STRATEGIES FOR GROWTH

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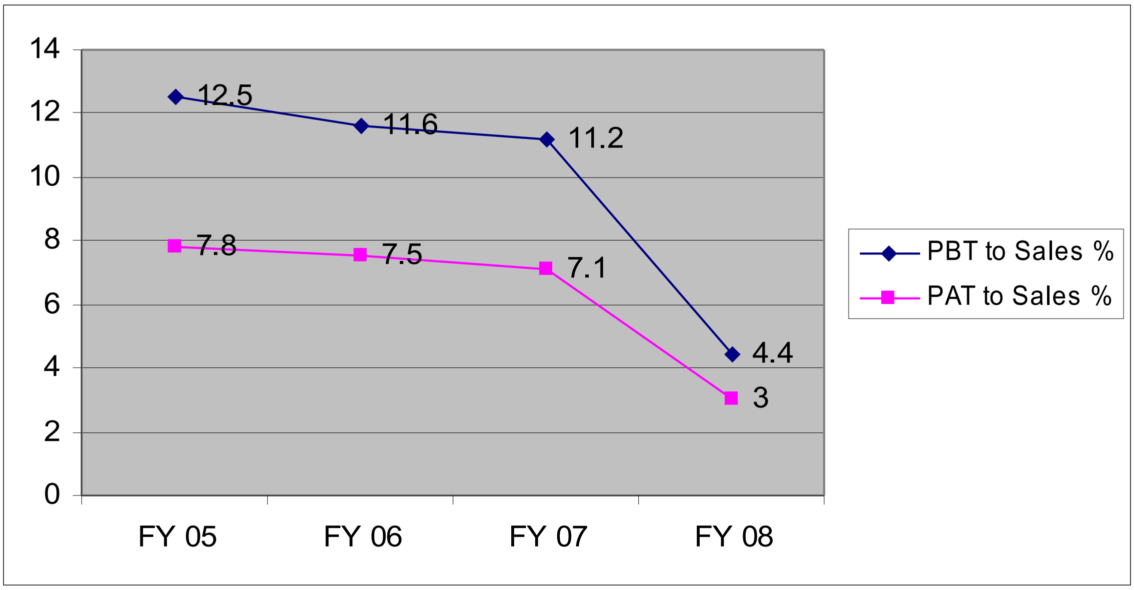
What Highly Successful Companies Do

Economic cycles are predictable. You know boom will be followed by bust followed by boom. When they occur is unpredictable and will remain so. All companies do not suffer equally during a period of recession. Some perform well while most don't. What is it that sets highly successful companies apart that they continue to perform well during economic downturns? Let's look at three cases, each very different from the other.

Starbucks: no more the icon
When Howard Schultz acquired Starbucks in 1987 and re-branded his old company Il Giomale as Starbucks, he wanted to bring the Italian coffee experience to America. He wanted Americans to savour not only the flavours of superior coffees but also enjoy the leisurely and social coffee drinking experience. He decided to open thousands of stores. In 1992 at the time of the initial public offering Starbucks had 165 outlets in USA. In 1996 the first Starbucks cafe opened in Tokyo signalling the company's international expansion. In November 2005 London had more outlets than Manhattan. By 2008 the company had 16,680 stores in 48 countries; 11,000 were in the US alone.

Between 2005 and 2008 the number of stores increased 60%. Sales grew 63% to $ 10.38 billion. Then something strange happened. In 2008 sales growth dropped by half to 10%. Profit before tax as per cent of sales slipped from 11 to 4.4% and PAT dropped to 3%. Stock price fell from the high of $ 40 in late 2006 to 12 in late March 2009. The company that had outperformed NASDAQ for six years was barely ahead of the benchmark now. What had gone wrong?

