A **Capital Agenda** for confidently facing digital disruption, difficult investors, recessions and geopolitical threats

THE STRESS TEST EVERY BUSINESS NEEDS

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Chapter 15

Will your strategic goals ensure your company reaches its full potential?

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Throughout this book, strategy has been an ever-present and close partner of the Capital Agenda, but it hasn't had to work very hard. With the exception of our discussion of integrating strategy, finance, and operations (Chapter 10) and our deep dive into business strategy in a digital world (Chapter 12), we generally took for granted that a company's strategy was well-defined, value-creating, and properly connected with the rest of the enterprise. In reality, your Capital Agenda needs some heavy lifting from your strategy to fully answer questions like these:

- *Portfolio optimization*. Which of our businesses should we continue to own? Which should we divest? What gaps do we need to fill through building, buying, or partnering?
- *Capital allocation*. How much should we invest organically in each of our businesses? What can we afford to pay for acquisitions?
- *Valuation*. Which of these alternatives do investors favor? What strategic moves could increase our intrinsic value and market value, and reduce the gap between them?

Neither your Capital Agenda nor your strategy can be determined independently of the other. In Chapter 1 we defined the Capital Agenda as a comprehensive approach to managing capital, executing transactions, and applying practical corporate finance tools to strategic and operational decisions. Capital can't be allocated properly and the right transactions won't be executed until strategic decisions are made, including deciding which markets to operate in and how to best serve customers. And strategic alternatives need to be evaluated with the financially disciplined mindset and tools we discussed in Chapters 2 and 3.

To highlight the kinds of rigorous analyses you can perform to help make those strategic decisions, we're going to share a diagnostic tool kit we call the Full Potential Paradigm• (FPP). FPP works with your Capital Agenda to assist in setting operational targets, informing portfolio strategy, and understanding investors' value drivers. Let's start with a short story.

A well-known media company was once a Wall Street darling, growing at 14% annually, based on both overall market growth and taking market share from the competition. But its focus on gaining share led to saturating the addressable market. Growth began to level out as the company reached what management viewed as its full potential.

When the next recession arrived, its market value declined dramatically, as negative GDP growth compounded its market saturation. The company could have followed several strategic initiatives to avoid such a hard hit from the market. It could have taken a more holistic perspective on setting targets, such as improving margins and investing in new services, or acquiring businesses with compelling synergies. The company could also have communicated better with investors to describe how it was reaching a more mature phase of growth that would better align with the market. These actions could have moderated investor expectations, and the market's reaction to the downturn might not have been so dramatic. In the pages ahead we'll describe a structured approach management could have followed.

A good strategy starts with setting the right targets

Reaching your company's full potential involves understanding the various paths to maximizing value, and starts with setting a data-driven strategy built on a robust Capital Agenda. One of your most important roles as a business leader is to establish realistic and achievable goals to guide decisions around choosing what markets to compete in and how. You need to identify and set these targets through a fact-based approach to analyzing what levels of profitable growth and sustainable margins are achievable. This effort employs certain universal concepts—such as business definition, relative market share (RMS), and competitive dynamics—that are relevant across industries and companies of all sizes.

FPP is a proprietary framework with four complementary elements that help illuminate part of the "Which targets should we set?" question:

1. Market context:
    - Have I properly defined my business, and do I understand the overall market and industry?
    - Do I understand the drivers of growth and profitability?
2. Margin performance:
    - Is my current business performing at its full potential?
    - Are the targets I am setting achievable and optimal for enabling the business to reach and sustain its full potential?
3. Growth opportunities:
    - Are our resources and targets aligned to maximize revenue and profit growth for the business?
4. Investor alignment:
    - Am I receiving appropriate recognition from investors for my company's accomplishments? Are market value and intrinsic value aligned?
    - Do I understand the capital markets' expectations for my business?

In today's dynamic and disruptive competitive environment, what CEO doesn't need to know the answers to these questions? And what CEO has solid quantitative answers to these questions in which he or she has a high level of confidence?

To set the stage, it is important to understand that FPP is based on what we call maniacal realism. This term represents our commitment to questioning assumptions and conventional wisdom in search of driving insights about a business.

