Creation and Destruction

Sustaining corporate growth in Australia

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Preface

'The problem that is usually being visualised is how capitalism administers existing structure whereas the relevant problem is how it creates and destroys them.' So wrote the great economist Joseph Schumpeter.

See Joseph A. Schumpeter, *Business Cycles: A theoretical, historical and statistical analysis of the capitalistic process* (McGraw-Hill, New York, 1939)

This collection of five short essays examines the process of 'creation and destruction' amongst Australia's top 100 companies. The lead essay was presented as a speech to the AGM of the Business Council of Australia on 22 October 2002.

In **Part 1**, we show that corporations have surprisingly short life spans. Of all the companies that were listed on the original Dow Jones Industrial Average stock index of 1896, only one survives today. And the turnover of companies on Australia's top 100 list since 1990 has been nothing short of astounding. Yet the magnitude, and implications, of this change are not well understood in Australia. Part 1 is a contribution to answering such key questions as:

- *How many companies have survived from the top 100 of 1990?*
- *Which companies have disappeared? Why did they fail to survive?*
- *Which companies climbed into the top 100? Why did they succeed?*
- *What has been the relative profit and share price performance of the newcomers versus the long-term survivors?*
- *How does the radical change in the mix of the top 100 reflect fundamental shifts in the Australian economy?*
- *Why does the new mix give cause for optimism about Australia's future?*

In **Part 2**, we note that while all individual businesses eventually mature, not all corporations must do the same. Enduring corporations find new horizons for growth as old businesses mature and decline. By examining the growth expectations implicit in the share prices of the top 100 companies, we address such questions as:

- *Which companies have growth expectations accounting for more than half of their stock prices?*
- *For which companies does the market have negative long-term growth expectations?*

- *What is the relationship between past performance and future growth expectations?*
- *How has the growth premium changed since the peak of the boom at the end of 1999?*
- *How are stock market growth expectations influenced by a company's growth strategy?*
- *How can the health of a company's growth strategy be diagnosed using the three horizon framework?*

In **Part 3**, we take issue with those commentators who argue that Australia is trailing behind the world in various dimensions of competitiveness and that Australian business risks global irrelevance. The extraordinary change that has occurred, and which will continue to occur, in the top 100 has strengthened Australia's corporate sector. To demonstrate this we offer answers to the following questions:

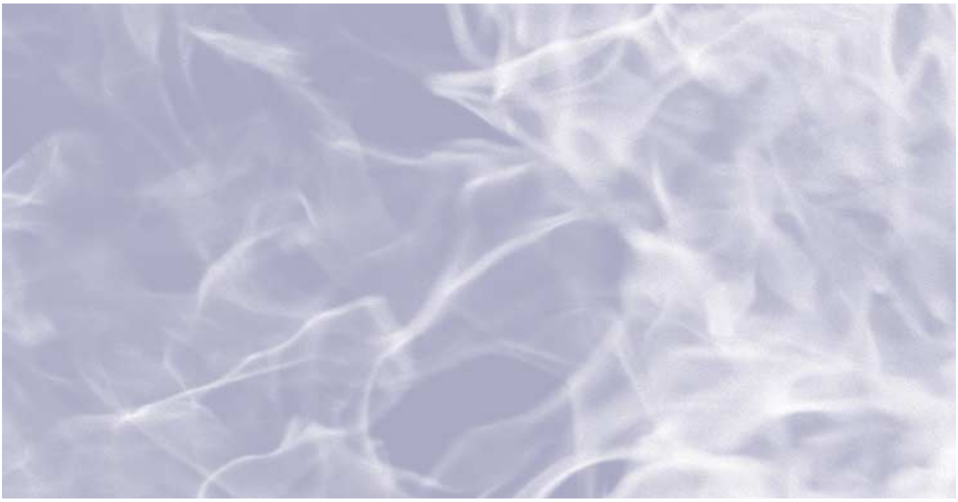
- *How has Australia's economic performance compared with other countries over the past decade?*
- *What has underpinned Australia's performance?*
- *What are Australia's three horizons for growth and what does this imply for Australia's future prospects?*

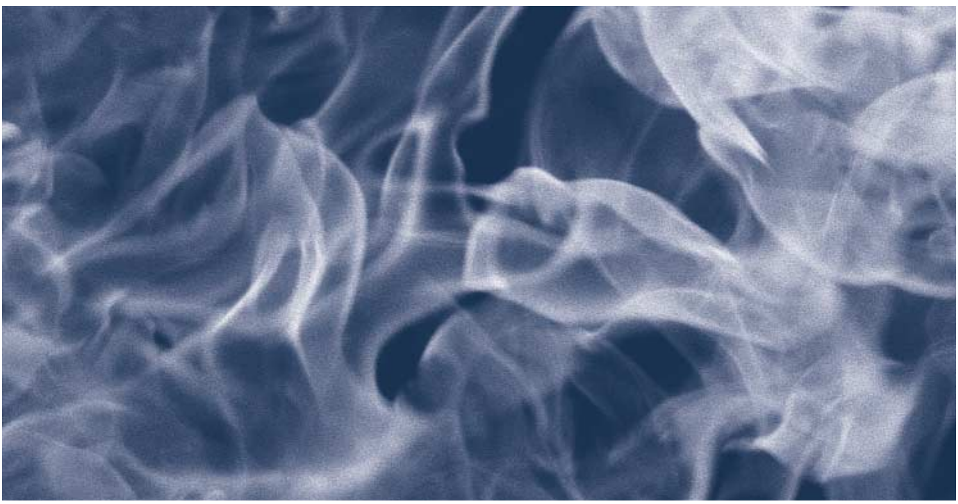
We trust that you will find the perspectives contained in this book to be useful and thought provoking.

David White
Director, Port Jackson Partners
Sydney, Spring 2002

Part 1

Impermanence





Creative destruction amongst Australia's top 100 companies

Philip Stern and David White, with Laura Eadie

This article is adapted from a speech given at the AGM of the Business Council of Australia on 22 October 2002.

Impermanence is a fundamental fact of nature. Living things will die. Matter will change form. No surprise then that the corporations that are important to our lives as providers of products and services, and as providers of employment and income, are also impermanent.

Unlike religious and educational institutions, there are very few examples of important corporate institutions that have survived for multiple centuries. Three of the oldest companies are: Stora, a Swedish pulp and paper manufacturer which began its life as a copper mine in central Sweden more than 700 years ago; Sumitomo Group, which has its origins in a copper casting shop founded in Japan in 1590; and Saint Gobain, which was founded in 1665 in France and built the Hall of Mirrors at the Palace of Versailles. But corporations that manage to survive and prosper for even 100 years are relatively rare.

The rarity of long-term corporate survival is apparent from examining the changes in the composition of leading US stock indices. In 1896, Charles Dow first published the famous Dow Jones Industrial Average stock index. Only one company, General Electric, survives from the original list. Similarly only 18 of the original *Forbes* 100 list from 1917 made it on to the list that was published 70 years later in 1987.

The same conclusion emerges from an examination of the more modern, and widely representative, index of US companies, the S&P 500. Of the 500 companies that constituted this list in 1957, only 74 remained on the list 40 years later in 1997.

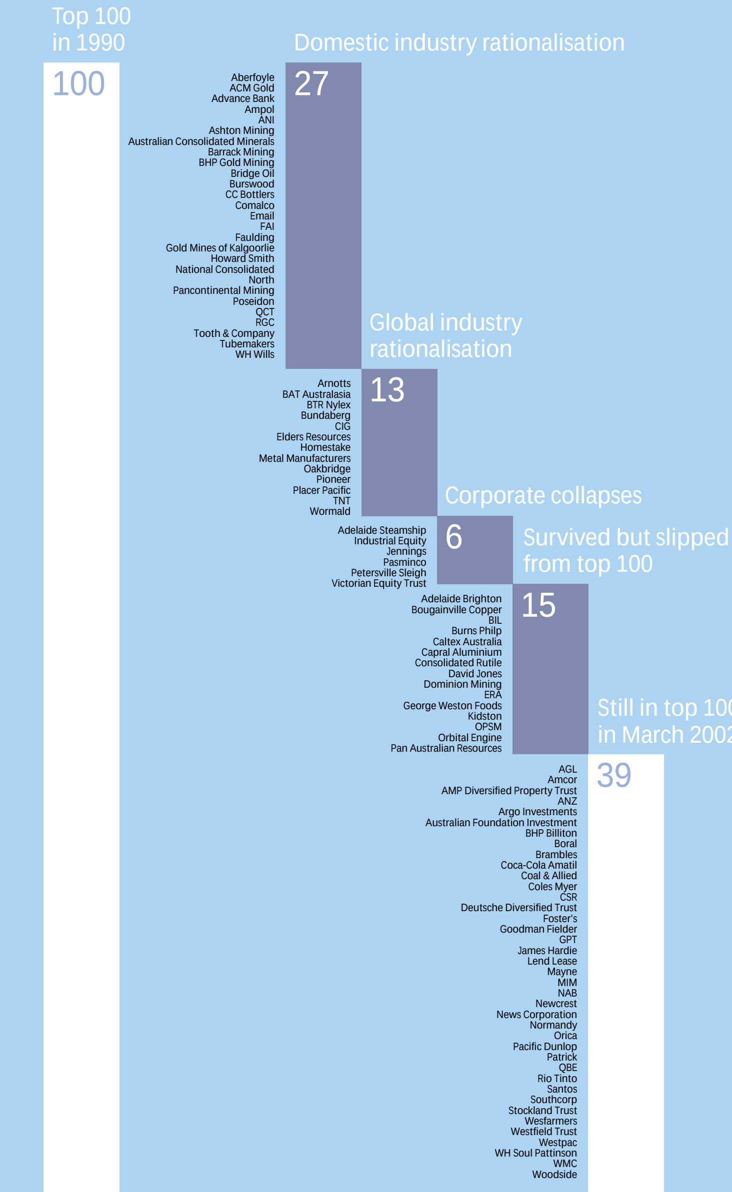
Impermanence in Australia's top 100

Corporate impermanence is not only a feature of the US economy. Of Australia's top 100 companies (measured by market capitalisation) in 1990, only 39 were still in the top 100 list in March 2002 *(Exhibit 1)*.

