

Why Organic Is Better

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Can you still grow?

Despite it all — the economic murk, strangled credit markets, slumping consumer demand — can you formulate a strategy to maintain profitability and even potentially nudge revenue upward to create some value for shareholders?

The odds don't look good on the M&A side. Just a few months ago, some observers were thinking that savvy strategic buyers and a few nimble private equity players might seize the opportunity to snag some bargains. The ongoing turmoil seems to have spooked all but the most stout-hearted. According to the ZEPHYR quarterly M&A report, published by Bureau van Dyke Electronic Publishing (BvDEP), the deal numbers and dollar volume for companies based in the United States and Canada tumbled in the third quarter. Deal values fell by 16 percent over the three months, while the number of transactions reached a low for the year at 2,480.

That's probably just as well. The evidence that mergers and acquisitions actually destroy shareholder value keeps mounting. Earlier this year, consulting firm A.T. Kearney analyzed 175 mergers and found that while return on sales increased slightly, sales growth and EBIT growth slowed by 6 percent and 9.5 percent, respectively. In addition, shareholder value creation, as measured by market cap, declined by 2.5 percent. In last month's issue of *Business Finance*, a feature exploring trends in mergers and acquisitions shared data from a study of 33 large M&A transactions in Europe, Canada, and the United States from 2002 to 2007. According to the article, these megadeals destroyed value more than 60 percent of the time, and they raised acquirers' risk profiles, resulting in a higher cost of capital.

Cost synergies are the traditional focus of M&A projects. But they can be hard to realize, notes Alan Gallo, CFO, global consumer business, American Express. While some potential merger synergies, such as back-office savings, are straightforward, others are “famously elusive, such as the ability to leverage each other's customer base or intellectual property for incremental revenue. History suggests that there's good reason to be skeptical, and finance professionals should play that role, stepping back to compare purchase price to realistic estimates of incremental revenue, earnings, customers, and market share.”

With debt financing likely scarce for the foreseeable future, the only way forward for most growth-minded organizations is via internally generated profitable revenue expansion — the organic route.

It's not as glamorous as M&A, and stakeholders may not perceive it as transformative in the way that they might perceive an acquisition (although companies that routinely generate organic growth usually find that they generate plenty of resources for transformative initiatives in other areas). And organic growth has the rather daunting reputation of being dependent on charismatic leadership and the ability to create a “culture of innovation.”

But success in generating growth internally may be less dependent on exceptionally skilled managers than on the careful optimization of a portfolio of growth options. What's more, companies that succeed in managing organic growth efficiently create, rather than destroy, shareholder value. This, in a way, is not surprising; organic growth is the hallmark of true managerial excellence. It's prized by the markets, and there's much to be learned from companies that excel at it.

JUST DO IT?

A glance at the literature on organic growth reveals a heavy emphasis on managerial style and the personal qualities of leaders. An example: Reengineering guru Jim Champy, in a recent post on TheStreet.com about his new book *Outsmart! How To Do What Your Competitors Can't* (FT Press, 2008), wrote that the high-growth companies he describes are characterized by “an inclination to action — akin to the Nike ‘Just Do It’ mantra. Managers don't spend lots of time debating or planning what needs to be done. They act mostly on intuition, doing what the business needs, when it is needed.”

There's no doubt that companies need agility and speed to exploit growth opportunities, and they need an informed, insightful understanding of their markets to predict where the next big win will come from. But is planning really so marginal to the process? And is it always clear exactly what the business needs?

Dissatisfaction with the qualitative emphasis of many organic growth studies was one motivator for a new study from Brilliant that maps the links between organic growth efficiency and shareholder value.

The firm looked at results for all companies in the S&P 500 from 2002 to 2007 by industry by determining how much organic revenue was created in each year and how much investment was required to generate that revenue. The first move was to strip out, for each company, the revenue growth attributable to the sector's overall expansion.

A rising tide lifts all boats, and 2002 to mid-2007 was certainly that. But not all industries or companies rise equally. “If an industry is growing at 10 percent and you are able to grow at 10 percent, it is not appropriate to take credit for the tailwind that maybe helped you to achieve that,” says Anand Sanwal, managing director, Brilliant. “However, if you're able to grow at 15

percent, then that increment can rightfully be claimed to be due to your management prowess and your decisions to invest in the company.”

Next, Brilliont examined M&A transactions for each S&P 500 company — more than 10,000 of them in aggregate — to filter out revenue that companies gained from acquisitions (or that they forfeited from divestitures). What was left was organic revenue, which is the revenue the company generates by funding internal projects and investments.

