



R O B E R T S

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Rough trade

It is great to live in a time of economic boom. But underlying this strong performance is a serious trade problem: Australia is not selling as much of what really matters to the rest of the world.

THE EMPTY CONTAINERS PILING UP at Australia's ports tell the story. For all the manufactured goodies that arrive from overseas – the irons, computers, iPods, plasma screens, medical-resonance imagers and the like – Australia sends little back in return.

Austrade figures show a growing reliance on comparatively low-value but high-volume exports such as minerals, and the country is not even in the game of relatively high-value goods.

The balance of trade deficit is not so bad in so-called substantially transformed manufactures, such as steel and aluminium ingots. Australia is roughly paying its way internationally in STMs, recording only modest deficits and the occasional surplus in recent years.

But the picture in more complex manufactures, so-called elaborately transformed manufactures, just keeps on getting worse. Australia's trade deficit in ETMs has risen steadily since 1982-83: from \$11 billion to a mind-boggling \$91 billion in 2005-06.

Australia doesn't have a national strategy – other than hope – to reverse this slide, believing that the high prices a booming

China is paying for minerals will close the gap and that India will follow on to further increase volumes.

This has not happened in the real world. Years into a supposed boom, Australia has suffered 56 consecutive monthly trade deficits, with November's a relatively modest \$843 million. Month after month, politicians find reasons for hope in the figure – this time, the drought is holding exports back. But there is absolutely no evidence that the structural imbalance – a profile of developing world exports and developed world imports – is changing.

This is the question that those opposing any sort of industry policy focused on high-value manufactured exports must answer. Where, if not from manufactures, will exports come from to bridge the trade gap? Because bridged it must be. It is not as if Australia is particularly strong in exports of intellectually dense services such as design and engineering.

Calls for a manufacturing focus are usually met with howls of protests that this must mean a return to protectionism. Active policy that attempts to encourage investment and exports does not necessarily mean protection.

Take the finance industry, for example – it has been a beneficiary of a long-running policy focus by law-makers that has removed obstacles to growth, developed skills and experience and placed Australian industry in a strong growth position. Numerous inquiries, such as the 1997 Wallis report on the financial system, and legislation such as the Financial Services Reform Act 2001 cleared the way for the sector to thrive. But for some reason, the same level of effort is not accorded to manufacturing.

The first step to changing Australia's fortunes must be to reject the knee-jerk notion that supporting manufacturing equals protectionism. It should not and it need not – it is just a lot of hard work. But will we ever see it? ●

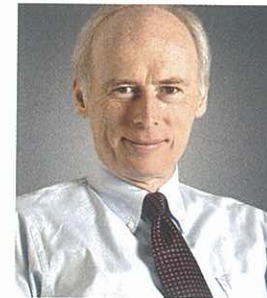
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DE – COMPLEX MANUFACTURES (ETMs)



C A L T H R O P

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Inertia is the enemy

Gaining a much sought-after footing in the list of S&P/ASX100 companies is one thing. Staying there is quite another.

All companies face the toothbrush challenge – to develop and manage an innovation system that keeps real prices inching forward.

NEARLY SIX OUT OF EVERY 10 COMPANIES that made up the S&P/ASX100 in 2000 are no longer there. A few went broke, some lost control of their destiny and were taken over, and the rest simply drifted out of the S&P/ASX100 towards irrelevance – good companies that were not able to grow as fast as the market demanded.

This “mortality” rate has been rising steadily, from 40 per cent in the 1970s, to 50 per cent in the 1980s, to 60 per cent in the 1990s. We're halfway through this decade, with a projected mortality rate of 73 per cent.

What is behind this disappearing act? Two factors: for one, the base of the S&P/ASX100 is rising at a surprisingly fast rate, pushed by a strong supply of companies entering the index. Between 2001 and 2005, the market capitalisation of the number 100 company on the index rose an average of 20 per cent a year. Add a representative dividend increase of about 3 per cent, and a company has to deliver total returns to shareholders of about 23 per cent a year to avoid sliding closer to the exit door – a sobering challenge.

But there is a second factor, especially daunting for incumbents within the index: commoditisation. This is the process by which any given product or service in a competitive economy trends towards a lower net price over time, in real, inflation-adjusted terms.

Left unfixed, it undermines companies' prospects of revenue and profit growth inch by inch, year by year, until they drop out of the index.

The only cure for commoditisation is innovation. Done well, it results in a higher net price per equivalent unit, and if it doesn't, under this definition it is not an innovation.

The trouble is, most companies confuse innovation with growth. As a result, they break the golden rule of innovation – that it must yield a higher net price per equivalent unit. Companies chase revenue, not “higher margin revenue”. It is the equivalent of walking under the bar in a high-jump competition – no prize.

More revenue at the same, or lower, price per unit builds complexity, as companies introduce new products and proliferate stock-keeping units. Complexity creates cost and compounds with commoditisation to create mortal risk to companies.

Here is the acid test: what does the net price per equivalent unit look like over time, in a business? If it is not going up, the business is headed for trouble. And how do the best companies keep prices heading north, without artificially inflating them?

Colgate-Palmolive, for example, in China began substituting local raw materials of acceptable quality in its toothpaste instead of importing them. That way it was able to improve margins while lowering the price of its toothpaste to just 44 per cent above local brands, a price point that appealed to consumers looking to trade up. The company also diverted cost savings into marketing and launched new products such as Colgate Herbal.

While Colgate's strategy in China is still being refined, its market share there has increased from 10 per cent in 1996 to more than 30 per cent in 2004.

In a similar way, Colgate has brought its approach to continuous innovation to Australia's toothbrush market, in this case offering a constant but controlled flow of new products that justify higher price points. Consumers think the new toothbrushes are worth it, so they comply.

All companies face the toothbrush challenge – to develop and manage an innovation system that keeps real prices inching forward.

The first task is to measure net price over time. Most companies do not do this, in any formal way that actually weights its average price by number of units sold at each price.

The second task is to set a simple yet powerful innovation rule – no innovation project should take up space in the system if it does not aim for a higher net price. Applying this rule with any sort of discipline cause the cancellation of many projects.

Taking the initiative is essential. To add to former Gillette chief executive Jim Kilts's quote – “the opposite of success is not failure but inertia” – standing still, in a commoditising world, is suicide. ●

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