It is astonishing that almost two-thirds of the top 100 companies from 1990 have disappeared. Why have they disappeared? What lessons can be learned by investors and managers?

Exhibit 1

Survival of the top 100 companies from 1990



Source: Port Jackson Partners

Twenty-seven companies were acquired in **domestic industry rationalisations**. Many of these rationalisations were executed to take advantage of economies of scale and scope. Ampol's merger with Caltex Australia and Advance Bank's with St.George, for example, released substantial value through cost and asset rationalisation. Small natural resource companies were particularly vulnerable, with more than a dozen mining and oil companies falling victim to stronger competitors over the past decade.

The opportunity to improve operational performance, added to the synergies available from scale, drove mergers such as the Wesfarmers takeover of Howard Smith. Industry restructuring to acquire attractive downstream assets characterised other rationalisations, including BHP's buy-out of the minorities in Tubemakers and Smorgon Steel's takeovers of Email and ANI.

Thirteen companies were acquired in **global industry rationalisation** plays driven by foreign companies – feeding the fear felt by some commentators that Australia may become a branch office economy. Foreign-owned parent companies bought out the minorities in Arnotts, BTR Nylex and CIG. Other companies fell to industry specialists seeking to build global presence and scale. For example, Bundaberg was acquired by Belgian group Finasucre, TNT merged with Dutch postal group TPG, Pioneer was bought by Hanson in the United Kingdom and, at the March 2002 cut-off date, Normandy was about to be absorbed by US-based Newmont Mining.

Some might argue that the mergers of BHP with Billiton, Brambles with GKN and CRA with RTZ were global takeovers, but we have treated these companies as Australian top 100 survivors.

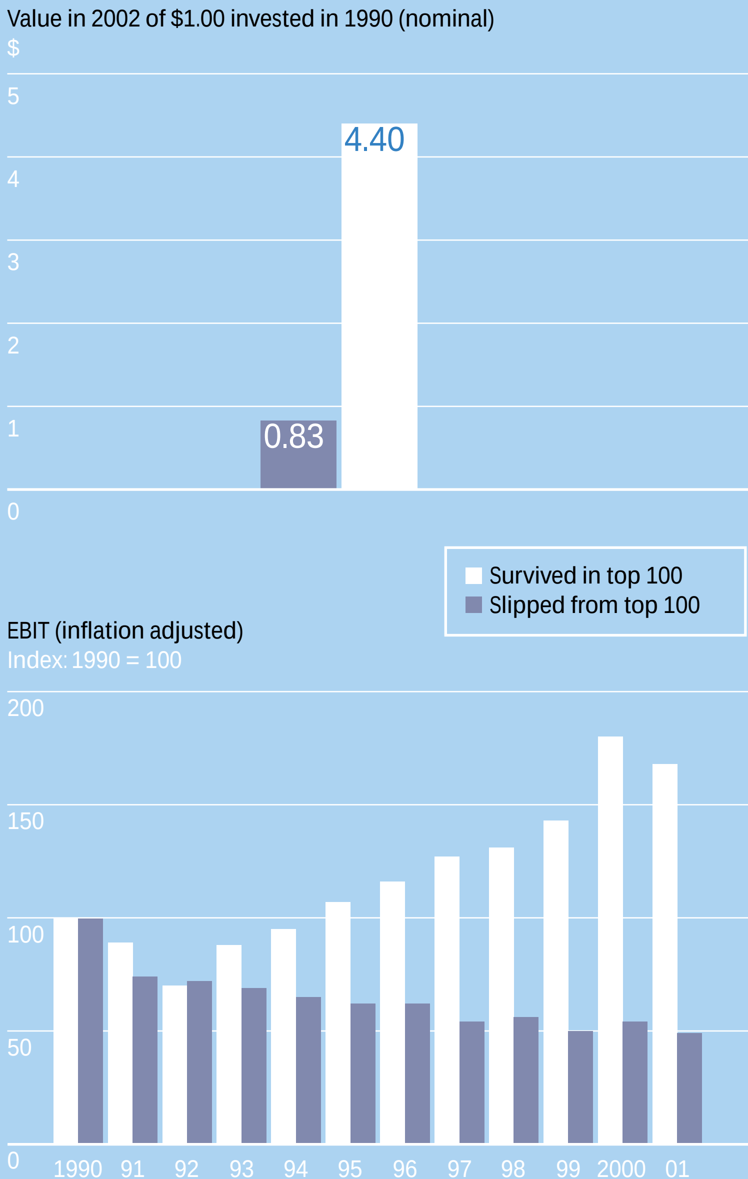
A further six companies disappeared due to **corporate collapses**. Petersville Sleigh, Adelaide Steamship and IEL were the last of the restructurings resulting from the failed entrepreneurial conglomerates in the 1980s. Pasminco is a more recent casualty of over ambitious acquisition and currency hedging transactions.

Finally, there are 15 companies who have **survived but slipped from the top 100**. These companies have failed to keep pace with their peers due to the constraints imposed by low growth industries (eg, Adelaide Brighton, George Weston Foods), lack of imagination, poor strategic decisions (eg, Burns Philp) or external events (eg, Bougainville Copper).

A number of these companies have remained doggedly focused on narrowly defined industries and have condemned themselves to decline with their industry. Focus is not always a sensible strategy.

Exhibit 2

Divergence in performance of the top 100 from 1990



Source: Port Jackson Partners

The failure of these companies to retain their place in the top 100 reflects not only poor performance, but also the reality that to earn and retain a place in the top 100 has become increasingly difficult. In 1990, a market capitalisation of only $333 million (in today's dollars) was sufficient to earn a place in the top 100 (the average market cap was $2.1 billion). To earn a place in the top 100 today requires a market cap of $1.0 billion (the average market cap of the top 100 is $6.5 billion) – a threefold increase in size.

Those companies that remained on the top 100 list since 1990 are distinguished from the survivors who slipped from the top 100 by their superior financial performance. On average, the 396 survivors in the top 100 delivered returns to shareholders from dividends and capital gains of 13 percent a year between 1990 and 2002, compared with negative 2 percent a year for those that slipped from the top 100. The cumulative impact of this difference is stark – if you were to have invested $1.00 in 1990 in the top 100 survivor companies, it would be worth $4.40 today compared with $0.83 for those that slipped from the top 100 group.

This divergence in shareholder returns was driven by poor profit performance. The survivors in the top 100 delivered cumulative growth in EBIT of 68 percent over 12 years, while the EBIT of those that slipped from the top 100 declined by 50 percent *(see Exhibit 2)*.

Newcomers to the top 100

The top 100 has been replenished by the addition of 61 newcomers since 1990 *(Exhibit 3)*. Where did they come from? How have they performed?

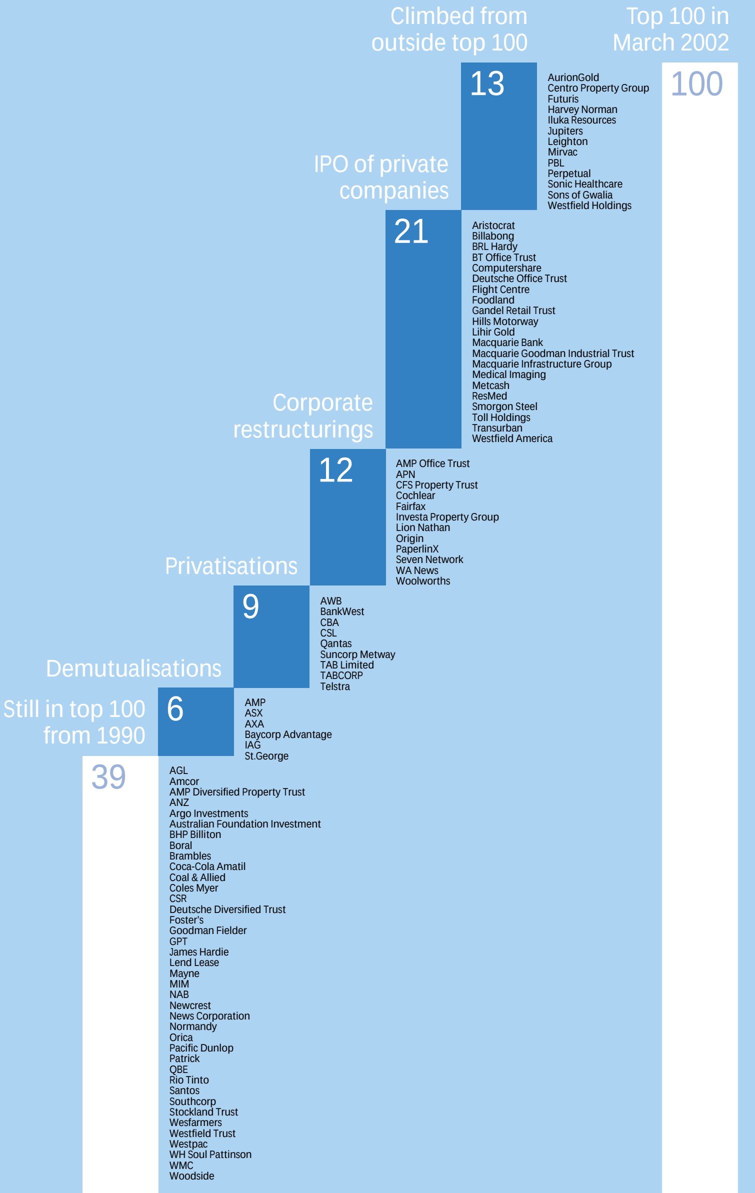
Six companies emerged from **demutualisations**. IAG, AMP, AXA and St.George have been important financial institutions for many years, but entered the top 100 index only after changing their corporate structure from mutuals to public companies. Similarly, ASX and Baycorp Advantage were previously structured as co-operatives owned by their major customers.

