CREDIT SUISSE

2017 First Quarter

Corporate Insights

Fighting the fade: Strategies for sustaining competitive advantage

Introduction

Few would disagree that having a competitive advantage is a good thing – it is a vital barometer of success for all corporations, regardless of industry. Yet the notion of quantifying competitive advantage can be elusive. Is it economy of scale advantages, market share dominance, cost leadership, intellectual property, product differentiation, first mover advantage, brand power, or something else?

One thing seems certain about competitive advantage: superior market valuations accrue to companies that find the magic of achieving and maintaining it. As we will show later in this paper, those companies able to sustain or even improve upon a competitively advantaged market position earn about 10% better returns to shareholders than the broader market. Per year.

With so many ways to define it, how do you really measure and compare competitive advantage? And – given the value associated with achieving that advantage – how can you change your competitive advantage?

In this, the latest in our ongoing series of **Credit Suisse Corporate Insights**, we examine competitive advantage in the context of the corporate lifecycle, and the value premium associated with achieving an advantaged position. We show how that competitive advantage is actually not just a binary notion; meaning it's not about whether you have it or not. It is more about how big an advantage you have and whether you can sustain that advantage in the face of competition. This is why a corporate lifecycle framework helps; it measures the relative size of a company's competitive advantage. Knowing that gap in performance – whether positive or negative – informs decisions about managing that gap. With the right tools, corporates can quantify their competitive position and then actively work to improve upon it, driving superior returns to their shareholders in the process.

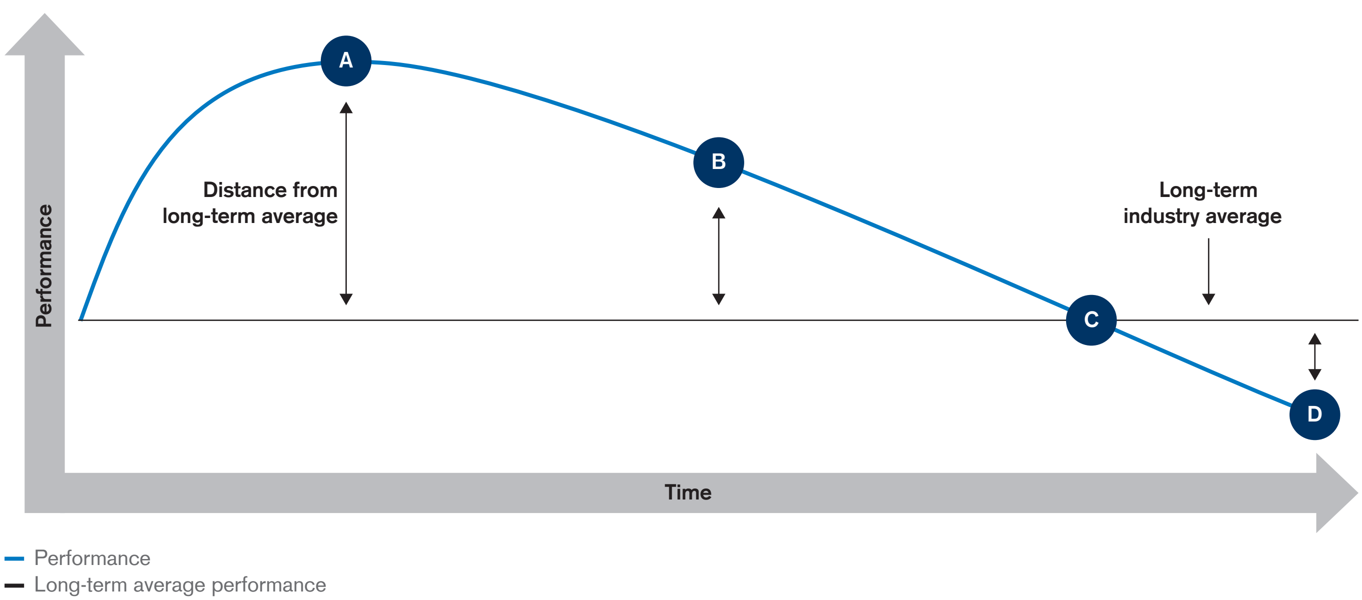
Corporate lifecycles reflect competitive advantage

What is the "corporate lifecycle"? Most people think of a lifecycle as companies neatly and inevitably progressing along a continuum over time from early start-up (no cash flow, high-growth prospects) to late-stage maturity (low-growth, steady-state, stabilized cash flows), as depicted in Exhibit 1 below.

