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Results

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The new brand tax

On our minds

"Big consumer products companies will need to be not only well known but also well regarded."

Nicolas Bloch
Partner
Bain & Company

Famous-brand companies must feel as if few of their good deeds count. Over the years, they've met demands for increased social and environmental responsibility within their operations. Now activists say they're also responsible for what occurs outside their walls—everything from how independent contractors treat employees to the way suppliers extract raw materials.

For household-name companies, this amounts to an added cost of doing business—a brand tax, holding firms accountable for links in their value chains they don't control.

Activists have a ready audience: An Environics study showed that at least two-thirds of 25,000 consumers in the US, Canada and Western Europe form impressions based partly on a company's ethics, environmental impact and social responsibility. As one Greenpeace member put it: "[Targeting brands] was like discovering gunpowder for environmentalists."

Many brands find themselves on the defensive. And many avoid taking direct action, even when they wish to do the right thing, fearing added expense and self-inflicted criticism.

There are two key ways companies can deal with these pressures. First, they can focus on values, not boycotts. One company doing that well is Unilever. The Anglo-Dutch concern monitors its global environmental and social initiatives and publishes yearly progress reports about them.

Yet Unilever's issue-management skills began in crisis. In the mid-1990s, Unilever and environmentalists shared a problem: Marine fishing stocks were dangerously depleted. Nobody wanted overfished seas—not the World Wildlife Fund (WWF), which sought more stringent fisheries management, nor Unilever. At the time, Greenpeace was campaigning against Unilever's practices in buying what today amounts to about 300,000 metric tons of frozen whitefish yearly.

Unilever took bold action. It joined with WWF in 1996 to form the Marine Stewardship Council, an independent certifier ensuring that producers comply with environmentally sound processes.

The second way companies can manage value chain issues is to focus on those closest to "home."

One approach assigns different actions depending on how close issues land to the core business. Dead-on concerns clearly associated with the company's brand—footwear suppliers to Nike, for instance, or coffee suppliers to Kraft—require direct engagement with NGOs or consumer groups.

Issues just outside center can erupt when a company has knowledge of an issue but limited direct involvement. Such issues are often best pursued in broad initiatives. De Beers's condemnation of "conflict diamonds" is an example.

Unilever isn't the only company trying to instill its principles among suppliers. But it will remain among the few until more companies see evidence that certified products can deliver a business benefit.

As such initiatives gather momentum, big consumer products companies will need to be not only well known but also well regarded.

In this issue

Europe's low-cost path to high-

Management feature

"There is an optimal path to value creation."

Philippe De Backer
Director and head of European Financial Services practice
Bain & Company

"Cost and revenue leaders are disproportionately rewarded by the market."

François Goffinet
Manager
Bain & Company

When HSBC Holding's widely scrutinized plan to buy a 20 percent stake in China's Bank of Communications closed in August, the UK bank succeeded in making the largest Western investment to date in the mainland's retail banking sector. At the time, Hong Kong chairman David Eldon made himself clear: HSBC had no intention of targeting a stake in China's state-owned Big Four banks.

There's more to that strategy than simply caution. It's a reflection of HSBC's cost-effective approach to expansion, which avoids a rigid universal banking model. In various markets, the company cherry-picks its acquisitions, buying only where its managers see value. It can operate as a retail bank in one market and an investment bank in another. As a result, it has been able to grow rapidly without letting costs spiral.

It's an approach that should please HSBC shareholders at a time when profit-conscious banks are asking themselves where to push first: expanding revenue or trimming costs? When we looked at 150 of the world's largest banks, we found, surprisingly, that banks like HSBC that contain costs first do more for their stock price than those that prioritize growth.

> "A cost focus remains the best path to achieving performance leadership."

Banks with the lowest cost-to-income ratios—those that ranked in the best third of our study—but annual revenue growth that put them in the worst third still produced annual shareholder returns 14 percent higher than the local stock market indices. However, banks that ranked in the top third for growth—but in the bottom third when it came to efficiency—returned just 3.5 percent more than their country indices. In other words, efficient banks with slow growth still manage to outperform their less efficient, higher-growth peers—by a factor of four to one (see Figure 1).

Achieving the magic combination of high growth and low costs isn't easy, and the ways banks can address that challenge vary greatly. For example, European banks cannot always take their cues from top American banks—the markets' dynamics are too different.

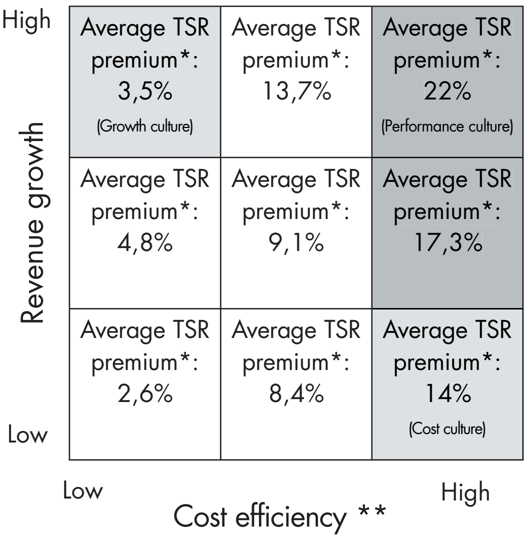
Take the level of consolidation. Despite a recent run of mergers, the top five banks still control only around a quarter of the US market, which means American banks can still generate growth by taking over their peers. Those that do it best tackle costs first: Bank of America, for example, which recently acquired FleetBoston, has maintained a cost-to-income ratio of 60 percent, compared with 67 percent for the industry as a whole.

