Prism

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Back to Basics

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The end of the internet hype, the bursting of the stock market bubble, or 9-11: These phenomena and the general dire economic situation make executives and industry watchers concerned with the theme of "back to basics" - which means that companies can sustain or return to financial health through solid management approaches that during the frenzy of the 1990's were regarded as hopelessly outmoded. The authors make a case in point that they are not.

The end of the internet hype, the bursting of the stock market bubble, the collapse of the telecommunications industry, the accounting scandals, the accumulation of bad debts on banks' balance sheets, the dire situation of once proud industrial behemoths, the prospect of at best moderate economic growth for coming years: all these phenomena encourage executives and industry watchers to turn their attention to the theme of "back to basics". It is centered on the belief that companies can sustain or return to financial health through some solid management approaches that in some cases came to be regarded as hopelessly outmoded during the frenzy and unrealistic expectations of the 1990s. During this period, insistence on profits and evidence of market demand were seen as a sign of lack of imagination.

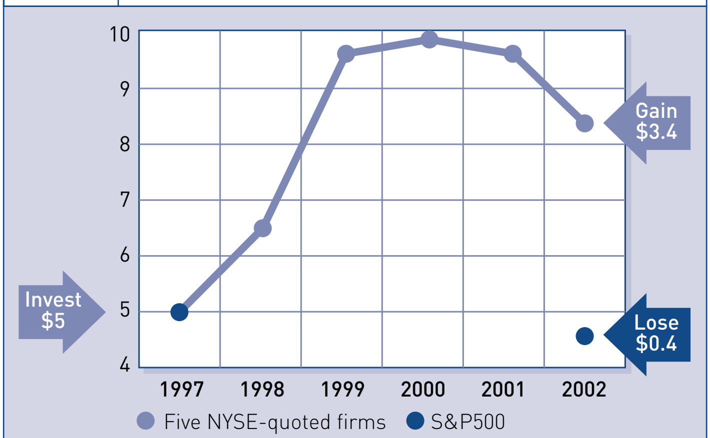
But what are these so-called "basics"? The perusal of the following statements from six companies should help:

- "With innovative products and services, well-known brands and leading-edge technologies, we serve a broad and ever-changing spectrum of consumer and industrial markets all over the world."
- "Our franchise has a number of competitive strengths which allow us to compete successfully in high value-added segments: worldwide market leadership positions; global brand and reputation; technological innovation; comprehensive high quality solution offering; global sales and service; largest installed base; and geographical, product and customer diversification."
- "Our strengths are: premier global brand; extensive global network, with state-of-the-art logistics capabilities and global sales and marketing network; one-stop shop for the [customer], with a broad product range and extensive range of services; technological leadership; premier and diversified customer base; global sourcing expertise."
- "We achieved this [result] by leveraging our existing customer relationships, extending our technologies into new markets and products, and using our applica-

tions expertise to increase customer value."
- "Our continuous renewal is built on four strategic cornerstones: creativity; innovation; global, regional and local expertise; and customer service."
- "We are all about creating new value. A consistent dedication to the development and continual improvement of technologies that dovetail with the needs of customers has been, is and always will be the source of our strength. Our fundamental business strategy is to aim to be the Global Niche Top. We work to gain the global top share in a variety of niche fields in emerging markets by providing unique and sophisticated products."

Do these sound basic, if not plain dull? They may indeed. In fact they are statements from six companies - Avery Dennison, Mettler Toledo, Fisher Scientific, Donaldson, International Flavors & Fragrances (IFF) and Nitto Denko, respectively - that have performed rather well over the past five years. If we had invested 5 times 1 dollar in the shares of the former five NYSE-quoted companies five years ago (start of 1998), we would have stock worth a total of $8.41 now (November 1, 2002), and would have received, in addition, a total of $0.29 in dividends over that period. This corresponds to a compound average annual stock value appreciation of a respectable 11 per cent. If we had invested the same $5 in an S&P500 index fund, we would have stock worth only $4.64 today (see Exhibit 1). By the same token, an investment in Nitto Denko would have yielded an average annual 2.5 per cent gain in Yen terms, compared with an average decline of 9 per cent of the Nikkei 225.

Exhibit 1 **Share Performance of Five NYSE-quoted Firms**



Green line shows the sum of the value of $1 invested in shares of each of the five NYSE-quoted firms (sum of dividends of additional $0.29 excluded). Begin date in 1997 refers to December 31. End-date in 2002 refers to November 1.

