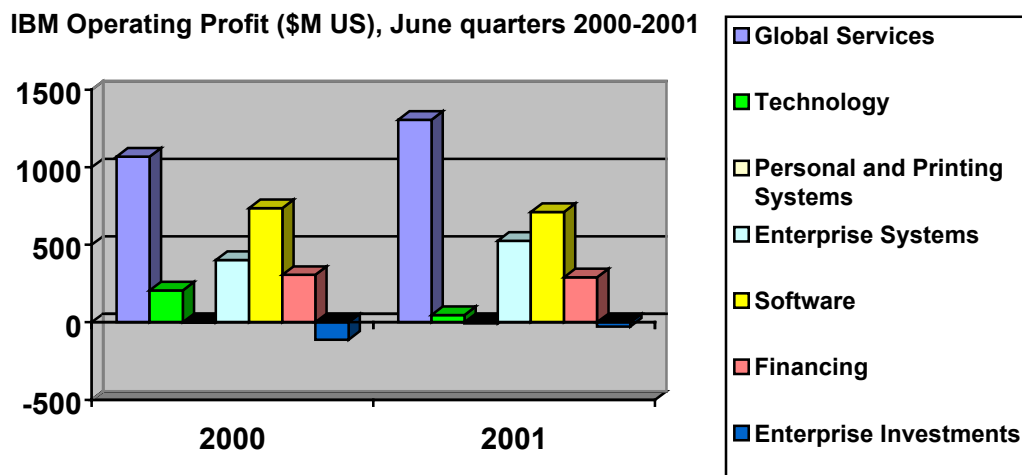
Source: Company Reports, L21 Analysis

In other words, the corporation as a whole is delivered overall margin growth of more than 2% by just two of its key initiatives. If some of its divisions have a bad year impacting negatively on margins, there is a buffer in place which allows the company to still record positive margin growth. In 2001 for instance, it is likely that the NBC television business will contribute negatively to operating margins due to the weak advertising market. A recessionary manufacturing climate will also mean that the large plastics division contributes negatively to operating margin. But the engines of growth – services and digitization – will almost certainly see a continued expansion in operating margins.

Much of what GE does is very specific to GE: its sheer weight allows it advantages which most companies can only dream about. But in eliminating cost through digitization and focusing on high margin services, the company provides a valuable model of relevance to all businesses.

## IBM

The giant technology company's segment profit reports make interesting reading. When we think of IBM, we tend to think of the personal computers for which the company is famous. But despite massive revenues of over \$US 3B US in the last two June quarters, the company loses money on personal computers. In fact, IBM only makes significant profits from three of its divisions – and only one of those divisions is focused on the sale of computing equipment.



Source: Company Report

In a similar vein to GE, we see a strong tilt towards services as the driver of profit growth. By the June 2001 quarter, the Global Services division was producing 41% of the company's total profits. Global Services is the technology outsourcing division that IBM operates around the world. In Australia, IBM Global Services is the largest provider of technology integration services to major corporates, and is operated under an ownership structure involving IBM, Telstra and Lend Lease.

Only two divisions contributed profit growth in the quarter: Global Services and Enterprise Systems. With the exception of the small Enterprise Investments division, Global Services and Enterprise Systems were the only divisions to see either increased revenue or increased profits.

The results are reflective of the company's strategy to position itself as a service provider to the largest global corporations. IBM set out in the mid 90s

to become an integrated service provider to corporations, selling the hardware on which to build systems and the software to run on those systems. As the PC and general technology market has softened, the need for enterprise solutions has remained solid. Even when large corporates want to reduce their IT spending, they will generally call in an expert to help them do it. IBM is in that largely recession-proof business.

IBM's move into services was strategically very challenging for the company. It effectively used and extended its existing brand strength to position itself in a business in which in reality it had little expertise. In the early 90s the company was just another (albeit the biggest) manufacturer of computing equipment. Its success since then has been driven by firstly identifying the likely sources of margin and revenue growth across the IT industry, and then building a brand which was "stretchable" enough to become dominant in those areas. Its heavy marketing spend on the "e-business" campaign of the mid to late 90s is one of the few examples in that era of a technology marketing initiative driving long term shareholder value.

The company's bet on corporate services flew in the face of conventional wisdom at the time. Many analysts were critical of IBM for entering into an area which they felt lacked scalability and may detract from its then core PC business. However IBM has been proven right. The collapse in both growth and margins in the fiercely competitive consumer technology market has seen main competitors Compaq and Hewlett-Packard report very poor results for the June quarter. As Compaq and Hewlett-Packard contemplate a merger, one of their key goals is to become competitive with IBM in the high margin services business. With such a strong brand and large market share to compete with, this will be no easy task.

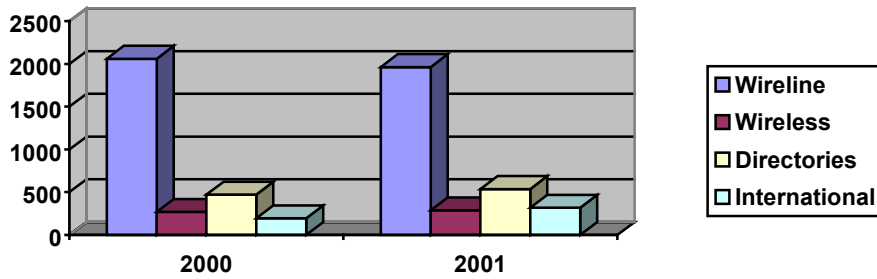
Like GE, IBM recognized early that services would be a key driver of profit growth. And like GE, IBM provides an example of the importance of focusing on the most profitable product ranges – even if the company's "core" business has to be reconsidered in the process.