Nine companies entered the top 100 after **privatisation**. Over the past decade, the privatisation of Commonwealth and State government assets through trade sale and IPO has changed Australia's corporate landscape. Today, almost 10 percent of the top 100 are former government enterprises, including important companies like Telstra, CBA, CSL and Qantas.

Twelve companies have emerged as independent top 100 companies after **corporate restructurings**. Cochlear was spun off from Pacific Dunlop and radically outperformed its former parent. Origin,

Exhibit 3

Newcomers to the top 100 since 1990



Note: Excludes AMP Shopping Centre Trust, AWB, Billabong, Deutsche Office Trust, IAG, Lihir Gold, PaperlinX and Transurban for which five years data not available.

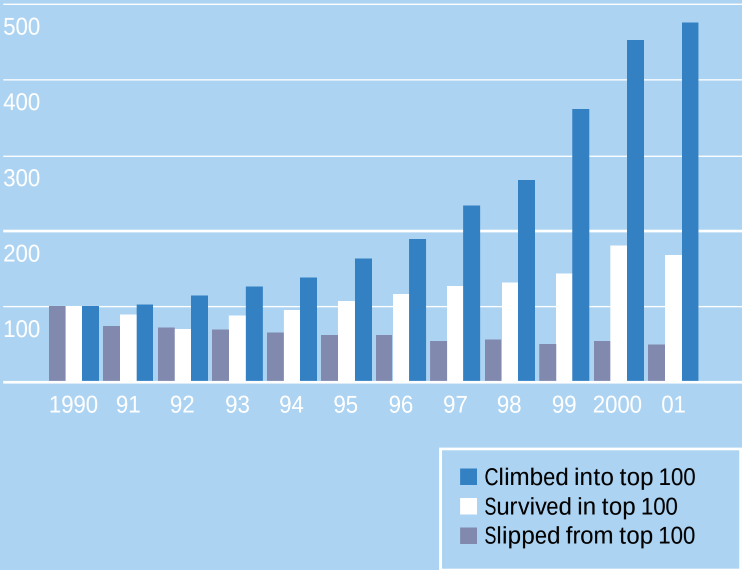
Source: Port Jackson Partners

Exhibit 4

EBIT and revenue growth of companies listed before 1990

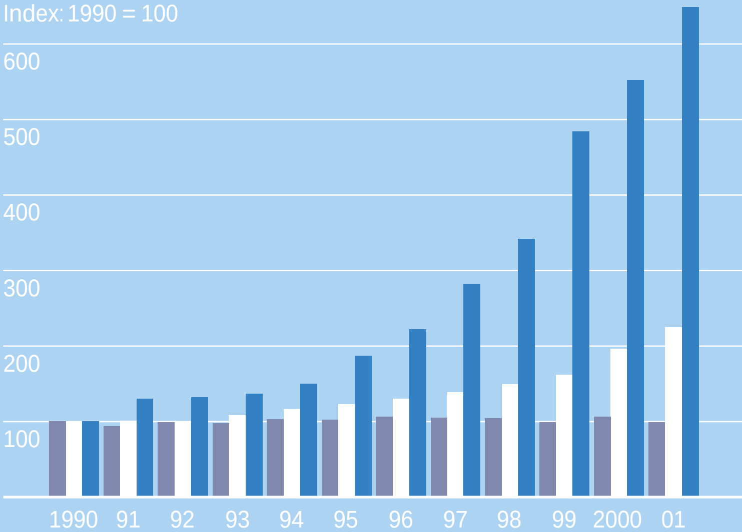
EBIT (inflation adjusted)

Index: 1990 = 100



Revenue (inflation adjusted)

Index: 1990 = 100



Source: Port Jackson Partners

PaperlinX and three property trusts are other examples of spin-offs from listed parent companies. Fairfax, Seven Network, WA News and Woolworths were relisted after the collapse of entrepreneurial parent companies including Quintex, Bell and Adsteam.

Almost two dozen companies entered the top 100 after IPO of **private companies**. Most of these IPOs have been followed by strong growth in revenue and profit. Many of these companies have been star performers. Macquarie Bank, Flight Centre, Toll Holdings, ResMed, BRL Hardy and Aristocrat, for example, have all dramatically expanded their businesses, and provided shareholders with extraordinary returns since listing.

Thirteen companies **climbed into the top 100** after beginning the 1990s outside the top 100. Companies such as Leighton, Westfield Holdings, Perpetual and Harvey Norman have demonstrated sustained and substantial growth in revenues and profits for many years to earn their well-deserved place in the top 100.

The superior financial performance of the 13 companies that were listed prior to 1990 and which subsequently climbed into the top 100 is evident from the exceptional earnings and revenue growth shown in *Exhibit 4*. As a result of this strong financial performance, $1.00 invested in the group of climbers in 1990 grew to $32.40 in 2002 – compared with $4.40 for top 100 survivors and $0.83 for those companies that survived but slipped from the top 100.

Newcomers have outperformed

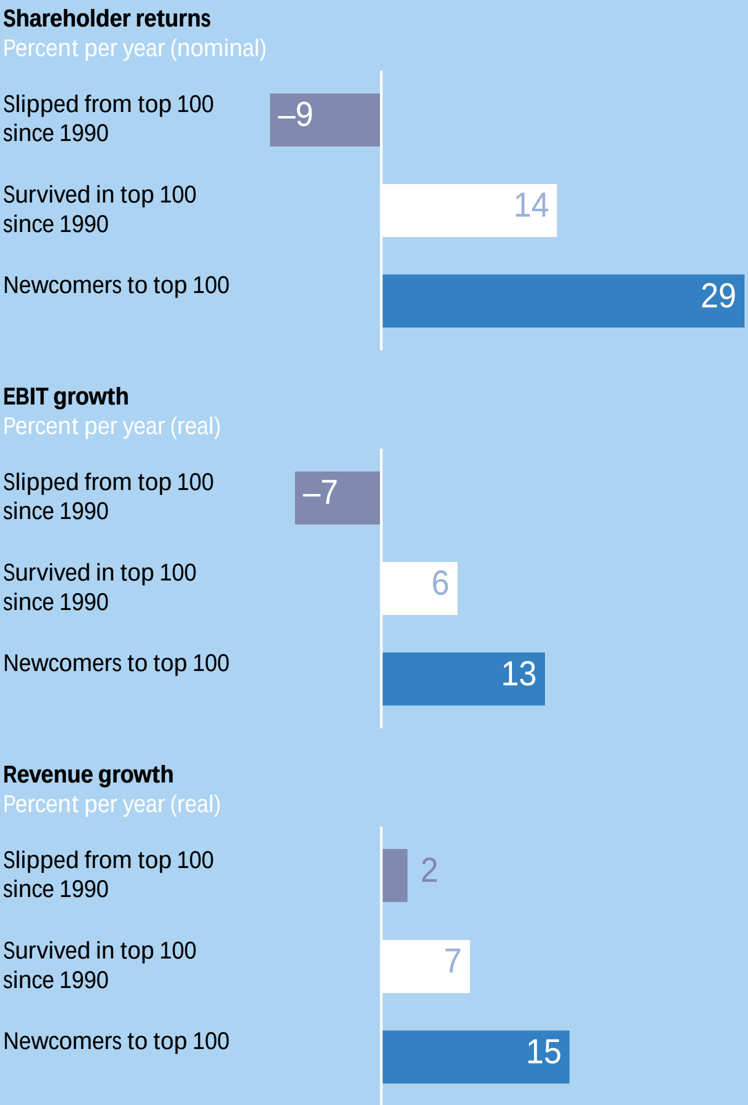
It is not only the 13 companies who climbed into the top 100 that have outperformed. In fact, the group of 61 newcomers to the top 100 (including demutualisations, privatisations, IPOs, restructurings and 'climbers') has dramatically outperformed the older public companies.

The group of newcomers as a whole has delivered returns to shareholders from dividend and capital gains of 29 percent a year over the five years from 1997 to 2002. By comparison, companies that survived in the top 100 from 1990 delivered only 14 percent a year over the same five-year period. Even more disappointing is the negative 9 percent a year return from the group of companies who survived, but slipped from the top 100 since 1990 *(Exhibit 5)*. These superior shareholder returns by newcomers have been driven by strong growth in earnings of 13 percent per year, which in turn has been fuelled by outstanding revenue growth of 15 percent per year.

The emergence of these high growth newcomers has dramatically

Exhibit 5

Superior performance over 5 years by newcomers to the top 100, 1997–2002



Note
Excludes outliers and companies for which five years data not available.

Source: Port Jackson Partners

reshaped the Australian corporate sector since 1990. Today's top 100 is better balanced than the top 100 of 1990, since a greater proportion of companies are operating in growth sectors and industries of the future. In 1990, 80 percent of the top 100 were operating in Australia's successful, but mature 'horizon one' – core industries such as mining and manufacturing. Only 20 percent were operating in the 'horizon two' growth industries in the service sector (for example, financial services, health, communications) and in the knowledge-intensive 'horizon three' industries of the future (such as medical devices and biotech). By 2002, more than half of the top 100 were operating in these higher growth horizon 2 and 3 sectors.