Purpose and design of the study

We did not pick these companies entirely at random, of course. We selected companies that are - at least to the outsider - in unglamorous business sectors, relatively unknown to the consumer, and downstream in the “food chain” of huge and highly competitive industries such as automotive, consumer goods, and pharmaceuticals. However, we did choose companies that are global leaders in their sectors, with annual sales between $1 and 4 billion. And we chose companies from sectors that, directly or indirectly, cater for elementary needs that we expect to remain in demand even in a slow-growth environment; unless economy and society collapse completely: environmental care, safety, quality and reliability, efficiency, hygiene and beauty, health, convenience, and the like. We tried to identify the factors that help explain these companies’ strong performance. We also looked for common factors among them. Unsurprisingly, there are strikingly common factors - the building blocks of “back to basics”. These factors led us to the conclusion that the currently often heard slogan “back to basics” doesn’t mean much to these companies - they have always stuck to the basics.

This study was not constructed as a thoroughly scientific, statistically significant project. Rather it was designed to yield insights into broadly applicable principles for a sustainable and successful business operation. We believe that following these principles is necessary for any sustainable success, even though they are of course far from sufficient. The best run company may fail because of factors largely outside its control. Nevertheless, these principles need to be reaffirmed and restated for the contemporary business environment. Some, perhaps most of them were often forgotten or deliberately flouted during the excesses of the 1990s, even by people who should have known better: CEOs, accountants, or management consultants alike.

Neither did we attempt to write yet another corrected or updated version of “In Search of Excellence” or “Built to Last”: we have all learnt in the meantime that miracle companies and managers are very rare. At least if we look at performance over a period longer than one business cycle. The very sources of success in one cycle may be the causes of failure in the next. Nor should these results justify calling a stock broker with a buy order: these six companies are such obvious performers that the stock market, despite its imperfections, in all likelihood has already priced them correctly. Furthermore, each of these firms has had or is having its share of challenges. Rather than providing prescriptions for action, the purpose of reporting our findings is to provide inspiration and encouragement to the innumerable executives and managers who labor every day with dogged determination to improve and sustain their companies' performance.

The building blocks of "back to basics"

It is quite a mouthful, but we can summarize the basics that these six companies embody as follows:

> They operate from a globally integrated and deeply rooted platform, from which they generate a multiplication of products and services aimed at a diversity of customer segments, with the clear imperative of maintaining global leadership. They systematically fortify and refresh their platform through acquisitions, while managing costs aggressively.

As in every mouthful, each bite counts. Let's take them one by one.

1. Diversity of customer segments
If we take a second look at the statements quoted at the beginning the phrases "a broad and ever-changing spectrum of markets", "customer diversification", "diversified customer base" and "extending into new markets" are striking. Indeed, a common trait of these companies is that they incessantly and determinedly seek to roll out their business into new market segments and toward new customers. Such expansionary impulse does not constitute a business diversification, though. These companies are constantly searching for and finding new applications for their core products.
For example, Avery Dennison realizes 75 per cent of its sales on the basis of its core of self-adhesives. Their adhe-

sives are found in such diverse products as signage for petrol stations, CD and DVD labeling, reflective road signs, labels for wine bottles, wristbands for identifying hospital patients, disposable diaper fasteners, and peel-and-stick postage stamps.

Fisher Scientific: 350,000 customers in 145 countries with none representing more than 5 percent of total sales.

Donaldson states that their fundamental business model is that "effective diversification of our end markets will support consistent, superior results." While it sticks to filtration solutions, its diversification strategy has three dimensions: spreading the business geographically, covering both capital equipment and replacement parts, and balancing sales between the various application segments. Also, its largest single customer accounted for no more than 3 percent of net sales in 2001. The same applies to Mettler Toledo.

To take the extreme, Fisher Scientific has more than 350,000 customers located in 145 countries, with no customer representing more than 5 percent of total sales between 1999 and 2001.

2. Multiplication of products and services

As these companies serve a diverse customer base, the capability of multiplying their products, often in close collaboration with their customers, is key. Mettler Toledo reckons that it has a more comprehensive range of instruments and solutions than any of its key competitors. With its more than 160 perfumers and flavorists, IFF creates and produces most of its fragrance and flavor compounds for the exclusive use of particular customers. Avery Dennison has created a venture board that acts as an in-house source of venture capital for internally developed ideas, which were totaling more than 60 in spring 2002.

At the same time, these companies try to generate a recurrent stream of revenues from their offerings. Mettler Toledo has the largest installed base of weighing instruments in the world. Service revenue represented 21 percent of net sales in 2001, of which almost half was derived solely from service contracts and repairs, with the remainder deriving from the sale of spare parts and software support. 2000 of its 8500 employees worldwide are engaged in service.

