



## Back to basics – again

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**Five years ago, after the bursting of the previous stock market bubble, the Prism article “Back to Basics” took a close look at the rules of the game followed by companies that have achieved long-term success. In this article the authors take a second look at the companies they analyzed back then – and draw some fresh conclusions about how long-term commercial success is built.**

Five years ago in our Prism article “Back to Basics,” we wrote: “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’”.

In that article, we reported on the results of a study about what these so-called “basics” might be. We had investigated which factors were common in explaining the extraordinary share price performance of six global companies during the period 1997-2002. In a nutshell, the conclusion then was that the slogan “back to basics” doesn’t mean much to these companies, because they have always stuck to the basics.

If you change a couple of words in the sentence quoted above – such as replacing “Internet” with “real estate,” “telecommunications” with “banking,” and “accounting” with “subprime lending” – we might as well have written it today. That is reason enough to re-visit the 2003 study and ask ourselves these questions:

- How did the six companies perform during the period 2002-2007?
- Do the same factors still explain extraordinary performance?
- What insights can we draw from studying performance over the entire 10-year period 1997-2007?

In this article, we will briefly summarize the findings of the 2003 study. We will also present an analysis of the share price performance of the six companies during the period 1997-2007, which demonstrates a return twice that of their

peer group. Rather than theorize about the success factors, we will then zoom in on one of the six companies, namely Mettler Toledo.

We want to reiterate that neither the 2003 study nor this update were set up in a thoroughly scientific way. Furthermore, none of us is naïve enough to believe there is a simple and imitable business recipe that guarantees sustainable success. Rather the study results should be read as credible hypotheses to inspire and guide executives in running their businesses, enabling them to ask “Which of these eight factors are relevant to explaining success in my industry?,” and, “To the extent that they are relevant, how well does my company score on these factors relative to competitors?”

### Summary of the findings of the 2003 study

The six companies we selected in 2003 are active in “un-glamorous” business-to-business sectors, are downstream in the food chain of highly competitive industries including automotive, food and pharmaceuticals, are global leaders and are fairly focused, with 2002 sales between US\$1 billion and US\$4 billion (see Table 1). Their share prices had more than withstood the shock of the 2001-2002 stock market collapse.

Table1			
Description of the six companies studied			
Name	Headquarters	Core business	Sales 2007 (\$ billion)
Avery Dennison	Pasadena, CA (USA)	Self-adhesive materials and products (labels, signage, etc)	6.3
Donaldson	Minneapolis, MN (USA)	Filtration systems and replacement parts (automotive, HVAC, etc.)	1.9
Fisher Scientific	Hampton, NH (USA)	Consumables for scientific research and health care	9.7*
IFF	New York City, NY (USA)	Flavors and fragrances (food, pharma, etc.)	2.3
Mettler Toledo	Greifensee (Switzerland)	Weighing and other precision instruments	1.8
Nitto Denko	Osaka (Japan)	Films, sheets and tapes (industrial, electronics, etc.)	6.7

Source: company reports  
 \* Fisher Scientific merged with Thermo Electron in 2006 to form Thermo Fisher Scientific. Their respective 2005 sales were \$5.6 billion and \$2.6 billion.

After studying the common factors that could explain the performance of these companies, we summarized the basics that they 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.”

That is quite a mouthful. Table 2 gives a short description of the eight underlying factors. For more details, we refer to our original Prism article (First Half 2003), which can be found on our website ([www.adlittle.com/publications](http://www.adlittle.com/publications)). None of the eight factors is really surprising on an individual basis – they are, well, pretty basic. What may make the difference, however, is their combination in a coherent management system and its consistent application over time.

Table 2 **The eight factors explaining extraordinary business performance**

<b>1</b>	<b>Diversity of customer segments</b>	Constantly search for new applications for your core products, and roll them out determinedly into new market segments and toward new customers
<b>2</b>	<b>Multiplication of products/services</b>	Multiply your products, in close collaboration with your customers, and generate a recurrent stream of revenues from your offerings
<b>3</b>	<b>Platform of shared assets</b>	Grow a diverse customer base (see 1) and multiply your products (see 2) economically by leveraging a set of shared assets, of a threefold nature: technologies, brands, and delivery infrastructure
<b>4</b>	<b>Globally integrated</b>	Anchor the assets that make up your platform – technologies, brands, delivery infrastructure – worldwide, and manage them according to a globally integrated concept
<b>5</b>	<b>Deeply rooted</b>	Preserve and enhance your legacy, by skillfully building your platform, without straying far from your original business
<b>6</b>	<b>Global leadership</b>	Make the strengthening of your leadership position an objective in itself, both for external and internal reasons, through product multiplication and acquisitions
<b>7</b>	<b>Systematic acquisitions</b>	Create value from acquisitions by verifying that the acquired company obtains leverage from your existing platform, and the acquired company’s business fortifies your existing platform
<b>8</b>	<b>Aggressive cost management</b>	Manage costs aggressively through good times and bad (product portfolio, facilities, productivity, working capital, procurement)

## Share price performance 1997-2007

In order to assess how the share price of these six companies performed over the entire 1997-2007 period, we compared each of them with a peer group of relevant competitors. Table 3 shows the results:

Three of the six companies (Mettler Toledo, Donaldson and Nitto Denko) outperformed their peers by a factor of roughly two to three. Their share prices increased by a factor of three to seven.

The fourth company, Fisher Scientific, performed even more spectacularly, with a share price appreciation of times 12 during the period 1997-2007 (strictly speaking, the share price is virtual, since the company merged with Thermo Electron, half Fisher's size, in 2006; Fisher shareholders received two shares of Thermo common stock for each share of Fisher common stock).