For an explanation of the three horizon concept, see 'Understanding growth expectations: The three horizons of growth' on pp. 28–32

Creative destruction in Australia's economy

The corporate impermanence witnessed in Australia's top 100 is systemic. The economist, Joseph Schumpeter wrote: '*The process of industrial mutation… incessantly revolutionises the economic structure from within, incessantly destroying the old one, incessantly creating a new one. This process of creative destruction is the essential fact about capitalism… The problem that is usually being visualised is how capitalism administers existing structures whereas the relevant problem is how it creates and destroys them.*'

See Joseph A. Schumpeter, *Business Cycles: A theoretical, historical and statistical analysis of the capitalistic process* (McGraw-Hill, New York, 1939)

The 'gales of creative destruction', as Schumpeter called the process, are likely to continue in Australia. Despite stringent policing from the Australian Competition and Consumer Commission, there is no doubt that domestic industry consolidation will continue at pace over the coming decade. The growing strength of the anti-globalisation lobby is unlikely to lower the growth ambitions of leading acquirers in globalising industries. Unfortunately, corporate collapses will occur and CEOs who fail to rejuvenate and reinvent their organisations will see them fall prey to higher performing competitors. These disappearing companies will continue to be replaced by innovators who climb into the top 100, and by new IPOs of high growth private enterprises.

The relentless process of creative destruction witnessed in Australia over the 1990s has positioned Australia to enter the new millennium with a much more robust top 100. More robust because the companies are three times as large in real terms. More robust because of the emergence of many internationally competitive and global enterprises. And more robust because of the profoundly more attractive balance of company types.

RESEARCH NOTE

Creative destruction in the small business sector

David White

The creation and destruction of enterprises has profoundly reshaped the composition of Australia's top 100 companies over the past decade. Yet big business represents only a portion of Australia's economy. The question arises as to whether the astonishing change in the composition of the top 100 is mirrored in Australia's economy as a whole.

The answer is yes. Data from a representative year (1997–98) shows that 463,000 (or 45 percent) of all jobs created in Australia came from the starting up of new firms; while 245,000 (or one-third) of job losses came from the closing down of exiting firms *(Exhibit 1)*.

Of the 463,000 jobs created by new firms, 69 percent were created by small or medium-sized new firms. Conversely 210,000, or 86 percent of jobs lost in exiting firms came from small and medium businesses *(Exhibit 2)*.

There is no doubt that the waves of creative destruction seen amongst the top 100 are also sweeping through the small and medium-sized enterprise sector.

Exhibit 1
Job creation and destruction in Australia, 1997–98

Thousands

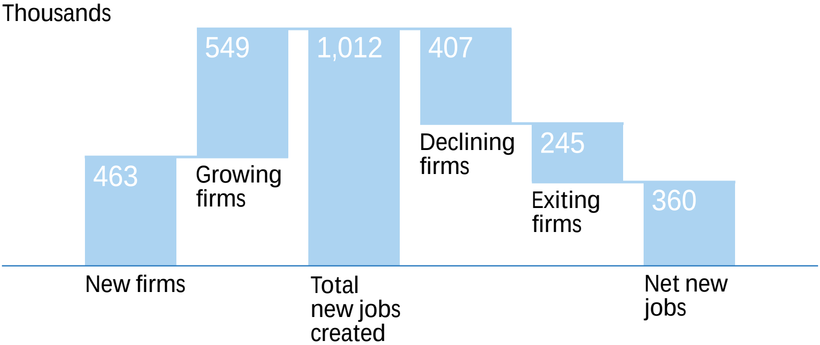
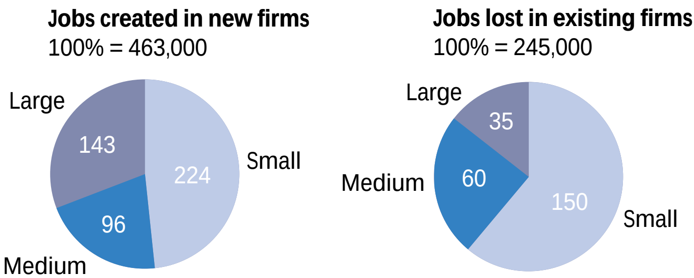


Exhibit 2
Creation and destruction in small and medium-sized businesses, 1997–98

Thousands



Source: *Global Entrepreneurship Monitor, 2001*, p. 19; based on ABS data

Part 2
Growth

Growth expectations for Australia's top 100 companies

Byron Pirola and David White, with Laura Eadie

This article is a reprint of 'Great expectations set challenge for best of teams' first published in *Australian Financial Review*, 19 July 2002.

'It was the best of times, it was the worst of times … it was the spring of hope, it was the winter of despair.' Dickens' famous words, from the opening of *A Tale of Two Cities* published in 1859, might well be used to describe the mood in Australian boardrooms today.

Some argue it is a time for caution. A time for cost cuts. After all, the Australian corporate landscape is littered with the carcasses of collapsed companies. Ansett has followed HIH, Harris Scarfe, Traveland, Franklins, One.Tel, Pasminco and thousands of small businesses into liquidation or receivership over the past year. September 11, Afghanistan and the threat of wars in the Middle East have damaged confidence. The US corporate governance, accounting and ethical issues involving Enron, Andersen, Worldcom, Tyco and Xerox have further eroded trust. Economic growth remains sluggish in the United States, Europe and Japan. Stock markets are down around the world. In the United States, the NASDAQ index is down 73 percent from its peak and the S&P 500 by 38 percent. In Europe, the FTSE Eurotop 300 index is down by 41 percent. In Japan, the Nikkei 225 index is stuck 72 percent off its record high. This is clearly a time to batten down the hatches and to manage conservatively, argue some.

Others argue it is a time for creation. A time to continue initiatives for corporate expansion. Economic growth of 3.6 percent a year in Australia over the past quarter is amongst the highest in the developed world, and the Australian economy has outperformed the United States for a decade. The Australian stock market is only 9 percent off its all-time high. A number of companies are announcing strong profit results. Consumer spending and confidence are sound. Interest rates, while rising, are still low. This is clearly a time to take thoughtful actions to build a new corporate future, argue growth-oriented executives.

So who is right? The Port Jackson Partners Growth League Table provides useful insights *(Table 1 on pp. 22–3)*. On average 18 percent of the market capitalisation of Australia's top 100 local companies is accounted for by expectations of long-term growth. To justify this growth premium, top 100 companies need to deliver 4 percent a year earnings growth for a decade.

Not surprisingly, this valuation is more conservative than it was in the days of the tech boom in August 1999, when growth expectations accounted for 31 percent of market capitalisation – a loss of over $95 billion in market capitalisation if applied across the entire ASX. While the decline in growth expectations can easily be misinterpreted as a call for a strategic shift from growth to cost cutting, we argue that this is an incomplete view. Despite the global shift from boom to uncertainty, Australian stock market investors remain interested in growth companies, and are demonstrably less interested in companies with unclear prospects for long-term prosperity.

At the top of the 2002 growth league table are 20 companies with growth expectations representing more than half of the share price. This is only slightly fewer than in August 1999 when 23 companies were valued as highly. For these companies, profit streams yet to be created are perceived to be worth more than the present value of the profit streams from existing business. High praise indeed. Looked at another way, earnings per share growth of 12 percent a year is needed over the

Growth league table definitions

The growth league table overleaf highlights the growth expectations factored into the share prices of 100 of Australia's biggest domestically-owned companies.

The value of current performance, shown as the white column on the left-hand side, is based on the 'consensus' earnings per share expected by analysts for the financial year 2002 (for companies that have already reported, 2002 actual earnings were used). The value of current performance is calculated as the net present value of these earnings in perpetuity, discounted at the relevant risk-adjusted cost of capital, plus the present value of the future stream of dividend franking credits.

The value of future growth expectation, or growth premium, is shown as the blue bar on the right-hand side. It measures the difference between the share price on 3 July 2002 and the value of current performance. The higher the growth premium, the greater the market's expectations for the earnings growth beyond 2002.

Table 1

Port Jackson Partners Growth League Table (as at 3 July 2002)

Contribution to share price: 100 largest Australian companies

Contribution to share price (%)		Company by rank		Share price ($ per share)
	100	1	Transurban	4.05
18	82	2	Newcrest	7.09
24	76	3	News Corporation	9.60
25	75	4	James Hardie	6.62
30	70	5	Flight Centre	26.50
32	68	6	Westfield Holdings	15.01
32	68	7	Cochlear	34.38
33	67	8	CSL	31.60
33	67	9	MIM	1.31
36	64	10	Patrick	16.51
38	62	11	Brambles	9.45
39	61	12	Sonic Healthcare	5.00
40	60	13	Toll Holdings	30.73
42	58	14	Computershare	2.13
43	57	15	Harvey Norman	3.05
44	56	16	Spotless	4.30
47	53	17	ASX	13.27
48	52	18	Lend Lease	10.67
48	52	19	Fairfax	3.23
49	51	20	ResMed	4.85
51	49	21	Seven Network	5.56
52	48	22	WMC	9.10
53	47	23	Macquarie Bank	27.89
56	44	24	PBL	8.72
56	44	25	IAG	3.13
56	44	26	Perpetual	42.60
58	42	27	Lihir Gold	1.27
60	40	28	AurionGold	3.74
60	40	29	Aristocrat	5.54
64	36	30	Amcor	8.26
66	34	31	Billabong	8.53
67	33	32	Jupiters	5.44
67	33	33	WA News	5.17
68	32	34	BRL Hardy	8.79
68	32	35	BHP Billiton	10.15
69	31	36	WH Soul Pattinson	59.00
70	30	37	Southcorp	5.26
71	29	38	Telstra	4.78
73	27	39	Origin	3.29
73	27	40	Wesfarmers	27.70
73	27	41	APN	3.56
73	27	42	Leighton	10.14
74	26	43	Normandy NFM	15.50
75	25	44	Coca-Cola Amatil	6.50
76	24	45	AMP	15.46
76	24	46	Woolworths	12.61
79	21	47	Sons of Gwalia	5.76
81	19	48	TAB Limited	3.14
82	18	49	St.George	19.01
82	18	50	Metcash	2.20