Fisher Scientific derives 80 percent of its revenues from the sale of consumable products. Its value-added services include pharmaceutical packaging, third-party procurement, contract manufacturing, and laboratory-instrument repair and calibration.

Nitto Denko has developed a strategy known in Japanese as Sanshin, which roughly means “three novelties”: the company is constantly working on new products and new applications to obtain new customers. Products launched within the last three years accounted for 41 percent of sales in 2002.

3. Platform

The goal of developing a diverse customer base and, as a consequence, multiplying the products offered is more easily said than done - economically. A so called “platform” allows each of these to achieve customer diversity and product multiplication and be economically efficient at it: a set of shared assets that enables the company to penetrate a new customer segment or create a new product with limited marginal investments in comparison to competitors with no such advantage. The assets forming the platform are threefold: technologies, brands, and delivery infrastructure.

Most of the products of these companies are variants that originate from a limited number of extremely well mastered core technologies. Avery Dennison, for example, leverages its profound knowledge and competencies in four key areas - coating, converting, microreplication, and film extrusion - to relentlessly shell out new products and enter new markets. Nitto Denko combines its core expertise in polymer synthesis and processing to offer products with a multitude of functions such as sealing, bonding, filtration, permeation, and diffusion.

Brands are the second component of the platform. In quotes the phrases “well-known brands”, “global brand and reputation”, and “premier global brand” stand out. The strength and reputation of the brands allow these companies to successfully extend their product lines. The other side of the coin is that they constantly search for new products or even acquire companies that fortify or extend their brands. Fisher Scientific, for example, leverages its widely recognized and respected name in the research and healthcare industries to expand into services.

Global platform power: The assets that make up the platform for global success: technology, brand, and delivery infrastucture.

Delivery infrastructure is the third component of the platform. Their global networks enable them to reach their diverse customer base with new products quickly and efficiently - in terms of sales, distribution, and service. By the same token, they have incorporated e-commerce capabilities into their basic business model. At Fisher Scientific, for example, e-commerce sales increased from 14 per cent of total sales in 2000 to 22 percent in 2002.

The platform model demonstrates that being diversified and focused at the same time is not a contradiction. Donaldson, for example, fully focuses on filtration solutions. Its customer base and product range though are diversified, including filtration equipment for heavy industries, computer disk drives, aircraft cabins, trucks and off-road equipment.

4. Globally integrated

All six companies operate on a global scale. However, they don’t simply do global business by exporting from their home base. They are, instead, spread all over the world. The assets that make up their platform - technology, brand, and delivery infrastructure - are spread worldwide and managed according to a globally integrated concept.

IFF, for example, has 38 fragrance and flavor laboratories in 27 countries, backed up by a central research center in New Jersey. Mettler Toledo is transferring not only the manufacturing but also the R&D for its low-end products to China, where it employs 110 out of its 750 R&D professionals.

In its global activities Mettler Toledo utilizes a dual brand strategy for certain market segments to improve its overall market penetration: in addition to its prominent Mettler Toledo brand, it uses Ohaus to sell balances to educative institutions. In China it targets the entry-level user with the lower-cost Viking brand.

The same globally integrated concept holds true for the delivery infrastructure, be it in manufacturing, sourcing, logistics, sales, service or online systems. Avery Dennison, for example, manages 40 integrated Avery Dennison websites all over the world. Fisher Scientific has a global logistics system that seamlessly links customers, distributors in 42 facilities worldwide, and its more than 6000 suppliers. Donaldson's Asian presence now consists of eight manufacturing plants (roughly one out of four worldwide) and more than 20 offices in 11 countries.

Longevity by itself is not a virtue - but the future is now. All six companies keep their legacy and preserve the platform. And, they avoid the trap of becoming overextended

5. Deeply rooted

Solid platforms are not built overnight. When we look at these companies' histories, it is not only their longevity through many business cycles which is striking, but even more so the fact that they do not appear to have strayed far from their original business. For example, Erhard Mettler started his own company of precision mechanics in 1945. It subsequently merged with Toledo Scale, founded in 1901 and the largest US manufacturer of industrial scales at the time of the merger. Chester Fisher founded his homonymous company to supply scientific tools to the then burgeoning steel industry in 1902. Frank Donaldson Sr. started manufacturing simple air cleaners for farm tractors in 1915. IFF's history dates back to 1917, when A.L. van Amerigen & Co. began importing essential oils from Holland into the USA. R. Stanton Avery manufactured the world's first self-adhesive labels in 1935. Nitto was incorporated as Japan's first manufacturer of electrical insulating materials in 1918.