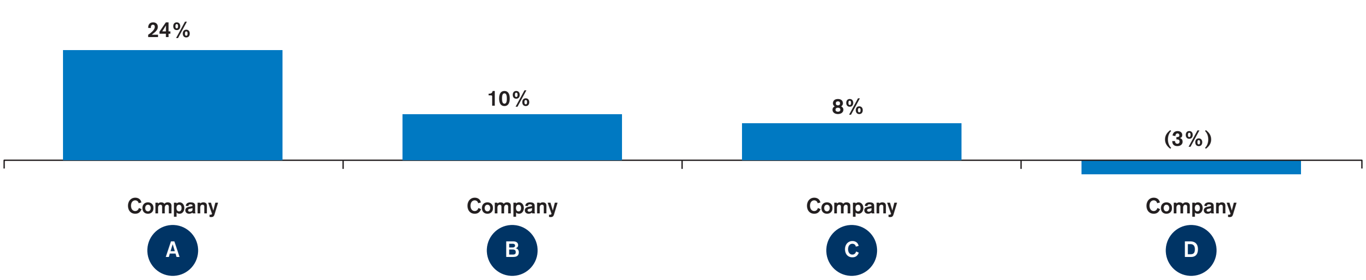
We believe this image can be misleading and that reality is very different. Corporate lifecycles do not reflect or predict the progression of a company through time; most companies do not advance sequentially over their course of their lives.

Indeed, many companies will jump around as they continuously seek to innovate and expand into new uncharted territories – succeeding at times, struggling at others. But companies can actively manage their lifecycle positioning to sustain superior performance. This idea is perhaps more clear if – as we noted earlier – you think about a lifecycle as a reflection of relative competitive advantage. Because a lifecycle notion – at its core – clarifies how far a company operates from its industry's mean. The further above a company's performance is from its industry's mean, the more competitively advantaged it is.

Exhibit 1: Corporate lifecycle positioning and consequences

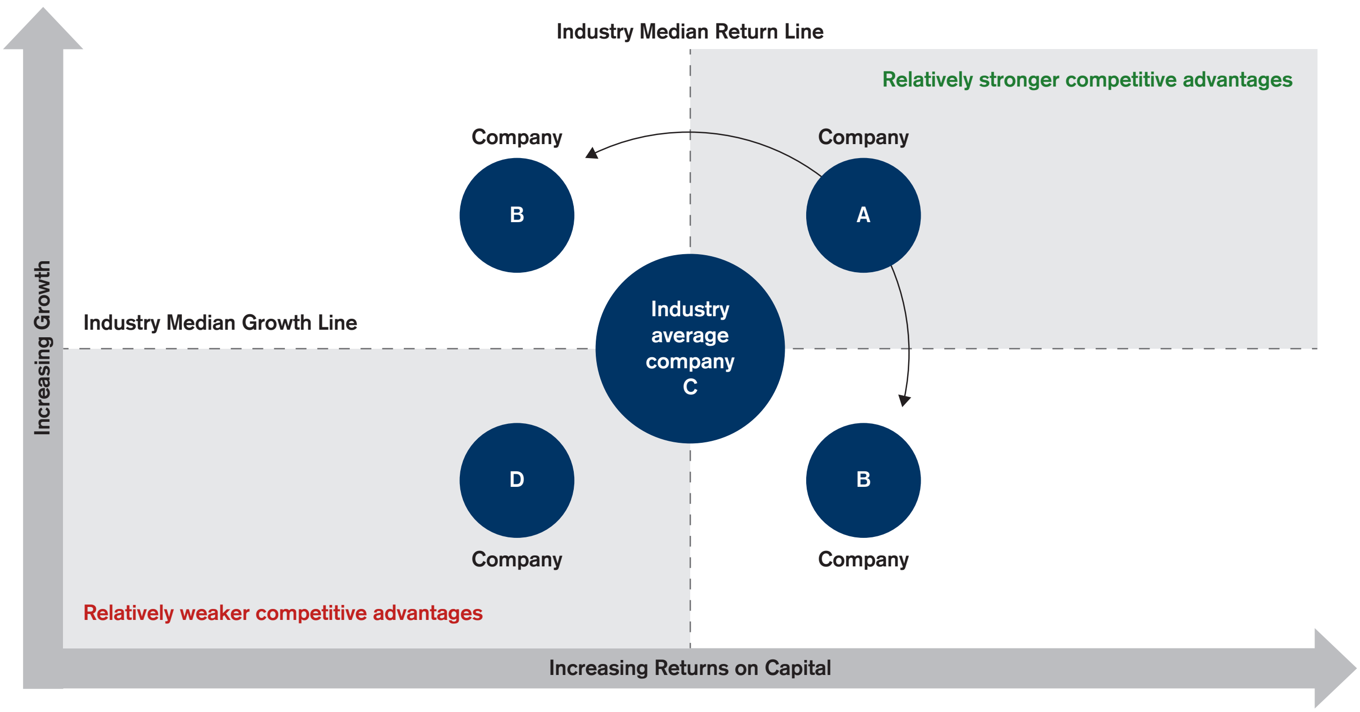


Empirical observation:
Total excess shareholder return based on relative competitive advantage positioning
Annual TSR data 1990-2015



Why should competitive advantage matter? The data tell us that a company's lifecycle position exerts a profound influence on market valuation. Exhibit 1 makes this point clearly, as companies at the peak of their competitive advantage generate returns to shareholders more than twice that of those further down the lifecycle. Peak companies generate the highest expected returns on capital and fastest expected growth. The market rewards them richly for that. Exhibit 2 shows that notion a different way, that the ideal position for a company seeking to maximize value is within the top right quadrant.