Value of current performance
Growth expectations

Contribution to share price (%)		Company by rank		Share price ($ per share)
84	16	51	Coles Myer	6.63
85	15	52	CBA	31.66
87	13	53	TABCORP	12.48
88	12	54	Qantas	4.55
93	7	55	Westpac	16.03
93	7	56	PaperlinX	4.89
95	5	57	Ansell	6.61
95	5	58	ANZ	18.90
98	2	59	Mayne	4.02
98	2	60	Boral	3.66
98	2	61	National Foods	3.60
99	1	62	Suncorp Metway	12.03
100		63	NAB	33.70
102		64	Stockland Trust	4.43
102		65	Westfield Trust	3.45
102		66	BankWest	4.26
104		67	Investa Property Group	2.10
104		68	Foster's	4.66
105		69	Westfield America	2.03
105		70	Centro Property Group	3.62
106		71	GPT	2.84
107		72	Mirvac	4.19
108		73	Foodland	18.36
109		74	CSR	6.40
109		75	Woodside	13.29
109		76	Gandel Retail Trust	1.22
109		77	AXA	2.63
110		78	AMP Shopping Centre Trust	1.40
110		79	Orica	9.57
111		80	BT Office Trust	1.49
111		81	Coal & Allied	26.50
112		82	Smorgon Steel	1.18
112		83	AMP Diversified Property Trust	2.63
114		84	AMP Office Trust	1.20
115		85	Deutsche Diversified Trust	1.17
115		86	QBE	6.72
117		87	Iluka Resources	5.00
118		88	AGL	9.49
118		89	Lion Nathan	4.74
118		90	Deutsche Office Trust	1.28
121		91	CFS Property Trust	2.21
122		92	ING Office Trust	1.23
123		93	ING Industrial Trust	1.64
126		94	Santos	6.45
127		95	Macquarie Office Trust	1.32
127		96	Goodman Fielder	1.69
135		97	AWB	3.74
139		98	Macquarie Goodman Industrial Trust	1.43
139		99	Macquarie Infrastructure Group	2.82
159		100	United Energy	2.15

Source: Thompson Financial Datastream, CommSec, Port Jackson Partners next decade to justify a growth premium representing half of the current share price. Those companies with growth representing three-quarters of the current share price, will need to grow EPS at around 23 percent a year for a decade.

While a few companies in this group have a high growth premium due to expectations of a takeover or a cyclical turnaround, most are being rewarded for the strength of their growth horizons. Most can demonstrate good profitability in existing horizon 1 core businesses, as well as rapidly emerging horizon 2 growth engines and a portfolio of horizon 3 growth options.

The most remarkable change since the peak of the boom is that, at the bottom of the table, the market is more severely penalising those companies that are perceived to lack strong growth engines. Some 37 companies have a negative growth premium, up from 11 companies in 1999. For these companies the market's judgement, right or wrong, is that current profit streams are unlikely to be maintained in the long term.

The management challenges presented by future expectations can be better understood in the context of past performance. *Table 2* divides the top 100 into six groups according to their track record of delivering growth in share price and earnings over the past five years (vertical axis), and the market's expectation for future growth (horizontal axis).

The most impressive group is the **high flyers** in the top right corner of Table 2. Growth expectations for this group are very high, accounting for over half of the share price. Their historical track record is also very strong. On average over the past five years, the companies in this group have delivered compound annual growth in EPS of 33 percent a year, and returns to shareholders from share price gain and dividends of 44 percent a year.

These companies have not ignored the imperative to contain costs. But in addition, all have established strong horizon 2 growth momentum through the replication and extension of successful business models. They have not been slowed by the uncertain global environment of the last year. For example, Patrick has raised over $660 million of capital to position itself for bold initiatives in buying half the National Rail, FreightCorp and Virgin Airlines assets. Flight Centre continued its strategy of growth through the international rollout of its highly productive airline ticket retailing formula, and raised $50 million last year to help fund its bid for the corporate travel specialist ITG. Westfield Holdings, through its affiliate Westfield America, raised an astonishing

Table 2

Port Jackson Partners growth segmentation (as at 3 July 2002)

	Low growth expectations	Medium growth expectations	High growth expectations
Above average track record	**Running out of steam** AGL AMP Office Trust ANZ Coal & Allied Foodland Foster's Iluka Resources Macquarie Infrastructure Group Mirvac NAB National Foods Qantas Suncorp Metway TABCORP United Energy Westfield America Westpac Woodside	**Strong performers** APN Aristocrat BRL Hardy CBA Jupiters Leighton Macquarie Bank Origin Perpetual Sons of Gwalia Southcorp TAB Limited Telstra Wesfarmers Woolworths	**High flyers** ASX Cochlear Computershare CSL Flight Centre Harvey Norman James Hardie Patrick ResMed Sonic Healthcare Spotless Toll Holdings Westfield Holdings
Below average track record	**The pack** AMP Diversified Property Trust Ansell AXA BankWest Boral BT Office Trust Centro Property Group CFS Property Trust CSR Deutsche Diversified Trust Gandel Retail Trust Goodman Fielder GPT ING Industrial Trust ING Office Trust Investa Property Group Lion Nathan Macquarie Goodman Industrial Trust Macquarie Office Trust Mayne Orica QBE Santos Smorgon Steel Stockland Trust Westfield Trust	**Hopefuls** Amcor AMP AurionGold BHP Billiton Coca-Cola Amatil Coles Myer Metcash Normandy NFM PBL Seven Network St.George WA News WH Soul Pattinson WMC	**Takeoff** Brambles Fairfax Lend Lease MIM Newcrest News Corporation

Source: Thompson Financial Datastream, CommSec, Port Jackson Partners

$2.4 billion in January 2002 to fund its Rodamco North American shopping centre acquisition. CSL, ResMed and Cochlear continued their rapid global expansions and R&D investments. Harvey Norman is continuing its industry changing rollout of a 'big box' retail format.

The challenge for the high flyers is to sustain growth at a rate that continues to justify the high growth premium built into their share prices. These companies are on an expectation treadmill. To simply hold share price steady at today's levels they need to deliver on large expectations. The only way to lift share price is to surprise the market with better than expected results. And any deviation from the 12 to 25 percent a year earnings growth expected by the market is immediately punished with a sharp fall in share price. Computershare and Sonic Healthcare, for example, plummeted after disappointing analysts' expectations. Even companies with excellent records of strategic execution (such as ResMed) have seen major price falls as the market winds back their PE ratios. While all management teams aspire to be recognised as a member of the high-flyer group, having got there the challenges do not get any easier.

The companies in the **takeoff** group also have growth expectations of over half their share price, but lack the high flyers' track record over the past five years – delivering EPS growth of 15 percent and shareholder returns of 7 percent a year. The group includes some turnaround stories such as MIM, as well as companies expected to benefit from cyclical earnings upturns such as Fairfax. The challenge for companies in this group is to create an earnings trajectory to justify the high growth premium.

The **strong performers** and the **hopefuls** groups both show moderate growth expectations between 15 and 50 percent of share price. The **strong performers** have a track record of above average performance over the past five years, delivering EPS growth of 14 percent and shareholder returns of 25 percent a year. Companies such as Wesfarmers are rightly perceived as reliable performers with plenty of continuing momentum.

The **hopefuls group**, by contrast, has recorded below average growth in EPS of zero percent a year and in shareholder returns of 9 percent a year. The hopefuls group includes companies such as Coles Myer and Coca-Cola Amatil where the market is betting on new management to lift performance. The prize for the hopefuls is to deliver performance that lifts them into the solid performer category, and ultimately to earn a re-rating into the high flyers group. The risk is that they could fall back into the pack if the market is not soon convinced that a sustainable lift in growth trajectory is emerging. Such has been the path for Mayne in the first half of 2002 as the market reassessed prospects for sustained turnaround after profit disappointments.

The top left corner of Table 2 lists the companies that are either **running out of steam** or **undervalued**. These companies have a low growth premium of less than 15 percent of the share price, despite a good track record of growing EPS at 14 percent a year and shareholder returns at 18 percent a year over the past five years. The big banks, for example, have all delivered well through disciplined cost reduction, substantial fee increases, and extension into faster growing segments such as funds management. Others, such as TABCORP, Suncorp Metway, Foodland and Macquarie Infrastructure Group have been travelling with strong tailwinds, which the market seems to believe are not sustainable. There are likely to be some undervalued stocks in this group. The challenge for all companies in this group is to maintain their historic momentum and demonstrate that they deserve a higher growth premium than the market is currently willing to award them.

The remaining companies are collected into **the pack** in the bottom left corner. They are distinguished neither by high forward-looking growth premiums nor by strong historic track records. On average, EPS growth has been 1 percent and returns to shareholders have been 9 percent a year. While some have strategy or management difficulties to work through, placement in this group does not necessarily imply poor management. Many members of this group are property trusts, a special asset class designed to deliver stable dividends with low risk. Other companies are constrained by low growth industries like food, building materials and beer. Some are simply undervalued. The challenge for companies in the pack is to overcome inertia and create confidence in new growth initiatives.