Obviously, longevity by itself is not a virtue. But the future is now. The executives of these six companies appear to be aware of their legacy and are keen to preserve and enhance it by skillfully building their platform, while avoiding the trap of becoming overextended.

6. Global leadership

Each of these six companies is a global leader in its markets. At Mettler Toledo, 80 percent of product sales are from products that are global leaders in their segment; in weighing instruments its market share is more than twice that of its nearest competitor; and most of its other sales come from product lines where it holds a top-three global position. Fisher Scientific claims to be "the world leader in serving science". Donaldson estimates it is a worldwide market leader in most of its product lines. With 17 per cent global market share, IFF is the largest supplier of flavors and fragrances. Nitto Denko has a strategy of aiming for at least a 50 percent share of any market it enters.

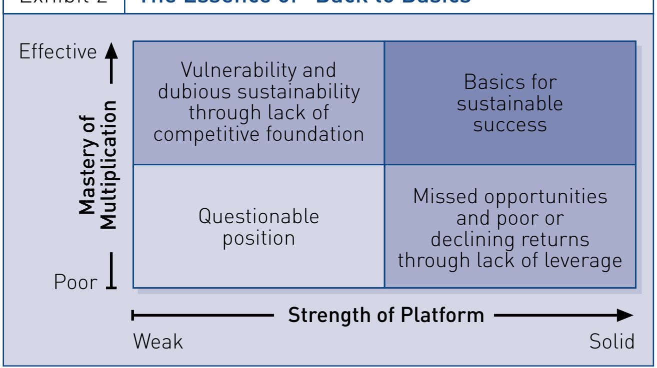
At these companies, being a market and technology leader is not only a corollary of past achievements. Strengthening the leadership position has become an objective by itself, both for external and internal reasons. As Donaldson states: "[Our mission is] to provide superior return for our shareholders, through consistent, long-term earnings growth built on global leadership in filtration solutions, thereby creating security, opportunity and challenge for our employees." Product multiplication and acquisitions contribute critically to continually and consistently meeting the leadership imperative.

7. Systematic acquisitions

There is a body of literature and anecdotal evidence showing that most mergers and acquisitions do not live up to expectations and destroy shareholder value for the acquiring company. Much of that evidence relies on studies of large acquisitions involving two publicly quoted companies. The track record from the six companies studied here seems to suggest that the above conclusion may not be inevitable.

Indeed, these six companies systematically acquire smaller companies. For example, Fisher Scientific has made 30 acquisitions between 1992 and 2002. Likewise, Avery Dennison, Mettler Toledo and Fisher Scientific state in almost identical words that "acquisitions are an integral part of our growth strategy." The acquisitions appear to create value by verifying that there is a strong mutual fit between the acquiring company's platform and the acquired company's business in terms of technologies, brands, and delivery infrastructure. The

Exhibit 2 The Essence of "Back to Basics"



acquired company obtains leverage from the existing platform; in return, the acquired company's business fortifies the existing platform. By the same token, these companies dispose of businesses that are a misfit with the platform.

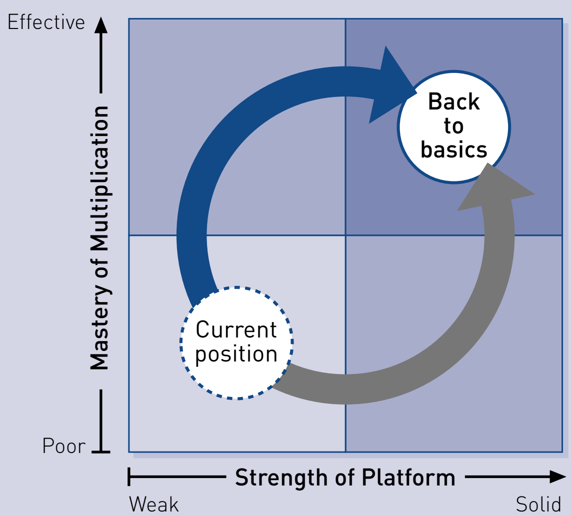
8. Aggressive cost management

Aggressive cost management, through good times and bad, is the final factor that is common to the six companies. They continually standardize and pare product lines. They close and relocate manufacturing plants and logistics facilities. IFF, for example, consolidated 16 operations in 2001. They improve productivity of all functions, be it in production or field service. Avery Dennison, for one, reckons itself to be an industry leader in applying Six Sigma as the foundation for productivity improvement. All companies strive to reduce inventory and working capital levels, and also launch global procurement initiatives.