Exhibit 2: Stronger competitive advantages drive premium valuations



Sustaining superior performance is challenging over the long-run. Competition tends to erode any individual company's superior performance over time. Simply put, *over the long-term, competitive pressures erode returns on capital towards an industry mean*. A well-known pair of companies illustrates this observation quite clearly. Let's take a look at Nokia in the 1990s and Apple in the 2000s, as shown in Exhibit 3.

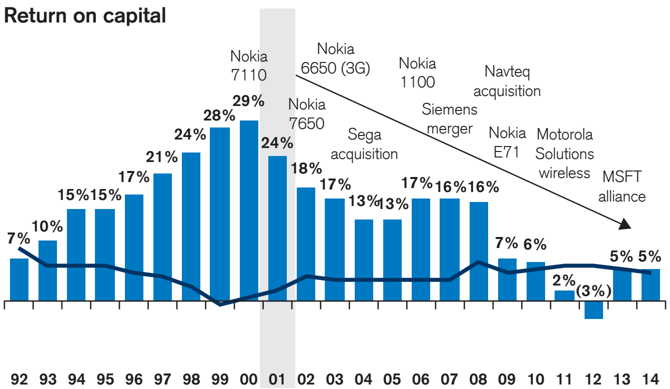
In the mid-1990s, Nokia evolved from a Finnish conglomerate to a global success story in the emerging mobile handset market. That success drove their returns on capital from 10% in 1993 to more than 25% in the early 2000s. But then Blackberry, Apple and Samsung launched their own mobile handsets with innovative features which caught Nokia unprepared. Over the subsequent five years, Nokia saw its market share decline globally and its returns on capital faded to a paltry 2% by 2011 with its share price following suit. As it took market share, Apple saw its return on capital rise by more than 30 percentage points over a little more than a decade as Nokia saw its returns dwindle. Apple became the single most valuable publicly-traded company in the world in 2015, with a market capitalization of approximately $775 bn.

But take a closer look at Apple's return on capital performance pre-2002; its returns were lower and fluctuated in the past, with several peaks and troughs. This makes a vital point that the rise and fall of a lifecycle is neither predetermined, nor finite. Companies evolve and company performance rises and falls with strategic challenges met or missed.

Exhibit 3: Nokia's vs. Apple's historical value creation

Nokia

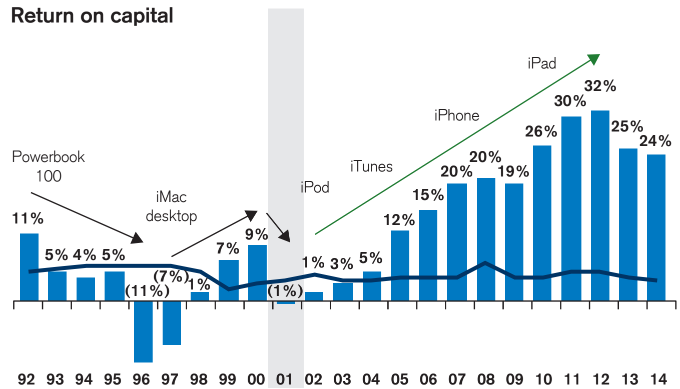
Return on capital



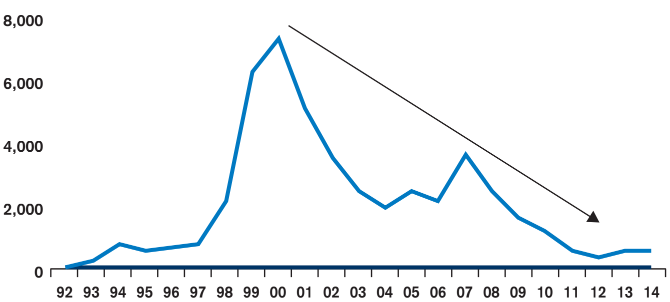
— Discount rate (adjusted for inflation)