In Europe, opportunities for consolidation are less evenly distributed. In the UK and France, five banks already control about 80 percent of the market in each country. That makes acquisition-based growth possible only on a cross-border basis—something few European banks besides HSBC have done successfully. In some countries as fragmented as the US, ownership structures limit consolidation opportunities. In Germany, consolidation tends to take place within ownership tiers that include public banks, cooperatives and private banks. If the Big Four shareholder-owned banks—Deutsche Bank, Dresdner, Commerzbank and HVB—were to consolidate, they still would hold only 16 percent of the retail market, with the lion's share held by the public savings banks.

And keeping costs down is even more difficult in continental Europe because of labor restrictions. Once banks have capitalized on

Figure 1:

Efficient banks with slow growth outperform their less efficient, higher-growth peers by a factor of 4 to 1.



Average TSR premium*: 3,5% (Growth culture)	Average TSR premium*: 13,7%	Average TSR premium*: 22% (Performance culture)
Average TSR premium*: 4,8%	Average TSR premium*: 9,1%	Average TSR premium*: 17,3%
Average TSR premium*: 2,6%	Average TSR premium*: 8,4%	Average TSR premium*: 14% (Cost culture)

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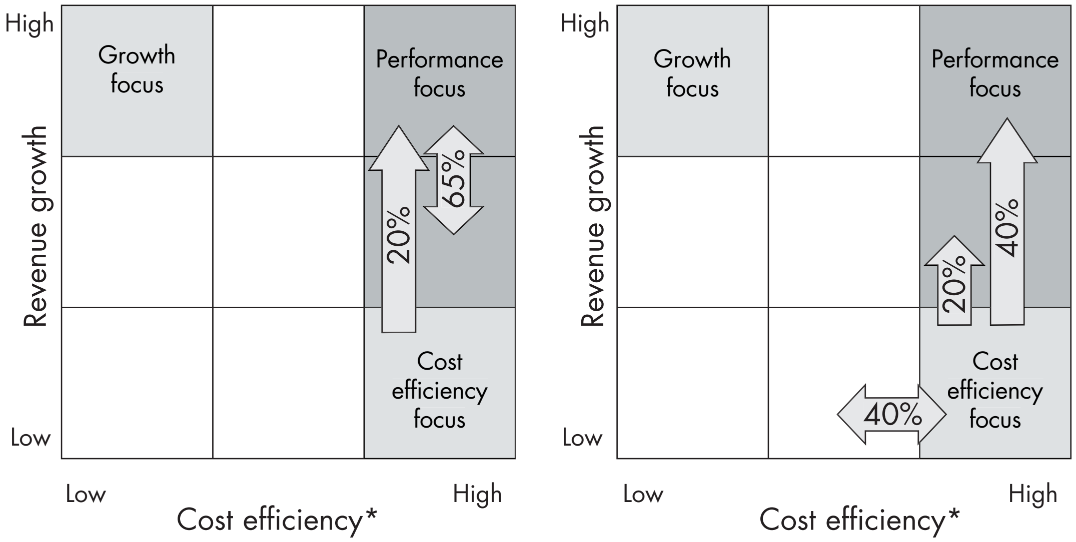
*Average total shareholder return premium over the country index.

** Cost plus net loan provision divided by income.

performance banking



85% of global performance leaders in 2002 were previously cost leaders

60% of global cost leaders in 1998 had evolved towards performance focus by 2002

Figure 2:

Building a cost-focused organisation is the best path to achieving performance leadership.

Note: % shows the proportion of banks in this box that moved into other boxes from 1998 to 2002.

* Cost plus net loan provision divided by income.

such low-hanging fruit as purchasing, they hit a wall. Going after technology savings is rarely an option because it usually requires outsourcing or offshoring. Similarly, branch reconfiguration generally results in job losses or at least requires shifting employees to another area. In most of Europe, except for the UK, such transfers go down like sludge.

Despite the difficulties, a cost focus remains the best path to achieving performance leadership for banks, in our experience (see Figure 2). Most banks can still gain efficiency by improving operations by simplifying processes or adjusting incentive structures to speed good ideas into action. But banks that have exhausted cost-cutting potential should not forget part two of high performance: increasing income. They can approach this cost-consciously, by focusing on increasing their business with existing customers rather than forays into new businesses.

The big UK banks that have pruned overlaps resulting from consolidation are now seeking to boost revenue growth. The UK's HSBC and HBOS serve as prime examples of how to go about it cost-consciously.