Insights for the executive

None of the eight factors described is really surprising on an individual basis. They all make plain management sense. However, the combination of the eight factors in a

Exhibit 3 Questions for "Basics" Check-up



How solid is our platform?

- Do we manage the development of our core **technologies** purposefully?
- How well do we protect and fortify the reputation of our **brand(s)**?
- How far-reaching and integrated are the various components of our **delivery infrastructure** worldwide?
- Are we managing **costs** sufficiently aggressive across the board (product lines, facilities, processes, etc.)?
- Do we ensure **disposal** of activities that do not support our future business?

How effectively do we multiply?

- How creative are we in identifying new application segments and **customers**?
- How successful are we at leveraging our technologies to originate new **products**?
- How far have we exhausted the **service** revenue potential from our products?
- How well do we ensure that our **acquisitions** fortify our platform, and that they in turn obtain leverage from the platform?
- Do we know when we stray too far from our platform and **stretch** too thinly?

Short Fact Sheet of the Six Companies Studied

	Core business	Sales 2001 ($ million)	Net income as percentage of sales
Avery Dennison Corporation Pasadena, CA (USA) www.averydennison.com	Self-adhesive materials, labels and other self-adhesive products	3,803	Average 1997-2001: 6.4 percent (lowest: 5.7 percent, highest: 7.3 percent)
Mettler Toledo International Inc. Greifensee (Switzerland) www.mt.com	Precision instruments, in particular weighing instruments, analytical instruments and metal detection systems	1,418	Average 1998-2001: 5.3 percent (lowest: 4.0 percent, highest: 6.4 percent). Net income in 1997 (year of IPO) was negative
Fisher Scientific International Inc. Hampton, NH (USA) www.fisherscientific.com	Consumables used in scientific research and healthcare	2,880	Average 1999-2001: 0.8 percent. Net income was negative in 1997 and 1998.
Donaldson Company, Inc. Minneapolis, MN (USA) www.donaldson.com	Filtration systems and replacement parts for industrial applications and engines	1,126 (fiscal year ending July 2002)	Average 1998-2002: 6.7 percent (lowest: 6.1 percent, highest: 7.7 percent)
International Flavors & Fragrances Inc. New York City, NY (USA) www.iff.com	Flavors and fragrances for food, beverages, pharmaceuticals, cosmetics and household products	1,844	Average 1997-2001: 11.2 per cent (lowest: 6.3 percent, highest: 15.3 percent)
Nitto Denko Corporation Osaka (Japan) www.nitto.com	Films, sheets and tapes for industrial, electronics and medical applications	2,824 (fiscal year ending March 2002)	Average 1998-2002: 3 per cent (lowest: 0.3 percent, highest: 4.3 percent)

coherent management system is rare and should be a stimulating call to positive reflection and to subsequent action. Among the eight factors, we can distinguish two dimensions that make the system work effectively: a solid platform and effective multiplication.

First, these companies make sure they maintain a solid platform. The technologies, brands and delivery infrastructure that make up their platform are kept at a leading edge level. They aggressively manage costs and dispose of non-core businesses in order to keep the platform in good shape.

Secondly, they are masters at leveraging the platform so as to effectively multiply the market segments they address and the products they spin into these markets, be it through organic developments or through acquisitions.

The combination of a solid platform with effective multiplication confers a competitive advantage. It provides employees and shareholders with the security and stability that makes them loyal. It also creates a barrier to emulation by competitors.

Nothing lasts forever - maybe not even these companies' success stories. The future is the arena where past sins are exposed, and past success factors may become irrelevant That is why we have not positioned the insights from the study as prescriptive. Nevertheless, as a minimum there is value for any company in seeking inspiration and guidance from the nuts and bolts strategies adopted by these six companies. We have therefore designed a “health check” to diagnose companies’ basics.

A “healthy” diagnosis will help convince shareholders, employees and other stakeholders that the company is being well managed. Identified symptoms of deficiencies or heightened awareness and understanding of the sources of pain will provide useful insights into how to improve the position and performance of the company even through difficult economic times.

Note: the data reported in this article are drawn from publicly available company information sources (annual report, 10K SEC file, corporate website, investor presentation, etc.) dating from the second half of 2002, and investor services (Wright Investors’ Service, Standard & Poor’s, MultexInvestor).

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