Apple

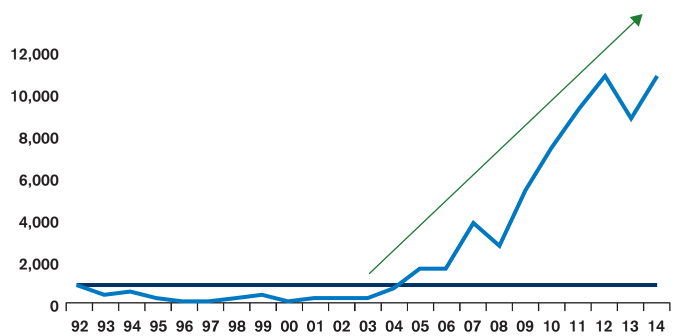
Return on capital



Relative total shareholder return



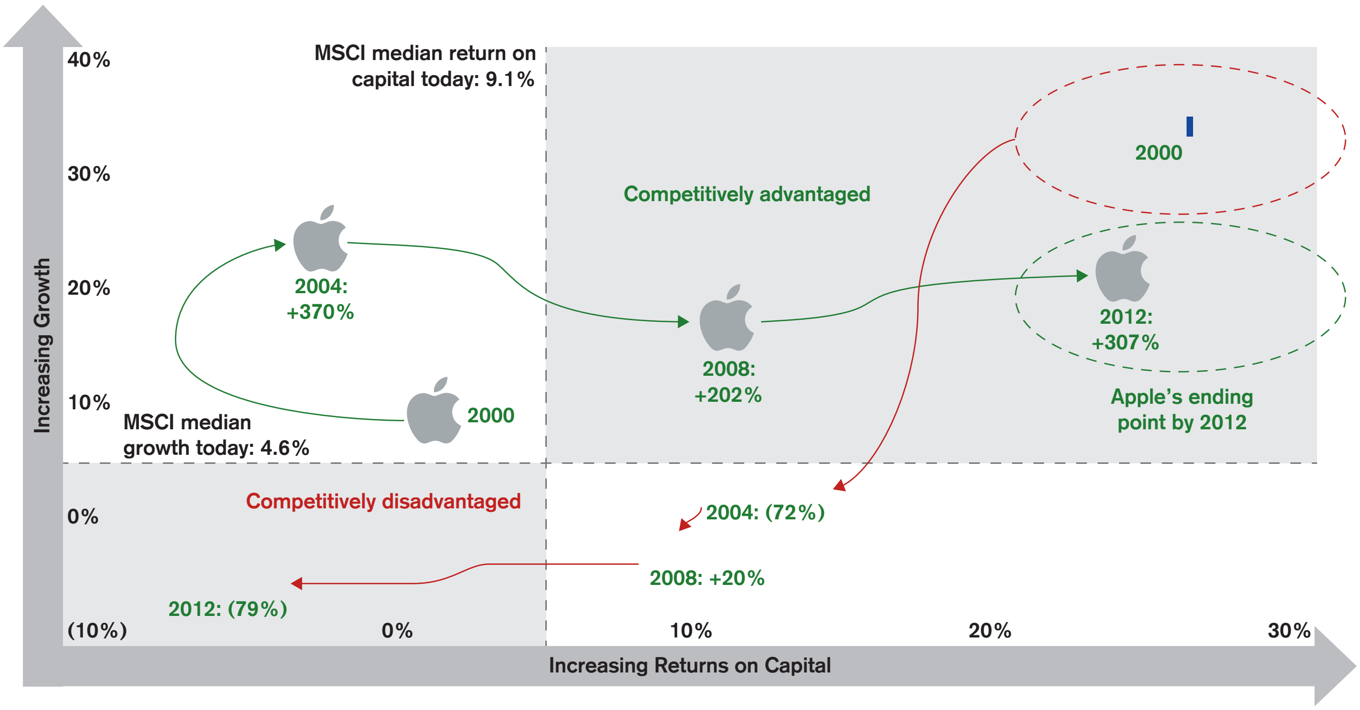
Relative total shareholder return



— Total shareholder return (TSR)
— S&P 500 Index

The connection between Nokia's performance and its value in the early 2000s and Apple's over the following decade makes a critical point: *lifecycle positioning or relative competitive advantage matters because of its impact on valuation*. Exhibit 4 shows that the progression of their respective operational performances drove their ability to create shareholder value.

Exhibit 4: Nokia's vs. Apple's historical operating profile and valuation: Expected growth vs. expected profitability
Labels indicates TSR relative to MSCI World Index



These examples also illustrate that the pull towards the industry averages – regression toward the mean – is more than theory. *Fade happens … unless companies adopt strategies to prevent it*. But how can you monitor this fade, and how can you develop defenses against the slide towards mediocrity? It is important to know where a company is positioned against the average, and where it sits within its own corporate lifecycle. This knowledge alone can help management make better investment decisions to reinvigorate the business and reduce the risk of the portfolio. The market rewards these decisions, as investors renew and raise their expectations along with the reinvigorated levels of profitability and growth. Happily, although fade happens, declines in performance and valuation are not inevitable.

Maintaining competitive advantage is vital to drive superior valuations

In his November 2016 paper "Assessing the Magnitude and Sustainability of Value Creation", our colleague Michael Mauboussin points to Warren Buffett's analogy that buying a business is similar to buying a castle protected by a moat, the moat here representing a competitive advantage that can thwart competitive forces, and thereby fight the fade. The wider that "moat" is, the greater the company's competitive advantage. Mauboussin established the corporate lifecycle as a construct for competitive advantage; in order to achieve sustainable value creation, companies need a strategy to fight competitive forces.[1]

We agree wholeheartedly. Corporate lifecycle reflects a company's *competitive advantage*. In other words, the further above its industry's long-term average a company is, the bigger its "moat", and the higher its market valuation. The right question is not "do you have a competitive advantage?" but rather "how big is your competitive advantage and can you keep it?"