Whatever a company's position, two things are clear. Growth is important. And growth is difficult. Whether the challenge is to lift a company out of the pack, or to justify the company's position as a high flyer, management will need creativity, discipline and courage.

Understanding growth expectations: The three horizons of growth

David White and Mehrdad Baghai

This is an abridged version of an article, 'Plan your pot of gold over horizon' first published in *Australian Financial Review*, 13 August 1999.

Whether you like it or not, the stock market is valuing the growth potential of your company every day. The share prices of some Australian companies have a giant growth premium built into them. If they don't fulfil these expectations, their shares are in for a tumble. Other companies on the stock market have small or negative growth expectations. If these companies are to boost their stock prices, they will need to prove to the market that they are developing new streams of revenue and profits. Australia's companies must focus not only on costs, but also on sustained profitable growth and its primary source – new business creation.

Some stocks have surprising results in the growth league table *(see pp. 22–3)* that may be explained by an overzealous or overcautious market. But the market cannot be wrong all the time. What is it then that can adequately explain how one company can be expected by the market to have a rosy future while a seemingly similar company does not?

The three horizons of growth

Editor's note The three horizon framework referred to in several places in this book was developed by McKinsey & Company and published in *The Alchemy of Growth: Kickstarting and sustaining growth in your company* by Mehrdad Baghai, Stephen Coley and David White (Orion Business, 1999).

The answer – as explained in the book, *The Alchemy of Growth* – is that as a company's businesses and revenue streams mature, it must have others ready to take their place. If continual growth is the goal, the pace of replenishment must be faster than the pace of decline. To sustain growth, there must be a continuous pipeline of new businesses that represent new sources of profit.

What distinguishes the corporations that carry on growing is their ability to create these businesses. They can innovate in their core businesses and build new ones at the same time. What they have mastered is the art of managing their pipeline so that fading sources of growth are replenished at exactly the right moment.

Imagine a company that has had sustained profitable growth for more than a decade. Its core businesses are already out of the pipeline, operating as fully developed profit generators. Inside the pipeline are younger businesses that are showing substantial growth in revenue (and perhaps in profits too). Further back in the pipeline are businesses in an earlier stage of formation. The pipeline thus contains emerging and future businesses to supplement the company's existing core businesses.

A healthy pipeline is a feature of all growth-sustaining companies. Unfortunately, companies boasting such a pipeline are the exception. Enterprises seeking to sustain growth cannot afford to leave gaps between the decline of one business and the ascent of another. Yet that is precisely what many companies do. Building and managing a continuous pipeline of business creation is the central challenge of sustained growth.

What makes this task harder is that the risks and management challenges involved change as a project progresses down the pipeline. To see how, it is helpful to break down the business creation process into three stages. A three-stage pipeline is useful in that it allows us to distinguish between the embryonic, emergent and mature phases of a business's life cycle. We refer to these stages as the three horizons of growth. Each horizon represents a different stage in the creation and development of a business. And each calls for radically different business initiatives *(see Exhibit 1 overleaf)*.

Horizon 1 encompasses the businesses that are at the heart of an organisation – those that customers and stock analysts most readily identify with the corporate name. In successful companies, these businesses usually account for the lion's share of profits and cash flow. Horizon 1 businesses are critical to near-term performance, and the cash they generate and the skills they nurture provide resources for growth. They usually have some growth potential left, but will eventually flatten out and decline.

Management's primary challenge in horizon 1 is to shore up competitive positions and capture what potential remains in the core businesses. Even when these are mature, continuing innovation can incrementally extend their growth and profitability. Traditional sales-force stimulation programs, product extensions and marketing changes can all contribute. Restructuring, productivity enhancement and cost-reduction measures will also help maintain healthy performance for as long as possible.

By the time a business matures into horizon 1, the initial strategic insight will have been long recognised by competitors, and early positional advantages may well be eroding. Survival depends on

Exhibit 1
The three horizons of growth

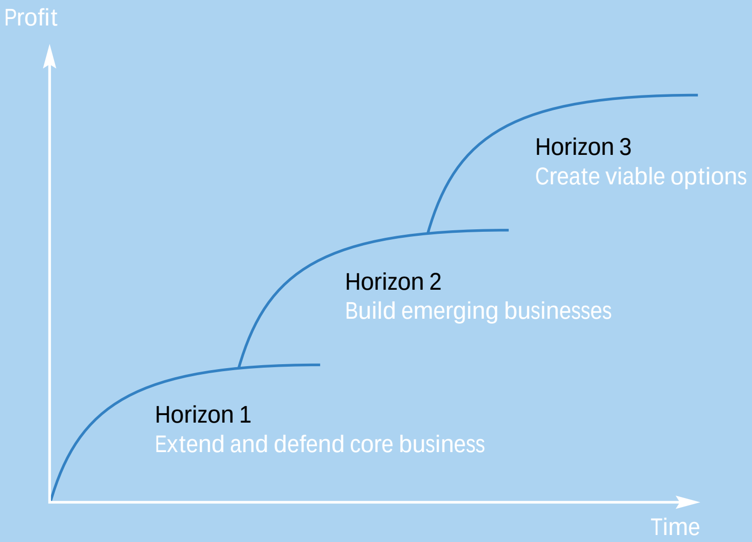


Exhibit 2
Six common unhealthy patterns

✓ Healthy
✗ Unhealthy

Horizon	**1**	**2**	**3**
Under seige	✗	✗	✗
Losing the right to grow	✗	✓	✓
Running out of steam	✓	✗	✗
Inventing a new future	✗	✓	✗
	✗	✗	✓
Generating ideas but not new businesses	✓	✗	✓
Failing to seed for the future	✓	✓	✗

Source: Baghai, Coley and White, *The Alchemy of Growth* (Orion Business, 1999) superior execution. Great discipline is required in operations, planning and budgeting to increase profitability.

Horizon 2 comprises businesses on the rise: fast-moving, entrepreneurial ventures in which a concept is taking root or growth is accelerating.

The emerging stars of the company, these businesses are attracting investors' attention. They could transform their company, but not without considerable investment. Though substantial profits may be four or five years away, they have fast growing customer bases and revenues, and may already generate some profit. More importantly, they are expected to become as profitable as horizon 1 businesses in time.

Horizon 2 initiatives are usually characterised by a single-minded drive to increase revenue and market share. They need continuing investment to finance rollouts or otherwise accelerate the expansion of the business. In a few years, horizon 2 initiatives should complement or replace a company's current core businesses.

The challenge is to take advantage of an insight before competitors do. The focus shifts to building the business quickly and establishing positional advantage. The pace becomes frenetic as increased risk taking, rapid judgement calls and larger investments become necessary.

Horizon 3 contains the seeds of tomorrow's businesses – options on future opportunities. Although embryonic, horizon 3 options are more than ideas – they are real activities and investments, however small. They are the research projects, test-market pilots, alliances and minority stakes that mark the first steps toward actual businesses, even though they may not produce profits for a decade, if ever. Should they prove successful, they will be expected to reach horizon 1 levels of profitability.

Building successful businesses means seeding numerous options. Some will fail for internal reasons; others will fall victim to shifting industry winds. Given these odds, a great deal of horizon 3 activity is needed.

If we look at the bottom of the growth league table on pp. 22–3, we have many companies whose growth expectations are negative. What is the market's judgement here? These companies will have difficulty adding any value to the assets they control, and that the inevitable attrition of old businesses will proceed faster than the creation of new businesses to replace them. Clearly, some of these companies do have a set of initiatives to move ahead and some have been harshly misjudged by the market. But few of them are as healthy as those in the top quartile.

For a company to grow it must have three healthy horizons. We see six common patterns that can prevent sustained growth – two of which we discuss below. These are shown in *Exhibit 2* on p. 30.

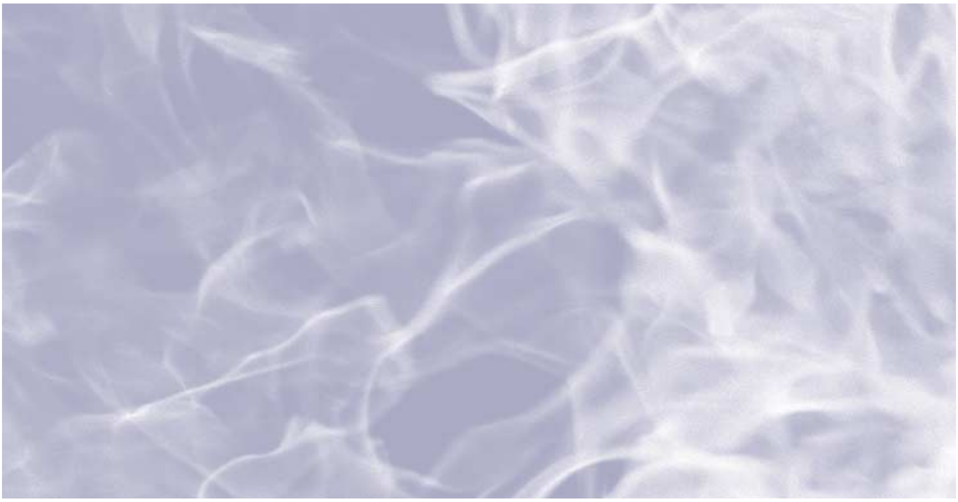
The first and worst of the patterns is when a company is 'under siege'. Here the core businesses of horizon 1 are underperforming, threatened by competitors, or facing imminent decline. Little is happening in the pipeline, so no new businesses are available to pick up the slack. Companies under siege suffer a double blow: not only will financial markets punish them for earnings decline, but investors will also look unfavourably at the capital investments they need to develop new businesses. The priority should be on survival and turnaround, not on growth.

