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HIGH PERFORMANCE COMPANIES

Tully Moss

The Holy Grail of American public companies is meeting investor demands for growth and earnings consistency. An Easton Consultants initiative has identified and profiled companies among the Fortune 200 that have excelled at meeting this goal.

To be designated a high performance company, two rigorous criteria had to be met: the company had to achieve a minimum return on total capital of 10 percent during *each* of the years 1992 to 2002 (a level of profitability that at least covers what we calculate to be an industry-wide average cost of capital of 10 percent), and it had to show compound annual revenue growth of at least 10 percent over the last decade.

Precious few companies meet both of these criteria. Among the Fortune 200, only six percent make it: only 12 out of the 200 largest companies consistently achieved at least a 10 percent return on total capital each year between 1992 and 2002 and also grew their revenues at a compound annual rate of least 10 percent over the last decade.

The 12 companies are from six different industries, including two – engineered product manufacturing and insurance/managed care – that are not typically thought of as being high growth/high profitability industries.

Table 1. Twelve High Performance Companies

INDUSTRY	COMPANY
DISTRIBUTION	Sysco
ENGINEERED PRODUCT MANUFACTURING	Illinois Tool Works
INFORMATION TECHNOLOGY	Dell
	Microsoft
INSURANCE/MANAGED CARE	Marsh & McLennan
	WellPoint
PHARMACEUTICALS/ MEDICAL SUPPLIES	Abbott
	Merck
	Pfizer
RETAIL	Home Depot
	Wal-Mart
	Walgreens

What we have gleaned from these high performance companies is this:

Focus is key to sustainable growth and profitability: All 12 companies are focused on one industry. There are no substantively diversified companies in this group. There are no conglomerates in this group. These companies do not stray from their core. When these companies search for new business opportunities, they look first within their core customer groups and within product areas that are adjacent to their core business.

Focus has enabled these companies to know their businesses better than their competitors and continually raise the competitive bar. It has enabled them to attract and train the managerial talent that identifies new revenue and efficiency opportunities before others do. It gives them the critical mass to dedicate substantial resources for R&D and this in turn enables them to stay at the forefront of product development curves. In sum, focus allows these companies to be more innovative, more efficient, and better managed than their competitors.

These characteristics in turn enable these companies to develop and sustain leadership positions: eight of the 12 companies hold the lead market share position in their respective industries, and the remaining four companies hold lead share positions in key segments of their industries.

Innovation in products or business models is critical to success: The majority of the high performance companies win either because they excel at innovation or because they have hard-to-replicate business models that are continuously being refined for superior performance. The innovation-intensive firms include Microsoft and the three pharmaceutical/medical supplies firms (Abbott, Merck, and Pfizer). Those with hard-to-replicate business models include Dell and the three retail companies (Home Depot, Wal-Mart, and Walgreens).

***Executive continuity and succession planning create strong leadership and considerable depth in the management ranks**:* In an era of impatient boards and substantially reduced CEO tenure, executive continuity can still yield substantial benefits. The chief executive officers of the 12 high performance companies have been with their organizations for an average of 20 years and have an average tenure as CEO of six years. Only three of the 12 companies brought in outsiders as CEO (Ray Gilmartin at Merck, Bob Nardelli at Home Depot, and Leonard Schaeffer at WellPoint).

While grooming executive leadership from within tends to be a superior approach, bringing in outsiders to turn around ailing companies can be necessary and can yield stunning results. Leonard Schaeffer of WellPoint was brought in to turnaround a company that at the time he was named CEO consisted only of Blue Cross of California. WellPoint now is the prominent "worst-to-first" story among the nation's largest corporations: when Schaeffer took over, Blue Cross of California was essentially a bankrupt organization. It now is one of the twelve best performing companies among the Fortune 200 and consistently is voted America's most admired health care services company.

***Organic growth yields higher growth rates, but this may be changing**:* Although all of the high performance companies make acquisitions, eight of the 12 companies have grown primarily through organic growth. These eight have not depended on acquisitions to fuel their top-line growth.

Some corporations that have been highly successful acquirers and that, on the basis of consistent profitability alone would have met the criterion for level and consistency of earnings, failed to meet the revenue growth criterion. Notable among these is GE, which consistently earned a return on total capital in excess of 10 percent each year during the 1992 to 2002 period – but grew its revenues by only four percent annually.

As innovation becomes more difficult to sustain and as breaking into foreign markets presents formidable challenges, the emphasis on organic growth may be changing. Reflecting the challenges of maintaining a high growth rate, Pfizer and Wal-Mart, two corporations that have grown largely through organic growth, have become more active in seeking large acquisitions.

Four of the 12 high performance companies – Illinois Tool Works, Marsh & McLennan, Sysco, and WellPoint – have consistently been making large or significant numbers of acquisitions and owe a considerable portion of their top-line growth to acquisitions.

Much has been written about how to be a successful acquirer – identify the right target companies, plan the post-merger integration long before the deal is finally consummated, etc. But there is an aspect of deal-making that is not well appreciated: walking away from deals that lose their luster. This may be the hardest and least appreciated part of the art of deal-making. Most people don't realize how difficult it is to back away from a deal once the acquisition chase has started. Emotions run high and there is enormous pressure from various constituents to do the deal. Once things reach this stage, it's hard to stop. Having the discipline to do so once the chase is in full flight takes tremendous discipline. At least one of the four acquirer corporations - WellPoint - does this better than most.

***Globalization helps – in certain industries**:* Before knowing which companies would meet our growth and profitability criteria, we expected to find that all high performance companies excelled at being global corporations. This is not the case. There is wide variation in the extent to which the 12 are international companies: the percent of revenues these companies derive from outside of North America ranges from virtually none (Walgreens, for example) to at least 37 percent of revenues (the three pharmaceutical/medical supplies corporations).

High leverage is not correlated with high performance: American corporations are far more leveraged than they used to be. But the 12 high performance companies on average make fairly conservative use of debt: the average ratio of long-term debt to equity among the 12 companies is 27 percent. The individual ratios among the 12 companies vary from zero percent (Microsoft and Walgreens) to 55 percent (Sysco).

It's not getting easier: The growth rates of most of the 12 high performance companies slowed in 2002, and the ability of these companies to sustain a ten percent compound annual growth rate may be in jeopardy.

To put the challenge of growth in a broader perspective, Easton Consultants analysis shows that nearly three quarters of the industries in the U.S. are growing at a real rate of less than five percent annually. Only four percent are growing at a rate in excess of ten percent annually. Even high performance companies will be challenged to achieve annual growth rates in excess of 10 percent when the industries in which they participate have substantially slower growth rates.

Going forward: In their statements to shareholders, the CEOs of the 12 high performance companies most frequently mentioned enhanced operational efficiency and improvements in creating customer value as fundamental initiatives designed to sustain their firms' superior performance. Other initiatives designed to ensure a high level of performance included innovation, geographic expansion, increased customer loyalty, strengthened senior leadership, and more systematic collaboration among operating units. There also were indications – related to our observation that overall industry growth is slowing - that there will be an increasing reliance on acquisitions to accomplish top-line growth.

Tully Moss is a vice president of Easton Consultants. Since 1984, Easton Consultants has helped large and midsize U.S. and European companies in a wide range of industries make strategy decisions that yield improved revenue and profit growth.

300 Atlantic Street, 11th Floor
Stamford, CT 06901
Tel: 203.348.8774
Fax: 203.348.9541
www.easton-consult.com