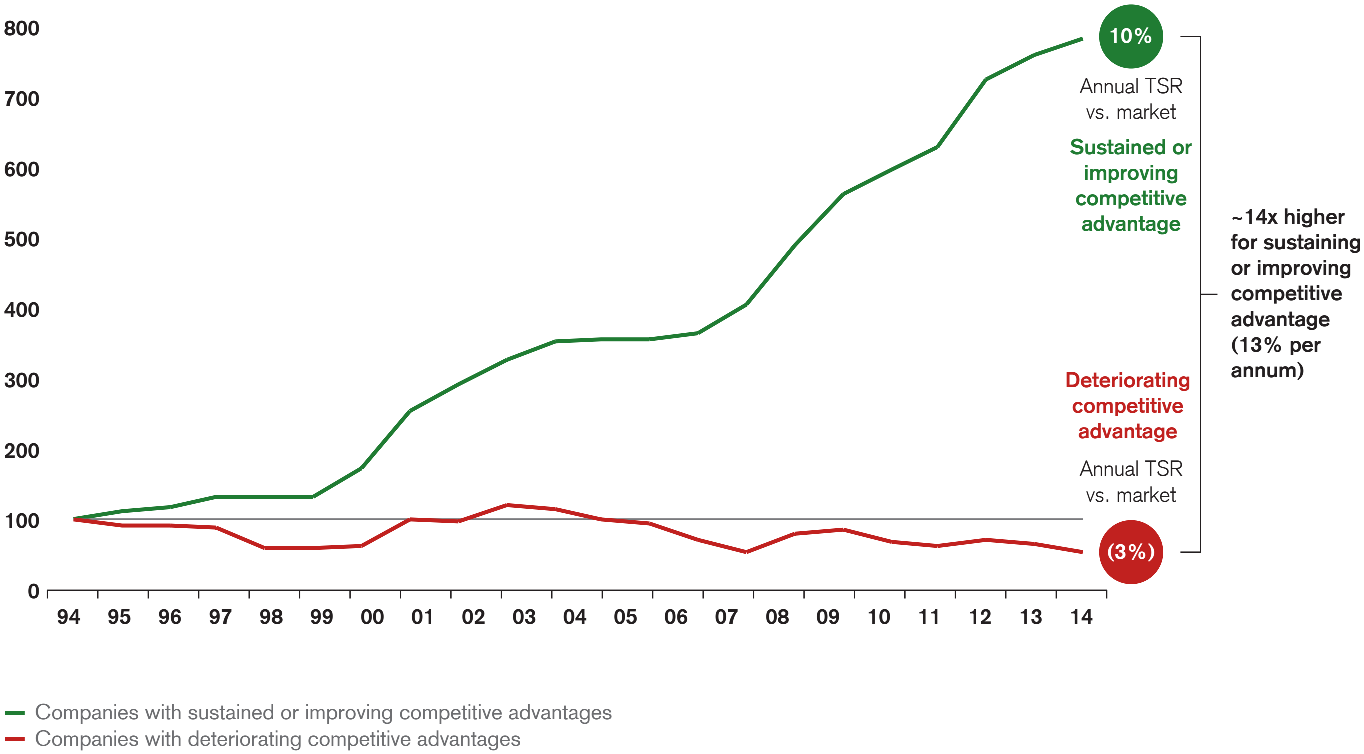
To answer this question, we looked at over 8,000 companies across North America and Western Europe across all industries over the last three decades.[2] We categorized each company annually based on its operational and valuation characteristics to define its lifecycle position (size of competitive advantage). Our analysis revealed that companies outperform and underperform the market based on their distance from the long-term industry average. We defined these companies' relative competitive advantages over time and observed what strategies they employed to beat the fade to sustain their competitive advantage.

The results show that *companies create the most shareholder value when their competitive advantage moat is the largest* (Exhibits 1 & 2). Companies that are the farthest above industry average levels earn an average excess total shareholder return annually of 24%.[3] This aligns with the principle that companies with superior performance (high-growth, high returns on capital) rightly get rewarded superior market valuations over the long-term.

While companies with the largest competitive moats indeed create the most value, not all companies can occupy or remain in such a position. In fact, only a minority of companies fell into this category.[4] Furthermore, the majority of companies with the greatest economic moat – the biggest competitive advantage – eventually saw a decline in their performance relative to peers.[5]

Exhibit 5 shows that the companies that sustained or improved their competitive advantage materially outperformed companies with deteriorating competitive advantages. Companies that succeeded in fighting the fade generated ~14x more shareholder value overall and an average of ~10% better shareholder returns than the index *each year* over the last two decades. On the other hand, the companies who saw their competitive advantage suffer in that time period underperformed the broader market by (3%) per year.