Starbucks Profitability



The seeds of trouble had been sown as far back as 2003 when Starbucks decided on rapid expansion of outlets as the means to growth. Schultz had envisaged that no urban American would live or work more than five minutes walk from a Starbucks cafe. Initially it paid rich

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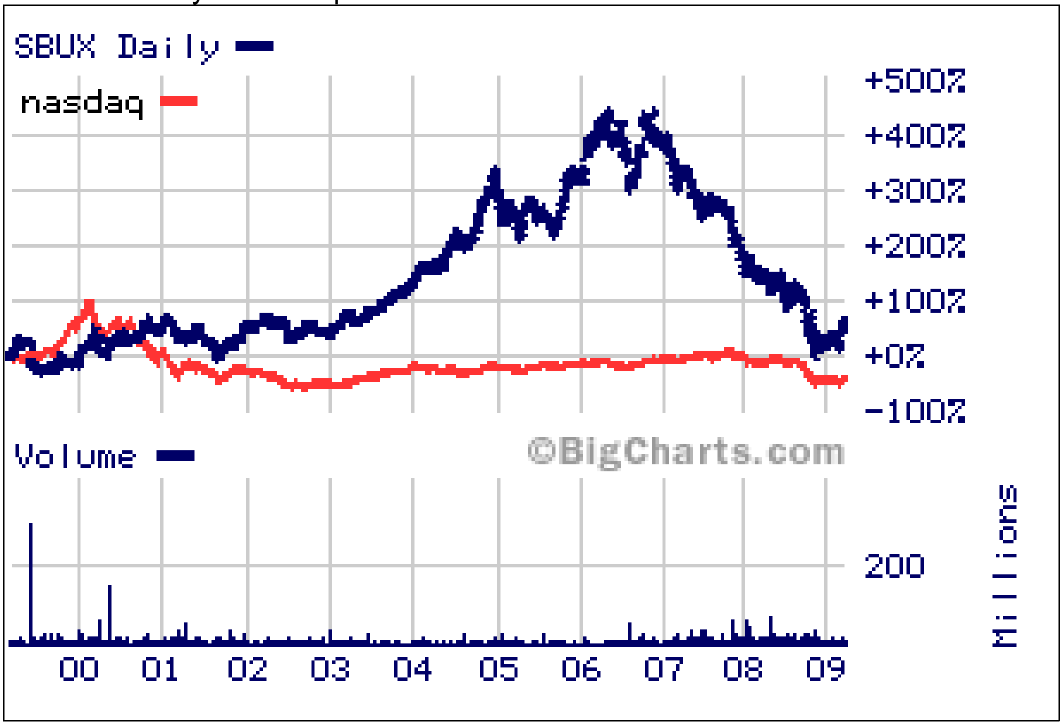
dividends. Along with expansion of stores, new products and services such as Hear Music, wi-fi, and merchandise were introduced.

New outlets attracted a new customer, the take away brigade. These people wanted a scalding hot coffee they could drink as they walked to or from work. They were not interested in savouring the smell of freshly brewed coffee or in chatting up the *Barista*, as the core customers of Starbucks did. They wanted quick service and an acceptable cup at a reasonable price. They were a sizable segment. To serve them Starbucks automated coffee making. They installed new counter top equipment that hid the *Barista* and the action behind the counter. Flavour locked packaging was introduced. It led to the loss of rich coffee aroma, the hallmark of Starbucks stores. And mushrooming stores had begun to cannibalise each other. Starbucks had begun to McDonaldise!

Starbucks: 10 year stock price chart



The stock market expressed its displeasure in no uncertain terms. Share prices had begun to dip steadily since September 2006 even when NASDAQ was steady. Schultz had been worried. In February 2007, he wrote to his top managers, “Over the past ten years, in order to achieve the growth, development, and scale necessary to go from less than 1,000 stores to 13,000 stores and beyond, we have had to make a series of decisions that, in retrospect, have lead to the watering down of the Starbucks experience, and, what some might call the commoditization of our brand.”