While every unhealthy pattern is a concern for a company, perhaps most common in businesses globally is 'running out of steam'. In this pattern, performance is not usually a problem – the company is often a respected, high-performing organisation. The problem is that it is unclear where future growth will come from because improvements to horizon 1 businesses are experiencing diminishing returns and there are no new drivers of growth in horizons 2 or 3. What is needed is a dedication to growth to equal the dedication to operating performance. There is no better time to resolve to grow than when the core is strong.

Changing trajectory

There is good news, though. It is possible to go from a bad situation to a good one – and this holds true even in the slower growing industries. For example, Foster's turnaround from its 1992 nadir – a company in crisis in a single mature industry to a well-regarded and growing company – is a strong demonstration of the potential to create new horizons of growth.

Australia's companies must do more to create growth. This is clear when one sees that a large number of the country' s top 100 companies have growth expectations of 10 percent or less. Developing healthy horizons in small, medium and large companies will translate to faster economic growth, more shareholder wealth for investors, including retirees and more jobs and greater prosperity for the country. It will help reduce our most pressing social problem – chronic youth unemployment and the disillusionment it spawns. By creating a sense of purpose, achievement and belonging, growth can create a more enriching work environment for all Australians.



Part 3
Australia's future

Australia's growth horizons in the new millennium

David White, Mehrdad Baghai and Belinda Everingham

This is an abridged version of an article, 'Enterprise creation is imperative to success' first published in *Australian Financial Review*, 20 August 1999.

Australians can rightfully take pride in the performance of their economy. The country's gross domestic product growth rate this decade has been higher than most other countries in the Organization for Economic Development and Cooperation, including the United States *(Exhibit 1)*.

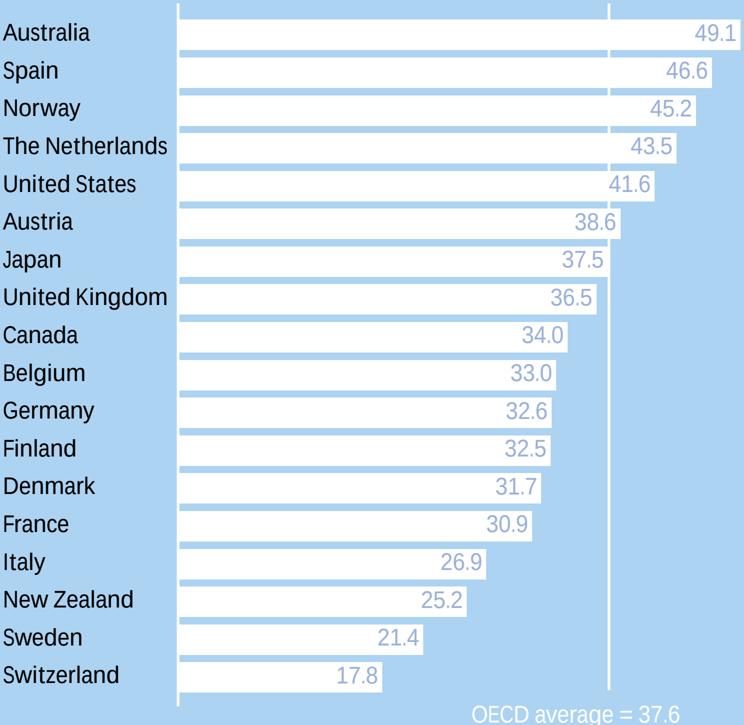
Australia's economy grew an astounding 49 percent between 1985 and 1998 compared with the OECD average of 38 percent. And even though the perception is that the Australian labour market is not as healthy as in the United States. Australia's rate of job creation has in fact been equivalent to that of the United States during the 1990s *(Exhibit 2)*.

How has Australia achieved this surprising growth? Economists attribute the success to 'productivity improvements' and 'structural adjustments' encouraged by reductions in tariffs and quotas, exchange rate flotation, competition policy, privatisations and financial and labour market deregulation. These government-led reforms offered the Australian corporate sector the chance to become more productive, and many companies have worked hard to streamline and cut costs. Indeed the 1999 Productivity Commission report found that Australia's productivity growth has been a massive 2.4 percent annually for the previous four years, compared with a long-term average of 1.4 percent.

But there is more to improving productivity than cutting costs in existing businesses: the creation of new businesses employing superior technology or better business models can also make an economy more productive *(Box A overleaf)*. Indeed, in recent years, the Australian economy has benefited from a big increase in revenues and employment coming from the creation of productive new businesses; many of them in newer sectors of the economy.

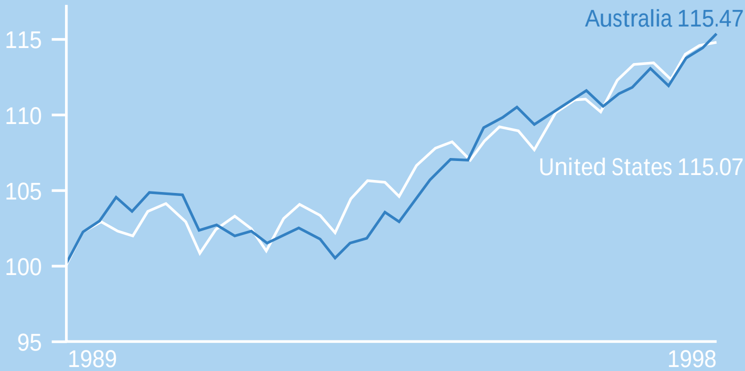
Yet many corporate executives in Australia still view cost cutting as the main tool for improving financial performance. It surely is easier than inventing new business models and creating new businesses. There

Exhibit 1
Cumulative GDP growth in the OECD, 1985–98
Percent



Source: OECD, McKinsey

Exhibit 2
Comparison of Australian and US growth in employment
Index: Common base = 100



Source: WEFA

Box A
The link between GDP, productivity and business creation

In an economist's definition, growth in GDP can be driven by the application of additional inputs of labour and capital or by an increase in output per unit of input (ie, productivity).

Productivity increases in turn can occur equally through the reduction in cost of the existing businesses, or through the start-up of fundamentally superior new business models. These new businesses are capable of meeting consumer needs with fewer resources than existing business because of application of superior technology or business system design.

Creation of more productive new enterprises – through new start-up companies and through the reinvention of established companies – has been a key driver of our superior economic performance over the past decade. And new business creation will continue to be a vital driver of Australia's economy for the next decade

always will be room for squeezing costs. But sustaining Australia's economic success will require entrepreneurs, the corporate sector and government to take action now to encourage creation of enterprises. That means putting business creation at the top of the economic agenda.

To see where the Australian economy stands, we examined it the way we usually assess the health of a company. We broke down the economy into 'horizons of growth' *(Box B)*.

Just as the three horizons approach explains the growth trajectory at a company, the concept can also be useful in assessing the health of an economy – in effect, the sum of many businesses.

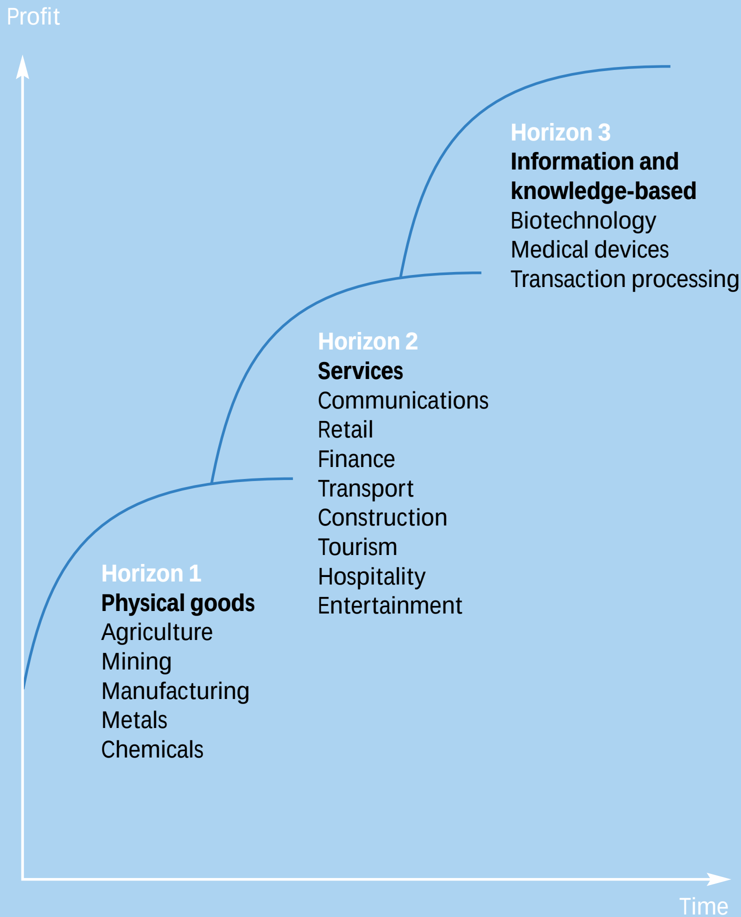
Box B
The three horizons of growth

The three horizons of growth offer a way of thinking about the composition of a company, a business unit or indeed an entire economy. In their book, *The Alchemy of Growth: Kickstarting and sustaining growth in your company* (Orion Business, 1999), Mehrdad Baghai, Stephen Coley and David White found that companies that had concurrently managed a balanced set of initiatives across three horizons sustained profitable growth over long periods. Horizon 1 is the traditional or core business of a company. In horizon 2 are the growth engines of a company, those whose revenues are rising rapidly and require significant investment. Horizon 3 initiatives represent the growth options of a company. They may be minority shareholdings in other companies, pilot programs or business concepts that are beginning to take shape within the research and development group of a company.