Exhibit 5: Valuation consequences of sustaining or improving competitive advantage over time
(Relative Total Shareholder Return)



A little more than half of the companies we evaluated demonstrated the ability to sustain or improve performance for long periods of time. And many fewer than that were able to do so for the full three decades of our analysis. Superior performance associated with a strong competitive advantage comes with rich rewards in terms of share price performance and market valuation. Yet the challenge of sustaining performance and reaping those rewards is huge, and many companies fail to do so. But what can we discern from those companies that consistently performed or even improved? What are their secrets? It seems to boil down to another concept we have written about before: capital deployment strategies.[6]

Allocating capital to growth is critical to sustaining or improving performance

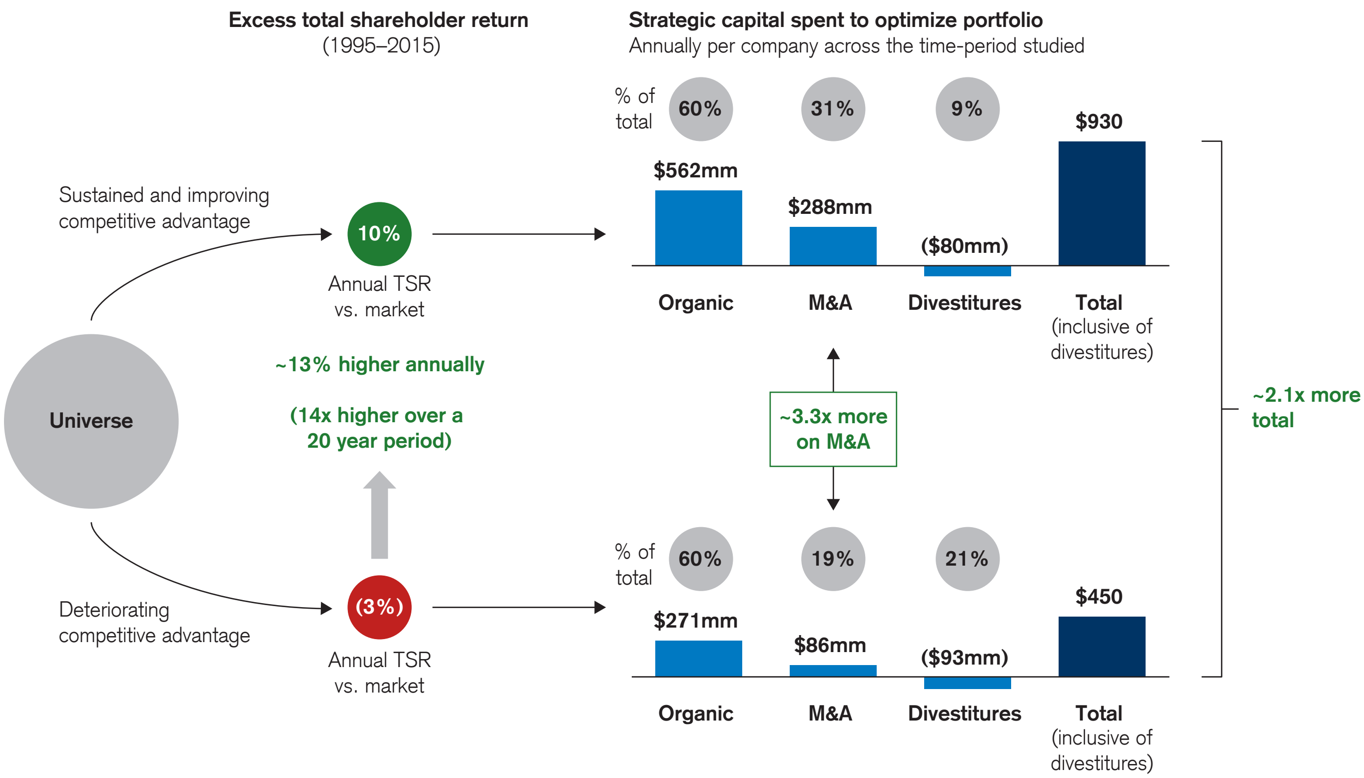
So how do some companies manage to sustain or improve performance when so many others fade? Trying to maintain the status quo may sound appealing but doing so ignores the competitive forces which challenge companies to constantly evaluate their business.

We examined the companies which made up the top cohort of companies in Exhibit 6. What were those successful and value-creating companies doing to sustain and improve their performance?

We studied the capital deployment profiles of companies with sustained and improving competitive advantages versus those with deteriorating advantages over three decades. Across the spectrum of capital deployment alternatives, *our data did not reveal a significant distinction between the top and bottom cohort in their capital distributions to stakeholders*. However, there were material differences in what we would characterize as strategic deployment of capital: M&A, divestitures and organic growth. In other words, what seems to work is a focus on investment in the business. We recognize that M&A represents a cash outflow and divestitures a net cash inflow. For purposes of this analysis we are adding the values of the two to serve as a proxy for strategic activity.