### **SBC Communications**

Baby Bell spin-off SBC Communications serves millions of telecommunications users across the US, and an increasing number of international customers. Because of the complex anti-trust laws governing the telecommunications market in the US, the company operates under numerous brands – Southwestern Bell, Ameritech and Pacific Bell are some of its larger companies.

Like GE and IBM, SBC reported declining revenues in the June 2001 quarter and yet increased earnings. The company achieved this despite declining income from the business which provides almost two-thirds of its profits.

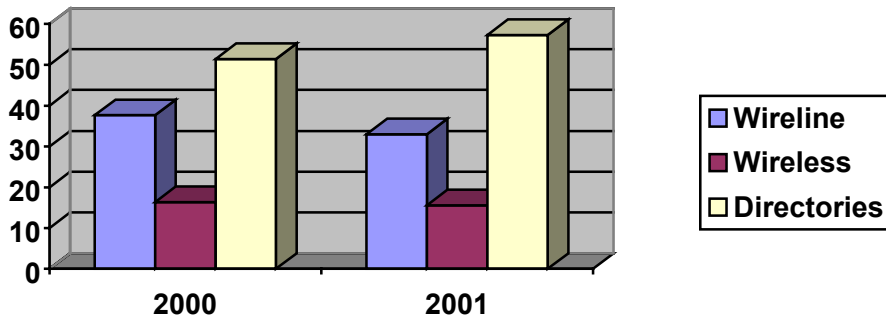
**SBC Operating Profit, US \$M, June Quarter 2000/2001**



Source: Company Report

Two divisions drove the company's improved profit performance: Directories and International. US performance was held together by the Directories business, which improved its operating margin to over 55%.

**SBC US Businesses Operating Margins (%), June quarter 2001/2000**



The directories business, while representing just 11% of domestic revenue, represented over 19% of domestic operating profits.

The decidedly old-fashioned business of directories advertising is the reason this future-focused company delivered an improved profit performance in the June 2001 quarter. The telco equivalent of the classifieds rivers-of-gold, directories are a consistent high margin performer across most telecommunications markets. In Australia, Telstra earns revenues of over \$1.2 Billion per year from its directories businesses under the Pacific Access umbrella. Fairfax is also aggressively pursuing the industry, through its online and offline versions of the CitySearch directory.

While SBC management emphasised its strong growth in areas such as data and high-speed Internet access, the fact remains that the stellar margin growth in the directories business produced the result.

Unfortunately, there is little lesson here for local companies: directories are a business for incumbents, as the mass of listings is what makes the product valuable. The cost base is low – sales staff and printing – and the benefit to businesses from listing is high. Consequently pricing for incumbent directories faces little pressure and customers are consistently happy with the return on their relatively modest investment. The Yellow Pages is a dream business for Telstra – and a hard one for challengers to attack.

## **Coca-Cola**

Times are tough in the beverages market. Two key factors have come together to make earnings growth for the US based leader Coca-Cola very difficult.

Firstly, sales of carbonated beverages are in a holding pattern. Particularly in western countries, consumers' palates are becoming more sophisticated and they are increasingly turning to the non-carbonated drinks typified by brands such as Snapple and Nantucket Nectars.

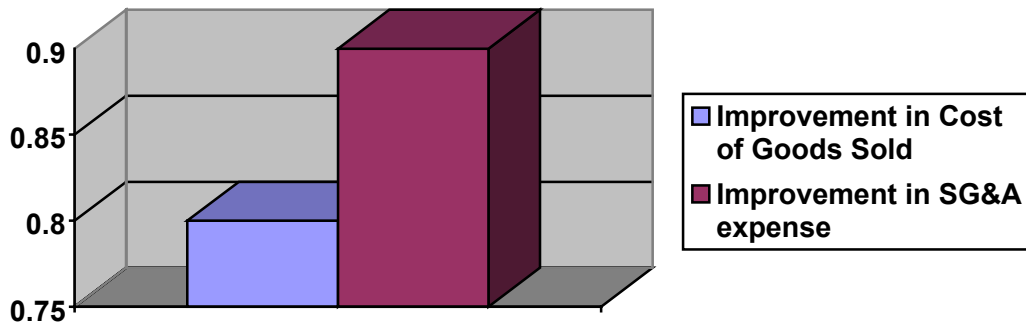
Secondly, the markets where growth is still strong – particularly Asia and Africa – have seen their currencies declining by more than 5% against the US dollar in the past year. So even in its still growing markets, Coke needs to grow revenues by 5% in absolute terms simply to stay square with the ledger.

These two issues came to a head in the June 2001 quarter, where Coca-Cola saw revenues fall by 4% year-on-year. The general market negatives were compounded by severe weakness in its German operation, which resulted in the wholesale replacement of the management team and a complete reversal of its previous bottling and marketing strategies.

And yet the company increased earnings by almost \$100M during the quarter.

While Coca-Cola's strengths are generally thought to be on the consumer side of the business – namely, selling – it was the improved performance of its back office operations which drove the result.

**Coca-Cola improvements in key metrics as a percentage of revenue, June quarter 2001/2000**



By cutting 1.7% out of the company's cost base, ex-patriate Australian CEO Douglas Daft delivered the company profit growth in a very difficult quarter.

Unlike the other companies in this analysis, Coke did not grow margins materially for any of its key products. Rather, it grew earnings by a focused approach to costs. And it showed a willingness to act rapidly when its capital was not being adequately utilized in the large German market.