To sustain growth, companies need strong activity in each horizon. In horizon 1, this may mean ensuring that costs are kept under control and the company is maintaining its market share. In horizon 2, the challenge is to drive the growth of major new streams of revenue. A good growth company needs to have several of these on the boil. In horizon 3, a company seeds and nurtures a portfolio of options, working to determine whether they can become successful business models and eventually move into horizon 2.

For many businesses, managing across all three horizons concurrently is a major challenge. Many simply focus on getting their horizon 1 businesses right, without thinking about where their long-term growth will come from. Others generate lots of ideas but fail to make them successful businesses. Great growth companies have activity in every horizon.

Exhibit 3
The three horizons of Australia
Examples



Horizon 1: Australia's foundation in the physical goods industries

In horizon 1 are Australia's mature businesses *(Exhibit 3)*. These include much of the resource and mining sector, most of the agricultural sector, many of the formerly tariff-protected manufacturing industries such as textiles, clothing, footwear and automobiles, and many other capital-intensive businesses such as oil refining and chemicals. Public sector utilities might also be placed in horizon 1. Since the late 1800s, Australia's economy and wealth grew predominantly through the development of these industries.

As important as they are, these industries are now in decline. Mining and agriculture have been declining in relative importance for many years and now represent just over 7 percent of total employment. Manufacturing accounts for only 16 percent of all jobs and is also in relative decline.

Much has been done to create the right environment for improved productivity in these industries. One result has been thousands of job losses. Productivity improvements in traditional industries would not alone have sustained Australia's economic growth in the face of reduced terms of trade and slow growth in these sectors. The robustness of Australia's growth through the last decade is to a large extent due to a number of strongly emerging growth industries, which form Australia's horizons 2 and 3.

Horizon 2: Profiting from the service economy

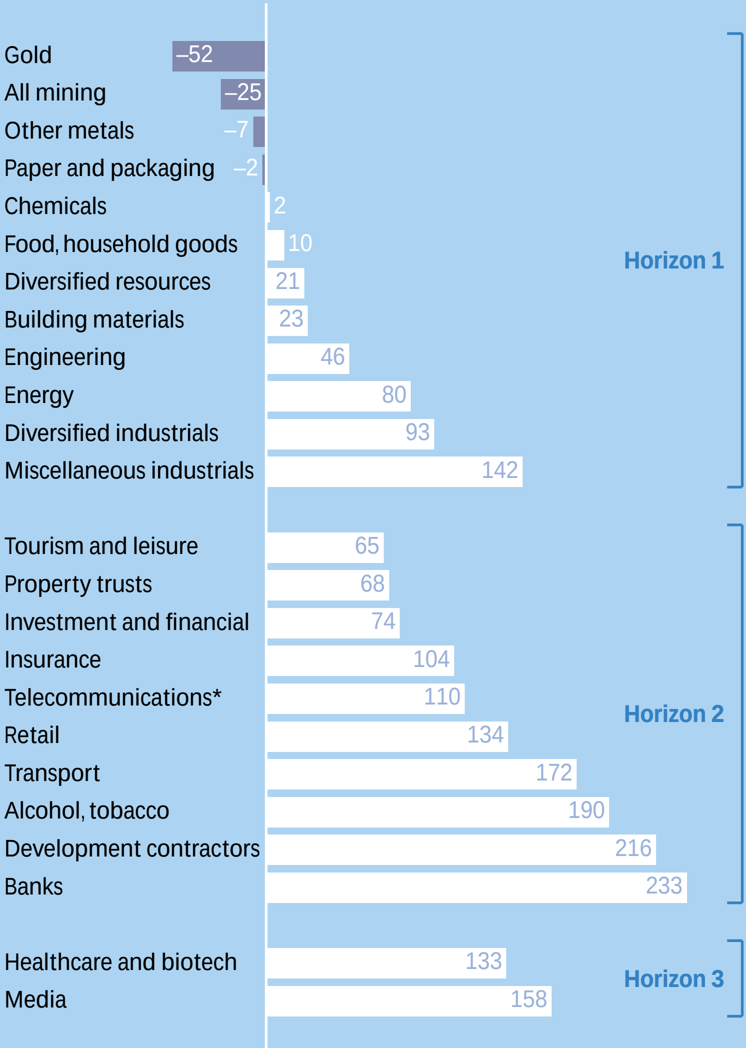
It is the service economy that has been driving much of Australia's growth. Much greater stock market wealth has been created in horizon 2 service industries than in horizon 1 physical goods industries, reflecting improved revenue and profit streams *(Exhibit 4)*. The service sector – including communications, recreation, construction, health and education services, personal services, business services, hospitality, retail and wholesale trade, finance and insurance and transport – now represents more than three-quarters of Australia's jobs. In terms of employment, the service sector has grown a strong 4.6 percent a year between 1991–92 and 1996–97.

But where has the growth in employment and shareholder wealth come from? In horizon 2, Australia has seen the emergence of powerful new enterprises with attractive business models in high growth industries.

Exhibit 4

Shareholder returns by industry grouping, 1995–99

Indexed growth for total return to shareholders



* Since December 1995

Source: McKinsey

Take telecommunications, for example. Of the top companies, only one, Telstra, existed in the 1980s. Cable & Wireless Optus, Vodaphone, PowerTel, AAPT and Hutchinson are all new enterprises.

A similar picture emerges in retailing, where newcomers with highly productive business concepts such as Harvey Norman, Flight Centre and Bunnings Hardwarehouse have entered the marketplace.

Evidence of the flurry of activity in horizon 2 is the rate of initial public offerings (IPOs) in Australia. This decade Australia's per capita rate of IPOs has increased rapidly. Since 1994, Australia has had a higher rate than the United States. In 1998, for example, Australia had 6.2 IPOs per 10 million people compared with a US rate of 3.7.

Growth in horizon 2 service industries has not only been driven by start-ups. Existing companies are also reinventing themselves in horizon 2. It is notable that many of the country's most successful large companies have not heeded simplistic advice to focus their business in one core area narrowly defined by historical industry boundaries. They have not condemned themselves to decline with the industries in which they operate, but instead have focused on exploiting existing capabilities, and building new ones, to extend into attractive related arenas.

This is not to suggest that radical, bet-the-company diversification is sensible. Merely that the transition in Australia's economy is being driven by, and mirrored in, the evolution of some of the country's large companies.

Australia is reaping the benefits from these horizon 2 growth businesses and industries, which were probably dreamt up last decade, built this decade, and are now starting to generate returns. The question is whether as a country we can sustain this faster growth rate into the new millennium. Our horizon 3 industries provide the answer.

Horizon 3: Growth for the new millennium

Australia's horizon 3 industries are the key to sustaining strong economic growth over the long term. Two of the more important themes driving horizon 3 industries for the new millennium are the information economy and biotechnology. Businesses in these industries will be knowledge, not asset, based. The information economy is rapidly changing the way we interact and do business. The biotechnology sector will have profound implications for healthcare, pharmaceuticals and agriculture.

Growth theory economists such as Paul Romer talk of increasing returns to innovation. Put simply, countries that innovate will grow faster than those that don't. The world experienced this during the last century with the economic divergence of East and West. Through developing more horizon 3 businesses, Australia must be one of the innovative nations during this next industrial or rather, technological, revolution.

A call to action

The nation's economic agenda for the next decade must continue to shift from productivity increases through market reforms and cost cutting to the creation of new business models and enterprises. Australia's focus must be on how the economy can encourage enterprise creation, both from within existing businesses and through new businesses. Action is needed from business, government and community leaders.

Business leaders, not government, have the principal responsibility for driving economic growth. Even companies in horizon 1 industries cannot abdicate growth to the new industries. In the mature horizon 1 resources sector, for example, exciting start-ups as well as ambitious projects in existing mining and resources enterprises are proving that profitable growth is possible. In agriculture, in the face of decline, new growth sectors have emerged to create jobs and replace lost revenue streams. These include wine, cotton and rice.

Even though Australia's manufacturing sector as a whole is facing greater international competition there are a number of bright spots. A 1994 McKinsey & Company study of 'emerging exporters' found a vibrant group of small and medium-sized manufacturers that were growing successfully through exports to niche markets around the world.

While business must lead, government does have an important role, too. Governments at all levels need to create the right environment for new enterprise creation, and to encourage entrepreneurs. For example, government can help to address the problem that Australia's business creation industry is much less vibrant than in the United States.

The relatively poor availability of venture capital funding here highlights how far Australia lags the United States. In Australia, there is $16 of venture capital funding per capita; in the United States, it is almost eight times this amount. The government's capital gains tax changes should help. But we need more entrepreneurs too.

Australians must learn again to respect entrepreneurs. Indeed, today's entrepreneurs are, for the most part, people of integrity and vision, pursuing dreams that are generating jobs and helping to transform the economy. In addition, existing corporations must foster skills and ambition in their employees to encourage new enterprise creation from within.

Australia is at a critical junction. While the country's success in terms of GDP growth has surprised everyone, there is much that can be done to ensure this success continues. To ensure that Australia's horizon 3 is full and vibrant, the leaders of small, medium and large businesses need to act not only to steward the assets that they inherited, but to create businesses that they can leave as a legacy. Such a legacy will help create prosperity and jobs for Australia's children.

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Byron Pirola has been a Director of Port Jackson Partners since 1992. Previously he worked at McKinsey & Company for six years. He holds a PhD in Biochemistry from the Commonwealth Centre for Gene Technology at Adelaide University and a Bachelor of Science from the University of New South Wales where he graduated with first-class honours.

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