But organic revenue by itself is of limited value as a gauge of success. After all, one company might decide to pour money into, say, developing new channels, and yet achieve only a 1 percent increase in organic revenue. Another might make a much smaller investment and generate a 3 percent increase. Clearly, what's needed is a measure of the efficiency of organic revenue creation — in other words, organic revenue per dollar invested in projects such as marketing, operations, sales, R&D, advertising, and capital projects.

Brilliont looked at the expenses for each company and, by using benchmarks and publicly available information such as earnings releases and presentations, determined the portion of expenses that were discretionary. Dividing organic revenue by this figure for discretionary expenses yields a metric that the firm's research unit has dubbed the organic growth multiplier (OGM).

So does organic growth efficiency, as measured by the newly-minted OGM, create shareholder value? Apparently so. An analysis of the data found a strong positive correlation between the firm's newest metric and shareholder returns. What's more, the correlation held good for each individual sector of the S&P 500, with the sole exception of the highly regulated and commoditized utilities and telecom industry.

Since the firm's data covered five years, the researchers wondered whether consistency of organic revenue growth creation over that period had implications for shareholder value. Again the answer was positive. Companies with a consistently high organic growth efficiency achieved higher annual shareholder returns than organizations in which the OGM was more erratic (see chart below "Why Consistency Matters").

Brilliont next looked at the mix of M&A revenue and organic revenue and how this affected total shareholder return (TSR). Sure enough, when the proportion of M&A-derived revenue in overall revenue growth was high, TSR was low. The companies that saw the best shareholder performance were those with a high organic growth efficiency and a low percentage of revenue growth from mergers and acquisitions (see chart below "Shareholder Returns: Organic Growth vs. M&A").

While the researchers focused mainly on sector-by-sector analysis — it wouldn't have made much sense to compare, say, Exxon Mobil with Kraft — they did compile a list of the Top 10 performers overall in the S&P ([see table "Where Organic Growth Has Paid Off"](#)) [1].

It's worth noting that three of the Top 10 hail from the consumer staples industry — not a sector that necessarily leaps to mind as providing easy pickings for an organic growth strategy.

Organizations like Procter & Gamble, under Chairman and CEO A.G. Lafley, have demonstrated that internally generated growth is achievable even in “mature” markets. Many observers attribute the long rise in P&G's stock price since 2001 largely to the company's relentless focus on sustainable organic growth, which Lafley describes as “less risky than acquired growth, and more highly valued by investors” in his book, with co-author Ram Charan, *The Game-Changer: How You Can Drive Revenue and Profit Growth With Innovation* (Crown Business, 2008).

PUNCH ABOVE YOUR WEIGHT

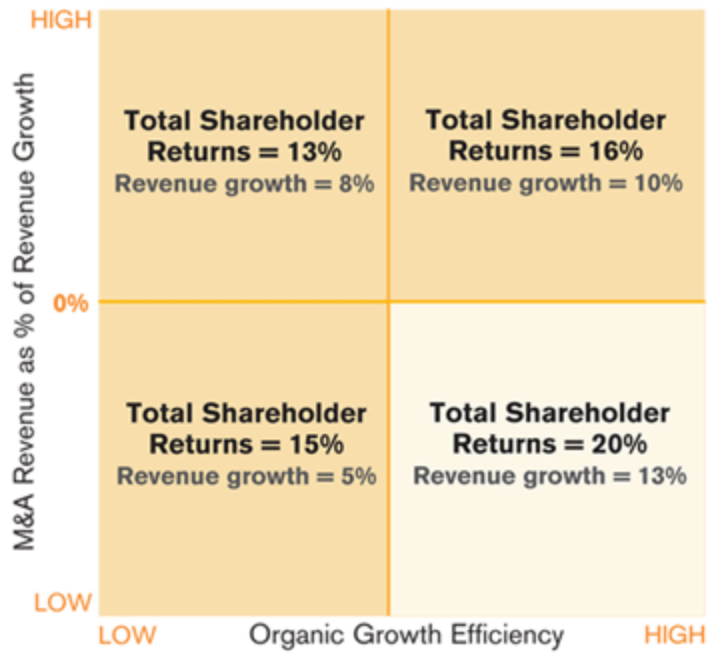
Heavyweights like P&G can devote enormous sums of discretionary cash to organic growth efforts (the company's ad budget alone is \$6.7 billion, the world's largest, according to *Fortune* magazine). But any organization can learn to punch above its weight by pursuing organic growth through incremental changes, modifications, and improvements, according to Sanwal.