Defining market context

Defining market context is a critical first step to help ensure your strategic goals fit your business and industry. This exercise identifies the specific industry and competitors, as well as growth and profitability drivers, and answers these questions: Is the industry consolidated or fragmented? Is it consolidating, fragmenting, or stable? What is the basis for competition? Where are the boundaries of your industry under attack? What are competitors' market shares, and how are they changing? Defining your business is often not as straightforward as it sounds, given all the transformation and disruption in the world today. As an example of how complicated things can get: historically, Yellow Cab competed with Checker Taxi and other taxi companies. Today, it also competes with Uber and Lyft. Uber, in turn, is also competing with Amazon (in distribution) and car manufacturers (for transportation solutions). Does that mean Yellow Cab is competing with Amazon, Ford, Toyota, and General Motors?

Business definition takes into account both your business today and where it is headed, starting with a clean slate and not relying on conventional assumptions. The analysis looks at customers, competitors, and costs to identify peers and competitors. Understanding the value chain remains the core requirement, even though value chains have become increasingly complex, shared and digitized.

Mapping your market

An important first step is to create a Market Map of your business's position within its industry that shows individual companies' participation across segments, as well as the level and type of competition. Figure 15.1 maps the global beauty market at a recent point in time and shows the breakout of total industry sales by segment: skin care, hair care, cosmetics, and fragrances. Along the vertical axis are the individual market participants within each segment as a percentage of revenue. Each box on the chart represents a competitor's revenue in a segment.

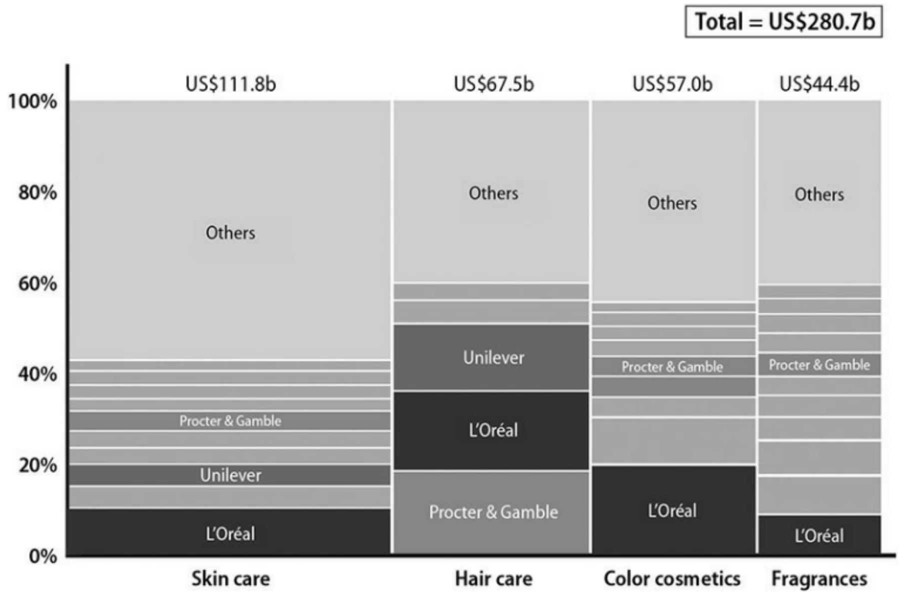

Figure 15.1 Global beauty Market Map.

Note: Companies with <2% market share in a given category are grouped into "Others." P&G's sales include beauty business sold to Coty in late 2016.

Source: EY analysis; Euromonitor.

We can make specific observations and formulate questions to help advance the analysis:

- Does segment market share appear to correlate with profitability?
- Are there smaller competitors that have good profitability? Why?
- What are the benefits of playing in multiple segments?
- Which acquisitions and segment divestments could create the most value?

Further segmenting the market (such as by geography or by men's and women's beauty/grooming) might generate more actionable insights. A full FPP process would determine what level of detail is sufficient, and in practice we suggest continuing until the story doesn't change.

Setting margin targets using the Performance Gap

A Performance Gap analysis examines a company's market position to help develop a rigorous understanding of achievable margins, and alternative paths for reaching them. On the way to setting operating margin targets that are aspirational but achievable, you should be able to answer these questions:

- How is profitability driven by our market position?
  Does being a market leader limit our profitability?

- How do we determine if our performance is sustainable?

For a properly defined business, profitability is driven by RMS,[1] so companies with high RMS should, all else being equal, earn more than those with lower RMS. This is derived from and similar to the experience curve.2 Our research spanning more than 30 years shows that this relationship holds for both cost efficiencies and pricing advantage. In fact, high RMS does not tend to limit revenue growth, which debunks the notion that companies may be "too big to grow."