HBOS has expanded impressively—attracting 1.2 million new bank accounts and one million new credit card customers in 2003, as well as carving out a 23 percent share of the mortgage market—by running multiple brands off the same low-cost platform. In mortgages, for example, HBOS is the lowest-cost provider among the UK's Big Five, and it uses that platform to process all its mortgages, regardless of which customer segment it's targeting. Its cost-to-income ratio fell from 45.2 percent in 2002 to 41.6 percent in 2003. Result: In 2003 the bank's profits jumped 27 percent. On the other hand, HSBC in Europe, as in China, illustrates how to acquire growth cost-consciously across borders. For example, in 2000, HSBC purchased Crédit Commercial de France, a medium-sized French bank, which gave it a foothold in the retail market in continental Europe. With 650 branches, CCF had only the eighth-largest retail branch network in France, but it was the country's most profitable retail operation. This acquisition helped HSBC's profits attributable to shareholders to jump from $5.4 billion in 1999 to $8.8 billion in 2003.

While the ability to manage costs varies by country, it's possible for European banks to take a cost-conscious approach to expansion without resorting to layoffs. Ultimately, banks that keep costs in the foreground, even when targeting revenue expansion, will find the path cleared for sustainable, long-term growth.

> "Achieving the magic combination of growth and low costs is no easy feat, and the means by which banks can address that challenge vary greatly by region, country and player."

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Growing through the value chain

Guest interview

Interview with
Guus Hoefsloot
Chief executive officer
Heijmans N.V.

In one of the most competitive markets in Europe, 70-year-old Dutch construction group Heijmans has always emerged on top. Today, as the Dutch construction industry undergoes a major shakeup that's forcing all players to comply with tough new standards, Heijmans has zoomed in on opportunities and announced optimistic forecasts. Its recent contracts include the construction of 10 hospitals across The Netherlands, a section of the North-South metro line connecting Amsterdam to Schiphol and the conversion of nine castles into a luxurious 1,000-unit residential complex with full facilities, including a golf course. CEO Guus Hoefsloot explains the major changes in the construction market and outlines how his company will tackle its next wave of growth.

"Heijmans has grown impressively since going public in 1993. In less than a decade, it went from being a regional player to one of the top three construction companies in The Netherlands. Last year's order portfolio boasted €2.3 billion worth of projects, and profits came to €75 million. But the increase in the company's size brought with it a host of new issues, many of which we've had to address over the past year. And at the same time, we've had to deal with a major upheaval in the construction market."

"When I became Heijmans's CEO, one year ago, we sat down to tackle the uncertainties and consider the company's future. We decided to first cope with our short-term priority: working through the difficulties ushered in by the large-scale violation of construction laws in The Netherlands. This major scandal—which involved strategies for spreading risks and costs, particularly in infrastructure construction—came out in the open in 2001. The Dutch parliament launched an aggressive inquiry that's still ongoing."

"This debacle has placed new restraints on our market especially in combination with the downturn in the Dutch economy. As a result we've become extremely selective about the projects we take on, much more cash-driven and much more careful during the bidding process. We know that if we win a project by estimating too aggressively on a low-cost basis, it will come back to haunt us. Today we run a tight ship in terms of cash management, fixed costs and risk management, which means we've had to accept a 15 percent drop in our net profits. Under the present circumstances in The Netherlands, our shareholders still find this acceptable."

New trends, new opportunities

"Despite the burden of the parliamentary inquiry, Holland still offers exciting opportunities. One we've seized upon is the demand for total solutions. Both individuals and organisations are now looking for construction companies that can provide a complete set of services: design, financing, construction, maintenance and other services."

"This is why we've decided to increase our activity in the front end of the value chain—namely, activities giving us a greater grip on the development phases of a project—from its current level, 25 percent, to 35 percent by 2008. We also want to increase our presence at the back end of the value chain—namely, more maintenance activities—and take it from its current level of 5 percent to 20 percent by 2008."

"By connecting with customers at a project's earliest stages and displaying more flexibility in project management, we've become more customer driven than capacity driven. Be it in residential development, office building or infrastructure construction, we aim at codeveloping with our customers. I believe this is where we differ from other construction companies and developers."

Acquiring other players to grow offerings

"If we stick to this strategy, I see more opportunities for future business. Positioning ourselves as proactively as we have, on the front and back end of the value chain, has prompted tangible new goals for the company. The first goal is to grow our profit margins and returns. This will fuel organic growth and internally financed acquisitions over the next five years."

Expanding abroad

"Another goal is to become more active abroad, but only if we can play the same role of total solution provider, not just capacity provider, as we do at home. There's demand for that in the UK. Heijmans is among the top four players in Belgium, which, combined with activities in Germany, accounts for 15 percent of our activities. But we have to be careful and approach foreign markets on a piecemeal basis. I'd like to see activities abroad become 20 percent of our growth activities as a first step."

Embracing multidiscipline

"Finally, our overriding goal is to create an atmosphere of multidiscipline and market innovation in this otherwise traditional industry. As I mentioned, we need to bolster our full-service offerings through partnerships not only with customers but also with our suppliers and subcontractors. This is the exciting part of growing a business like ours, because it marks a historical turn in the company's development: from a technologically driven entity to a market-driven service provider."

Interview conducted by Gilly Weinstein, of So To Speak