Remember, what's crucial for shareholder value creation is not the level of spend on organic growth; it's the efficiency of that spend. A company that makes each dollar of investment go further can, over time, start to encroach on a larger competitor's turf. Or, if it's already an industry leader, it can accelerate even further beyond its peers.

Success is a matter of constantly improving your investment selections to increase their efficiency, adds Sanwal. Through a disciplined evaluation process and the careful use of data, you may be able to squeeze a little more revenue and profit out of every dollar you invest in marketing, for example. Perhaps you can spend a bit less on every IT project or pull funds out of an underperforming operations project. The benefits to revenue and profitability may initially be incremental, but “such systematic improvements to investment selection and performance, year after year, will have a very material impact on your results,” Sanwal notes.

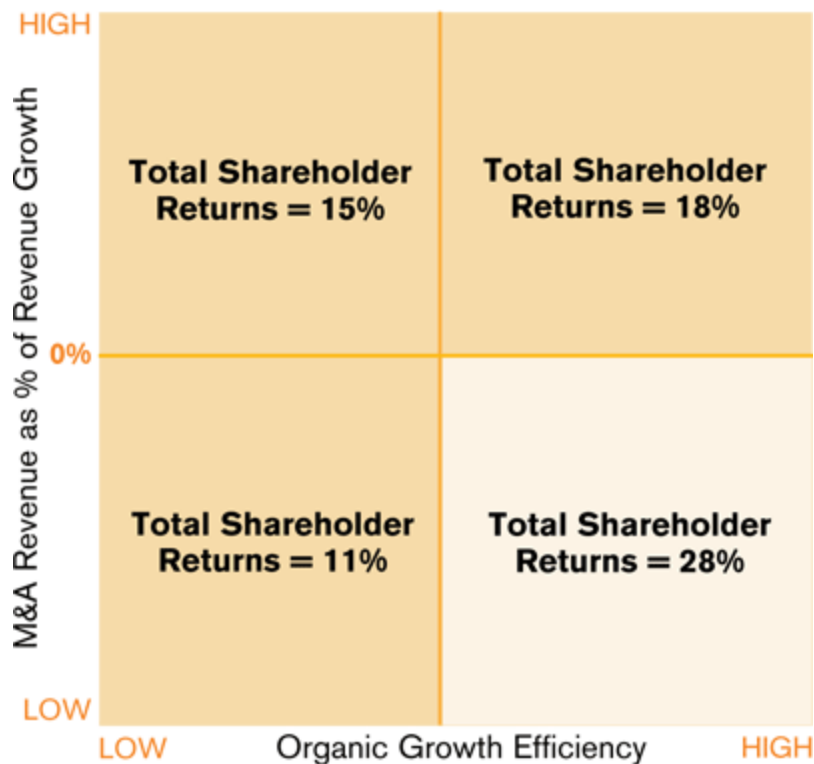
He adds: “It's entirely possible for an organization to improve its organic growth efficiency by 10 percent over a period of a few years. For the companies in our research, this translates to millions of dollars of incremental revenue and profit. The best part is that you don't have to invest more to get this benefit; you just have to do more with the same resources — or even with fewer resources, given today's conditions. You're not going to be lauded in the press for these continuous improvements, but they'll be welcomed by shareholders.”

WHY CONSISTENCY Matters



Note: Data presented for S&P 500 financials

SHAREHOLDER RETURNS: Organic Growth vs. M&A



ORGANIC GROWTH To-Do List

Best practices for internally generated growth have received much less attention than those for M&A projects. Anand Sanwal, managing director, Brilliant, suggests five guidelines:

1. Make organic growth a hot topic

Critical though it is, organic growth can all too easily slip from the top of the agenda, especially since a phalanx of investment advisors and bankers are constantly pushing companies toward M&A ventures. These players have no interest in promoting organic growth, which is something that companies can manage on their own.

Winners make sure that loss of focus doesn't happen. General Mills, a Top 10 OGM performer, has a formal strategy process that's centered "almost entirely on organic growth," reports Dan Malina, senior vice president, corporate development. "We have discussions at the seniormost level; we have presentations by each of our business units and functions, and then we roll it all back into our long-range plan. We don't include acquisitions. We see those as very important, but opportunistic."

Senior championship can help to ensure that discussions of organic growth don't fizzle and that they remain grounded in reality. “Because CFOs sit at the crossroads of so much information in the company, they're probably among the best-positioned leaders to measure organic growth effectiveness,” says Sanwal. “Finance leaders can provide a lot of insight and a dispassionate view of what the data says.”