Such strategic investment pays off irrespective of how wide your current competitive moat is. We found that companies in the top half of Exhibit 6 allocated approximately 3.3x more capital toward M&A than the companies in the bottom half did (competitively disadvantaged firms). The companies with the best track records of sustaining or improving their relative competitive advantage spent more time, money and effort on M&A, divestitures and organic investment than other companies and garnered massive valuation outperformance in the market as a result of their efforts.[7]

Exhibit 6: Strategic capital spent to optimize portfolio



A company can change its lifecycle profile, as well as the lifecycle profiles of each of its segments, by making decisions that reduce risk in the portfolio by selling businesses that have begun to fade. Companies should evaluate their lifecycle positioning for each segment separately, and then consider the appropriate capital allocation decisions.[8]

Lifecycle can be useful in considering the economic implications of a prospective deal. Exhibit 7 provides a framework for evaluating how a target's position in its lifecycle can affect the M&A transaction, from the price paid to the value created.

To look at this, we evaluated nearly 450 material public M&A deals from 1995–2015.[9] An acquirer looking to reshape their portfolio can buy up the lifecycle curve (higher returns and higher growth), down the lifecycle curve (lower returns and lower growth), or in the same position (similar returns and similar growth). We placed transactions into these categories (e.g., the distance from industry average performance) of the target relative to the acquirer.

Exhibit 7: The M&A lifecycle roadmap

Now, here's where things get interesting. We found that acquisitions generally can create significant value along the entire lifecycle spectrum regardless of where prospective target company sits.[10] Of the companies that "get it right," the upside for successful execution is hugely rewarding – the average of all successful M&A transactions in our data set created double digit total shareholder return in excess of the index, to the tune of +17%.[11]

What made these transactions so successful? The characteristics of a successful deal vary depending on the lifecycle category of the target relative to the acquirer. Exhibit 7 shows that buying up the lifecycle curve has the highest potential upside – the most successful deals create 21% returns. Yet this upside can come with some risk – the average incremental premium paid to market price for an acquisition target up the curve is an incremental 2.2x premium to its current EBITDA.[12] Companies buying up the curve should keep this in mind; although the upside is significant, there is a risk of overpaying. This risk may explain why transactions that involved buying up were the smallest subset of our sample (28% of all M&A deals analyzed).

While buying up the curve has the highest upside, buying down the curve or within the same bucket can create meaningful value as well. When a company purchases a target with a relatively weaker position, the acquirer has opportunities to extract significant synergies from the target, and create significant value as a consequence. Competitively disadvantaged companies also tend to sell for a cheaper price (1.2x for down, 1.6x for same), meaning there is less risk of overpayment.

In nearly three-quarters of the deals we evaluated, the acquirer purchased a target in its same lifecycle category or in a less attractive lifecycle category. If we accept the notion that a lifecycle is just a way to think about the distance between a company and the long-term industry average, then it makes sense that M&A can create value across the entirety of the lifecycle spectrum. From this perspective, M&A is about the relationship of the purchase price paid to the value received. Companies in later stages of the lifecycle may have lower returns and lower growth than the highest competitively advantaged companies, but they are also likely to have more steady, stable and predictable performance, making them less risky and still attractive as targets – and at a lower purchase price. As Exhibit 7 shows, the successful acquisition of companies in a similar lifecycle position or lower still created double digit total shareholder returns in excess of the market of +15% and +18%, respectively.

There is no one-size-fits-all strategy. Sustaining or improving performance may not be feasible for some companies in some competitive environments. Companies operating in sectors like autos or airlines face very different industry dynamics than those in high-growth technology or biotechnology. That said, knowing how to monitor and how to potentially improve your competitive advantage is important. The valuation rewards of doing it right are huge. The valuation consequences of failing to do so – or of getting it wrong – are equally big.

Conclusion

Let's return to the questions we posed at the outset.

First, does competitive advantage really matter when it comes to value creation and investor perspectives on performance? Yes. Competitive forces work against you in the long-run and force all companies to fade toward an industry mean. But to counteract that, companies should be vigilant about their competitive advantage because their position influences both investor perception and market valuation. Companies that sustain or improve their distance from the average level of industry performance deliver the greatest level of shareholder wealth creation.

And second, since competitive advantage matters, companies can protect and expand their competitive advantage (lifecycle positioning) through astute portfolio optimization and thoughtful capital deployment and capital investment strategies, including M&A.

Here are the practical implications for our corporate clients:

1. Quantify your competitive advantage or position in the lifecycle. Know the size of your moat and continually assess it for any relative changes.

2. Apply the same approach to your business portfolio segments. Evaluate the competitive advantages of each in order to identify portfolio optimization opportunities.

3. Consider M&A in the context of lifecycle positioning. M&A can be a very powerful, effective and value-creating strategy to fight competitive fade and protect your moat.

Competitive advantage is much more than just a list of company-specific attributes informed by Porter's Five Forces or a sweeping mention of brand power. Competitive advantage can be quantified and its influence on valuation controlled. With the ideas in this paper, you can fight the fade.