Figure 15.2 is a diagnostic tool we call the Normative Band, which highlights where a company's profitability is on track, outperforming, or in need of improvement. Here we continue to look at the global beauty retail market. These concepts underpin the analysis:

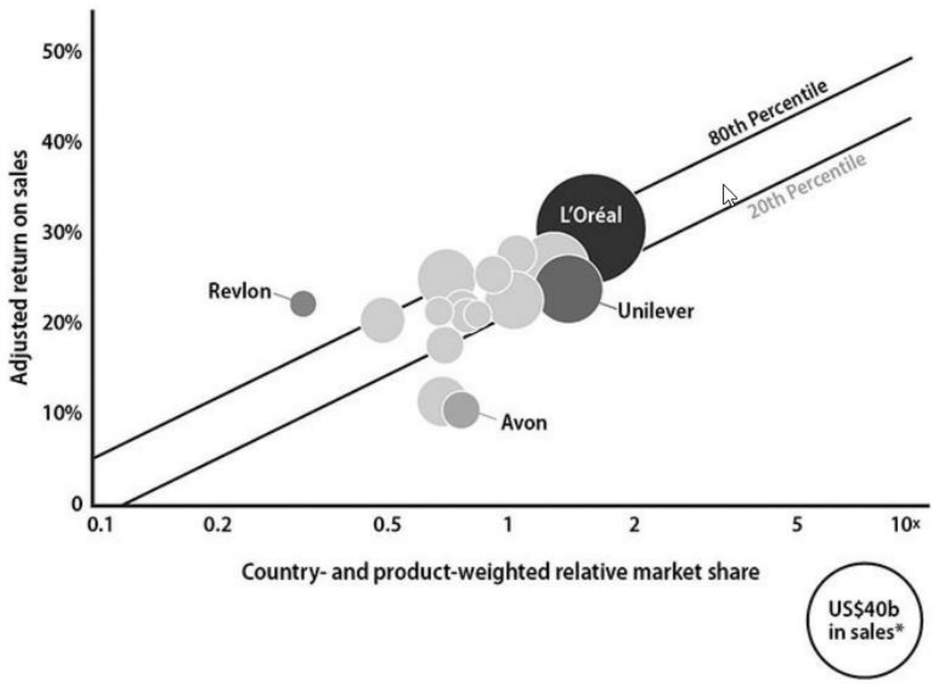

Figure 15.2 Global beauty Normative Band.

*This bubble area = US$40b in sales.

Source: EY analysis; Capital IQ; Euromonitor; analyst reports; company presentations.

- On the horizontal axis, RMS translates individual company market shares to show who in the industry has the most power.
- The vertical axis plots return on sales (ROS) adjusted for nonoperating measures.
- The relationship of RMS to ROS follows the experience curve: profitability should improve by a repeatable fixed percentage over time for each doubling in RMS. In this

example, we see how L'Oréal presents the highest RMS and, as a result, the highest profitability.

- The upper and lower bands (parallel diagonal lines) are relative performance indicators among competitors. We analyzed company data in more than 500,000 observations across several hundred industries. Consistently, exceptional performers usually perform at about the 80th percentile, which is where we draw the top of the Normative Band. Companies in the 80th percentile tend to stay around the 80th percentile with much greater stability than at any other performance level above the median. That makes the 80th percentile a great target because it's stable outperformance but not overperformance. Similarly, competitors falling below the 20th percentile (represented by the bottom of the Normative Band) tend not to recover.

Again, this analysis helps you develop useful hypotheses and questions about both the general market and specific companies, including:

- The first thing you notice is that the firms are highly clustered between 0.5 RMS and 2 RMS, and only one competitor is above the 80% band—the optimal performance. In other words, there are many players with middling margins, indicating a market that may be unstable and ripe for M&A—driven consolidation.
- Further analysis would be required to determine why Revlon is able to have significantly higher margins at significantly lower RMS.
- Is Avon's profitability low because of the cost of direct selling?

Based on where your company lies relative to the Normative Band (between the 20th and 80th percentile lines), there are multiple levers you could pull to reposition by moving up (more profitability) and to the right (greater market share). These potential strategies include acquisitions, divestments, and operational improvements to help achieve sustainable margins.

Setting growth targets with the Opportunity Gap

Where the Performance Gap focuses on business as it is today, the Opportunity Gap analysis shifts that focus to what could be—asking managers to look outside the box, albeit not necessarily very far outside, and often in someone else's box. The analysis works by identifying strategic opportunities that require further organic investment, while also identifying M&A and divestment prospects.