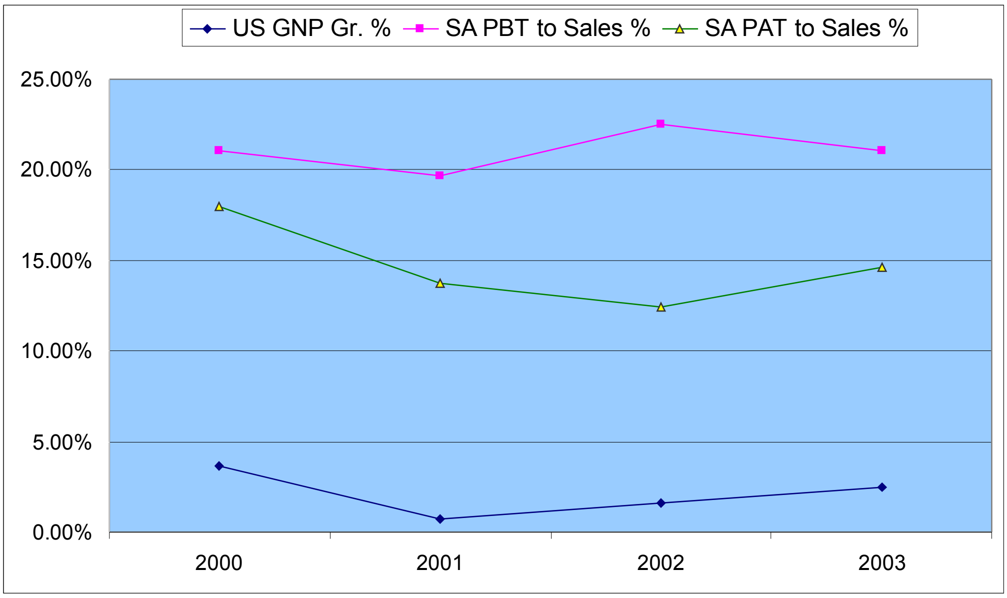
Starbucks has proved harder to fix. When recession hit America, the Company had already lost most of its market value. Its stock price was at mid 2003 level. By January 2009, it was barely above the NASDAQ composite index. Curiously, the same Starbucks had bucked the trend during the previous economic downturn in the US. Between 2000 and 2003 its stock price had steadily gained even as NASDAQ slipped.

Starbucks has paid the price for chasing top line growth. Trying to win the take-away segment was unwise. They were susceptible to cheaper coffees from Burger King and others. But the bigger damage was weakening Starbucks' value delivery to core customers. Sigma Aldrich has not made the same mistake.

Sigma Aldrich
This American specialty bio-chemical and organic chemicals company has been supplying lab kits and chemicals to laboratories and R&D units for fifty years. They sell 130,000 products, of which they produce 46,000 themselves, and supply them in small quantities sometimes as little as 5 grams. They serve 1 million customers in 36 countries.

Sigma Aldrich has been a highly profitable company for many years. Between 2003 and 2008 they steadily increased profit before tax (PBT) and profit after tax (PAT). Profit before tax to sales rose steadily from 20.6% in 2005 to 22.24% in 2008. Profit after tax to sales has hovered around 15-16% for six years now. The company has achieved a compounded annual growth rate of 11.1% since 2003. What is remarkable is that profitability improved in 2008 in spite of slower revenue growth in that year (sales grew at 7.9% in 2008 against 13% in the previous year).