End notes

1 Michael J. Mauboussin, Dan Callahan and Darius Majd, "*Measuring the Moat: Assessing the Magnitude and Sustainability of Value Creation*," Credit Suisse Global Financial Strategies, November 1, 2016.
2 We analyzed 8,300 companies across a 26 year period (1990-2015). Universe includes companies within North America and Western Europe that exist in the Credit Suisse HOLT database; all GICS sectors were included with the exception of Financials.
3 Dataset includes 8,300 companies across 26 years and results in 215,800 observable instances of companies exhibiting a particular lifecycle position or distance from the industry average. Among 215,800 observable instances, we categorized 47,522 instances from1995–2015 in which companies exhibited an operating profile (or lifecycle position) consistently for three or more years. Total shareholder returns for these 47,522 categorized instances were computed on an annual basis and were observed across each year that a company was categorized into a lifecycle position. All total shareholder return metrics are shown relative to the MSCI World Index. Constituents in the TSR data shown throughout this paper do not necessarily reflect the entirety of constituents in the MSCI World Index.
4 See end note three for the methodology and calculation of total shareholder returns across our universe of observable instances. Of the 215,800 observable instances that we analyzed, only 5% of instances fell into the most favorable lifecycle position with the largest competitive "moat" where the highest levels of TSR were observed.
5 Sourced from Credit Suisse's HOLT CFROI framework and global database; defined as instances where a company sustained operational characteristics in line with the lifecycle category furthest from the industry average for three or more years and then proceeded to decline towards the industry average.
6 **Credit Suisse Corporate Insights**, The Capital Deployment Challenge (Q4 2015).
7 Total capital spent to optimize the portfolio via M&A, divestitures, and organic growth is an illustrative measurement for the total activity across each of these actions. While we recognize divestitures as being a net cash inflow to the seller, we add the absolute value of divestiture inflows to the absolute value of capital spent on M&A and organic growth to characterize the level of total activity in dollars.
8 For example, a fast-growing, high return company may consider selling a fading segment that operates in a mature industry. Conversely, a company seeking to improve its growth prospects could consider the acquisition of a faster-growing target in an early-lifecycle industry. These decisions influence investor perceptions of the company and materially improve the growth prospects and risk profile of a company.
9 We analyzed a dataset of 441 transactions from FactSet and Dealogic that occurred from1995–2015. The dataset includes only companies where the acquirer and the target were both publicly-traded companies at the time of the transaction and the target was greater than 10% of the acquirer's enterprise value at the time of announcement.
10 Since the average total shareholder return across all M&A transactions was value neutral (median total shareholder returns in line with the index), this underscores that getting M&A "right" is important and that there is indeed an art to the deal.
11 See end note nine for M&A universe description. The average TSR performance is relative to the MSCI World Index and is calculated in the two years following the deal announcement. The "best case scenario" TSR data shown in Exhibit 7 is calculated by taking the average of all deals that had a 2-year TSR post-announcement greater than zero.
12 The average incremental premium paid for each transaction was calculated by taking the delta between the target's [equity value / LTM EBITDA] at the time of the transaction's announcement and the [equity value paid for the target / LTM EBITDA] at the time of the transaction's announcement. This approach captures the relative premium given the purchase price for the transaction.

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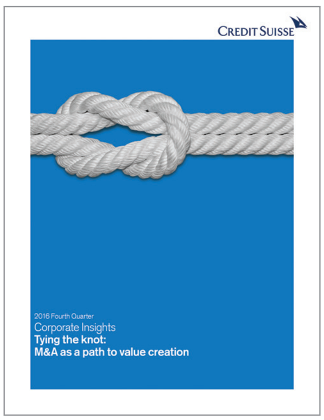

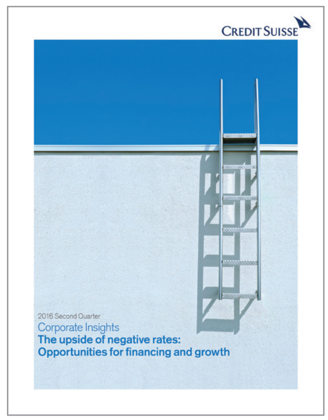

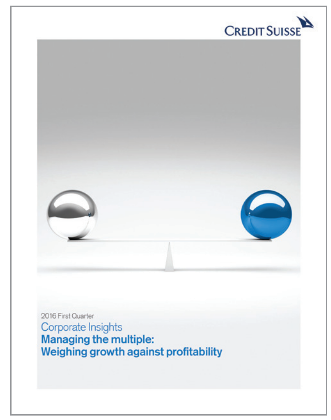

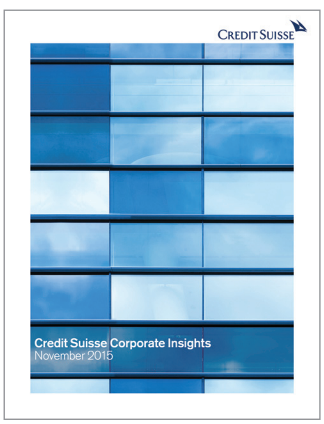

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