This analysis helps answer the following questions that are central to your Capital Agenda, particularly resource allocation and transaction execution:

- Am I over- or underinvesting in any of my businesses?
- Which of my businesses would benefit most from M&A?
- Are there businesses within my portfolio that are divestments candidates?

The Opportunity Strength Matrix (OSM) compares a business's strategic position to the opportunities available to that business. The notion of comparing strategic position to opportunity is as old as strategy consulting itself. The OSM builds on perhaps the best-known chart in strategy consulting, Boston Consulting Group's venerable Growth Share Matrix,3 which uses a business segment's growth rate as a proxy for its opportunity. Now, decades later, companies can access much richer sources of information and sophisticated analytical tools to better assess market opportunity.

The OSM example in Figure 15.3 replaces the growth rate with a more predictive, industry-specific "opportunity attractiveness." Among the factors that can now be incorporated:

- Industry maturity based on adoption curves.
- Investment flows in converging industries that may be early indicators of disruption.
- Geographic segments with premium price points—for example, in consumer products.

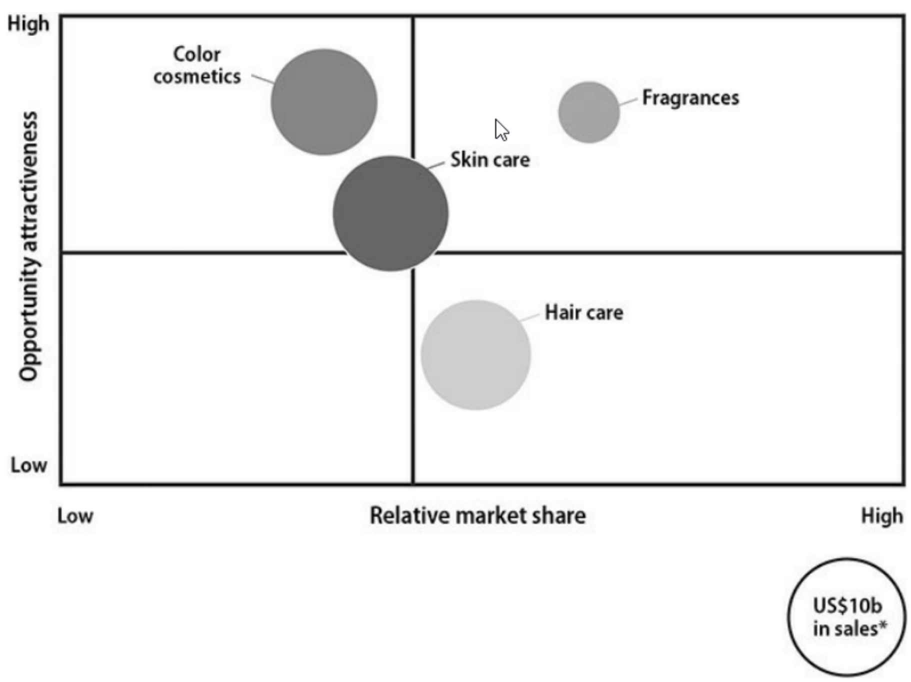

Figure 15.3 Global beauty Opportunity Strength Matrix.

Note: Illustrative example; does not represent an OSM for an actual industry participant.

Figure 15.3 shows that color cosmetics appears as both a current strong competitor and an interesting growth investment. Interestingly, in a traditional growth share matrix, color cosmetics would be least attractive based on its historical growth rate. Conversely, the hair care segment is clearly the least attractive based on the OSM analysis, though its growth rate would be equivalent to the other three businesses.

Aligning with investors via the Perception Gap

The Perception Gap uses regression models to deconstruct a company's market valuation to help align operating targets with investors' perspectives. Market participants rarely reveal all the factors that go into their stock valuations, so this analysis enables management to prioritize resource allocation and deploy capital more in sync with investor priorities. For example, if the company could improve both revenue and margin, but the Perception Gap analysis suggests that margin is a more important market value driver, then that's where management should focus more of its efforts.

The Perception Gap part of the FPP diagnostic supports answers to the following questions:

- Which controllable variables influence market value?
- What is the relative effect on valuation of each of these variables?
- Are our communications with the market in line with expectations and our performance?

Figure 15.4 summarizes a market value drivers analysis looking at various contributions to a company's market capitalization. Underlying the calculations is a sophisticated regression model that incorporates both company-specific and industry-wide variables.