Sigma Aldrich: profitability during economic slowdown



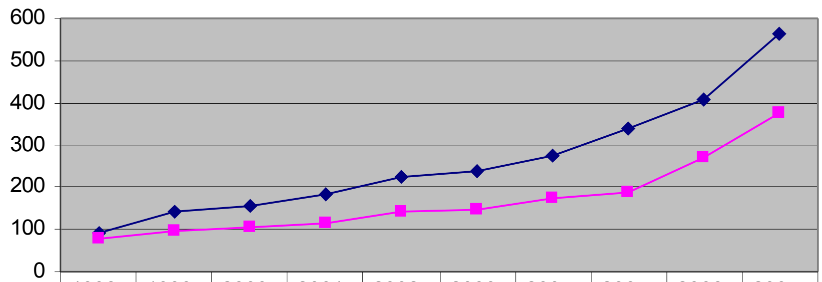
During the 2000-2003 slowdown in US GNP growth slipped from 3.66% in 2000 to 0.75% in 2001 and slowly rose to 2.5% in 2003. During this period Sigma Aldrich continued to remain highly profitable. PBT hovered above 20% of net sales. PAT to sales declined from 18% to 12% before rising to 15% in 2003. The stock market recognised this remarkable performance. Share price of the Company rose from $ 15 to 25 when NASDAQ nose dived. The stock has continued to outperform the index handsomely to the present day in spite of the current mayhem in US stock markets.

Sigma Aldrich: 10 year stock price chart

Asian Paints

Take Asian Paints, India's largest and most successful paint company for over four decades. Ranked 24th in the world on sales, it has averaged PBT at 14-15% of sales. Only 1/8th the size of Akzo Nobel ($ 8 Bn in 2007) the world leader in paints, its profitability is nearly 50% higher than the Goliath's. Akzo Nobel's profitability at 10-11% (PBT to sales) is nothing to sneeze at!

Asian Paints: profitability track record



	1998-99	1999-2000	2000-01	2001-02	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08
PBT Rs. Cr.	93.8	143.1	155.9	181.4	224.9	237.9	275	338.5	409.9	564.5
PAT Rs. Cr.	76.9	97.3	106.4	115.3	143.4	147.6	173.8	187.8	269.9	376.6

In the decade ending in fiscal 2007-08 Asian Paints improved its PBT from 10% to 17% of sales. PAT gained from 8 to 11% in the same period and revenue grew at 15.5% compounded annual basis.

Remarkably, Asian Paints continued to improve performance between 2000 and 2003 when the Indian economy slowed. During those four years revenue continued to grow, albeit at a slightly slower pace, at between 11 and 16% annually. Is it any wonder that Asian's stock has outperformed the Nifty since early 2002? Since September 2008 when the share markets have been in a tail spin, Asian Paints has continued to outshine the bourses.

Asian Paints: 9 year stock price data

Sigma Aldrich and Asian Paints have nothing in common. Their businesses are as different from each other's as chalk is from cheese. But look for the reason behind their remarkable success and you'll find one thing both share: love of the core customer. Both companies are strongly focussed on serving their target customers. They avoid, indeed shun, customers they feel they cannot serve well. Sigma Aldrich does not encourage business from chemical industry and the manufacturing sector. Asian Paints has studiously avoided business from the project sector unless it is on its terms. Starbucks shared this character in its heydays, before they lost their way.

Asian Paints delivers value to the home improvement segment, the target customer segment, by ensuring higher availability of paints on retail shelves than any competitor. Better availability greatly reduces end user inconvenience and saves the painter lost wages. The result: painters recommend their products, consumers pay cash and the retailer pays the company promptly. Copious cash flow enables Asian Paints to buy raw materials cheaper than anyone in the industry and make handsome profits.

Sigma Aldrich has streamlined processes to produce stock and ship a mind boggling variety of high purity chemicals to over 1 million customers around the world in small quantities. Labs, R&D units and others who use such products have a natural affinity for the Company. It is very likely the Company's profitability stems from better realisation and low sundry debtors.

The lessons from the three companies are short and crisp. Staying focussed on delivering superior value to target customers creates favourable predisposition among buyers. This preference is competitive advantage. Sustained competitive advantage is the key to growth as well as profitability.

Highly competitive companies know growth is a consequence, not a goal. It is the outcome of competitive edge, honed and maintained over years. Competitive advantage makes firms resilient. They not only outdistance competition, they outstrip benchmarks. Investors love such companies. Economic downturns present the opportunity to return to one's core.

Asian Paints and Sigma Aldrich have been darlings of the stock markets because their focus never wavered. Starbucks' did and lost their love!

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