2. Understand your organization's capabilities

Winners know which divisions, products, and geographies offer the best opportunities, and they allocate resources accordingly.

Measurement technology giant Agilent Technologies looks for organic growth options that leverage a distinctive and sustainable competitive advantage. “We're focused on measurements, not a bunch of other related or unrelated activities,” says Adrian T. Dillon, EVP, finance and administration, and CFO. “It's a \$45 billion sandbox, which is plenty big enough for a \$6 billion company and one where we can really leverage our strengths.”

By applying the competitive advantage test, he adds, companies can build up “a portfolio of investment opportunities — some near-term, some mid-term, even a few longer-term ones. But obviously you apply the probabilities, and you very carefully gauge progress so that you don't end up throwing good money after bad when the criteria for success are no longer satisfied.”

General Mills pays close attention to opportunities for channel expansion, especially in new markets such as greater China, where net sales have been growing at more than 30 percent annually over the past three years, according to Malina. This has been driven primarily by organic growth initiatives.

3. Treat your resource allocation options as a portfolio

Companies that routinely generate organic growth view their investments as a balanced portfolio that takes account of the potential strategic and financial benefits as well as risk.

It's an approach that can bring rigor and discipline to the task, but one that few businesses have mastered, according to Sanwal. “To truly manage something as a portfolio means that you're looking closely at how its components perform, and then you're willing to allocate your resources differently based on past performance. In many instances, this type of dynamic resource allocation doesn't occur,” he says. “A company may say that it has a portfolio of businesses, but in terms of actually moving money across businesses because one business has a better opportunity set than another, this rarely occurs. Within a business division it may happen more, but still not as frequently as you would imagine.”

It's important to recognize that not all of your bets are going to pay off, notes Dillon. Three years ago, Agilent set up 10 new organic growth initiatives, knowing that only a few would likely succeed. “We just couldn't tell you which ones,” he says. “You go through it, you take your shots, and you shoot the losers so that you can double down on the winners.” Today, the four initiatives that remain are doing very well.

Companies need “a consistent process and measurement system for evaluating organic growth investments before they're launched and for measuring them after the results are in,” says Alan Gallo, CFO, global consumer business, American Express, which maintains a list of current investment proposals, ranked by return, and a waiting list of projects that can get the go-ahead if the dollars become available.

4. Balance analytical and intuitive decision-making

Organic growth leaders can access the data that they need to make investment decisions, and they couple the use of this information with creative ideas and new insights into their markets.

However innovative an idea might be, it needs careful scrutiny from the CFO. “It's up to finance professionals to make sure that their business partners are making realistic assumptions,” notes Gallo. “Compare the assumptions to what's going on in the economic environment, the marketplace for your product or service, and what your competitors are doing or how they will react. Often, you'll find that some assumptions imply levels of performance that are optimistic — better than you've ever done before or better than any competitor has done — or they imply a dominant market share.”

At Agilent, new product ideas are carefully assessed within a perspective provided by clear, consistent, fair metrics, Dillon reports. “Otherwise, it becomes a question of patriotism and loyalty, as opposed to everybody getting a fair shake and being measured by the same yardstick.”

5. Free your organic growth projects from annual budgets

Consider creating dynamic resource allocation processes that are not hindered by annual budgets. In this way, says Sanwal, “you're not stuck with a decision you made last November until the next cycle comes around.”

Achieving that kind of flexibility is perhaps the biggest challenge for organizations that are serious about ramping up organic growth. “One could argue that the second hardest thing to do in any company is to start something that isn't already going — and the hardest is to stop something once it's started,” observes Dillon. But companies that break out of once-a-year mode gain the ability to constantly invest in the best organic growth initiatives, reacting to market pressures and opportunities as they arise.

Organic growth strategy is an area in which CFOs can and should expand their support for their CEO. In IBM's 2008 Global CFO study, 71 percent of respondents said that

providing input into identifying and executing growth strategies was a critical or important area of responsibility for the finance function. But when asked how effective they thought finance was in this area of responsibility, only 40 percent said that it was effective or very effective.

Finance executives who are resolved to be the CEO's junior partner should build relationships with leaders across the organization, including the CMO, who are involved in growth projects. "They should be learning as much as they can about how strategic marketing works," says Dillon. "What are the buying criteria of the customers? Is it pure cost, in which case you're selling a commodity? Is it magical technical capabilities? Reliability?"

"Sorting out these types of things and adjusting not only the R&D portfolio but also the business model at times can be an enormous area of contribution, and the CFO has a unique perspective to bring," Dillon adds. "For me, being involved in that makes the job a lot more fun."