Based on these results, if you were a board member or CEO, you would recognize that growth has historically been highly valued by the marketplace in the form of either revenue or margin over the long

run. Therefore, assuming the same relationships hold into the future, focusing on shareholder payouts over profitable growth would not maximize value.

Full potential value synthesis

Once the business definition is complete and tested, base and stretch targets are established, and we have a core understanding of the drivers of market valuation and investor expectations, we start to model various scenarios for achieving full potential. These strategic options might include anything from incremental improvements to new market entry and to transformative acquisitions and divestments.

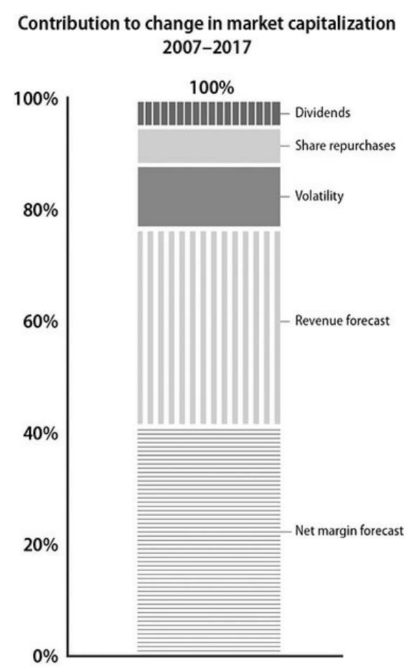

Figure 15.4 **Market Value Drivers analysis**

Source: EY analysis; Capital IQ; Oxford Economics.

Figure 15.5 presents one scenario that examines the effects of two acquisitions on a company. Starting in the lower left and reading the chart from left to right, we can understand:

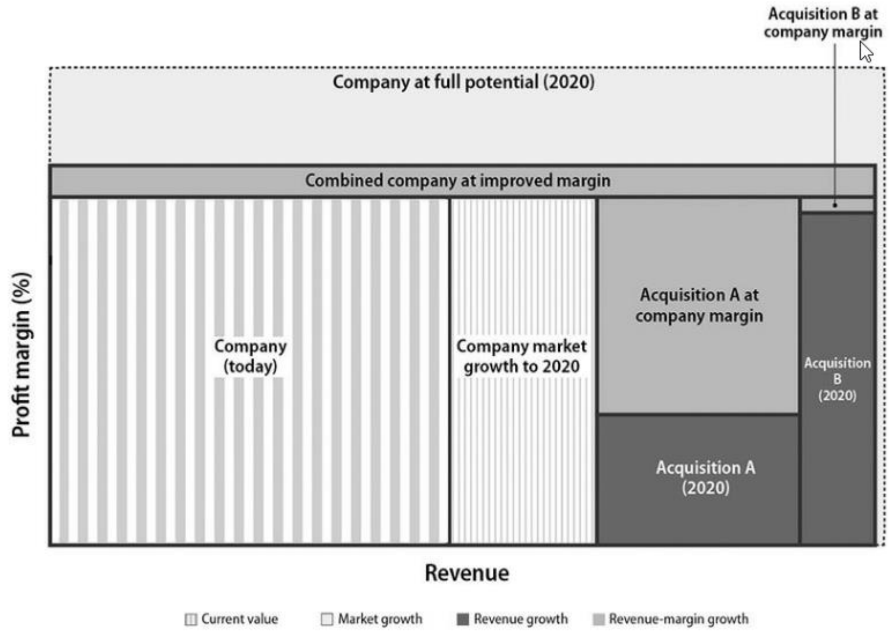

Figure 15.5 Full potential value synthesis

- How the company expects to grow on a stand-alone basis through 2020.
- The disproportionate effect of acquisition A, which would rely heavily on the acquiring company to improve margins, versus acquisition B, where margins would not be an issue.

Then reading up the chart, we see the remaining margin improvement necessary to reach the combined company's full potential value by achieving the 80th percentile in its Normative Band.

By pulling together all four FPP components and visually comparing alternatives, management can explore different combinations of organic initiatives and the sequencing of possible acquisitions and divestments. In this brief tour of the FPP diagnostic, we've seen how detailed and focused analytics help support strategic choices about which markets to invest in and which to exit. Integrating and qualifying these insights with a robust Capital Agenda helps provide actionable perspectives on capital allocation, portfolio optimization, and investor communications.