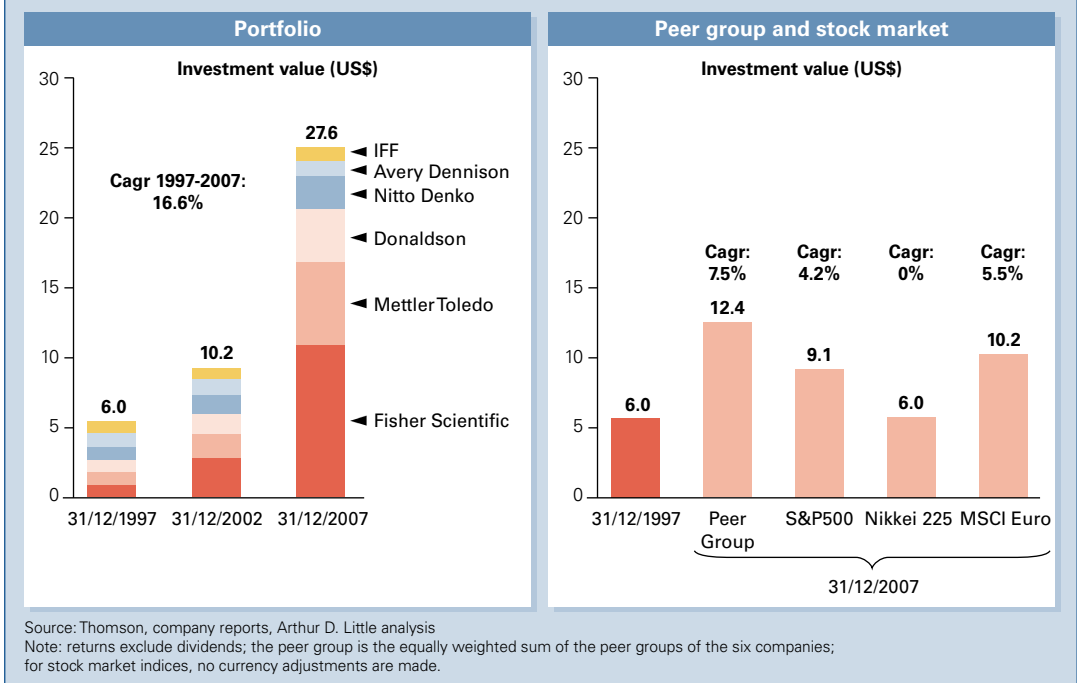
Avery Dennison and IFF, the two companies that were performing least well during the period 1997-2002, also failed to outperform their peers and the general stock market during the period 2002-2007.

Name	Share price increase			Share price increase above that of peers 1997-2007
	1997-2002	2002-2007	1997-2007	
Avery Dennison	x1.4	x0.9	x1.2	x0.6
Donaldson	x1.6	x2.6	x4.1	x1.9
Fisher Scientific	x3.2	x3.8	x12.2	x4.5
IFF	x0.7	x1.4	x0.9	x0.6
Mettler Toledo	x1.9	x3.6	x6.6	x2.1
Nitto Denko	x1.5	x1.8	x2.6	x3.4

Source: Thomson, company reports, Arthur D. Little analysis

An investment in the portfolio of the six companies at the end of 1997 would have yielded a compound annual return of 16.5 % by the end of 2007 (excluding dividends). This is roughly twice that of the composite peer group and roughly three times that of the stock market (see Table 4).

Table 4 Investment returns



It is worth stating that the purpose of our analysis is not to give investment advice. For one thing, most of these six companies have such a long, consistent and visible track record that the stock market, despite all its imperfections, may well have already priced them “correctly.” Our purpose is to understand the management philosophy underpinning strong performance, and derive relevant insights for executives in other businesses. Therefore, let’s zoom in on one of the six companies, Mettler Toledo.

### Zoom on Mettler Toledo

Mettler Toledo is a leading global supplier of precision instruments and services, in particular weighing instruments for use in laboratory, industrial and food retailing applications. The company was spun off by Ciba-Geigy (now part of Novartis) through a management buy-out in 1996, and became a publicly traded company through an IPO on the NYSE in 1997. In the 10-year period between 1998 and 2007, sales in constant currency grew a compound annual 7 % to US\$1.8 billion. In the same period, gross margin

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improved from 41 % to 50 %, and earnings per share and operating cash flow grew a compound annual 25 % and 20 % respectively. The share price increased almost seven-fold.

Let's look at how the company has addressed the eight factors listed in Table 2. Of these eight, three stand out: a diversified market franchise, sticking to the core for the long term, and striving for global leadership.

### **1. Diversity of customer segments**

Mettler Toledo's diversified franchise lies at the basis of its success. Its business is spread over many countries, end-use applications (laboratories, industrial and retail applications), individual customers (none accounts for more than 2 % of sales) and products. This diversity lends a great level of inherent stability to the business. When the economy is down in one place, it is usually up in another, so that the engine keeps running all the time. Any one of the individual units – a country, a product line, etc. – may be confronted with adverse market conditions at one point in time, but because of both its diversity and long-term orientation, the company can afford to give it the time to redress the situation.

### **2. Multiplication of products/services**

By constantly renewing and extending its product line, Mettler Toledo succeeds in maintaining the world's largest installed base of weighing instruments. The large installed base makes it cost-effective to offer service contracts, which in turn provide a strong, stable source of recurring service revenues (Mettler Toledo's service revenues grew from 17 % of net sales in 1996 to 23 % in 2007).

Its broad product range and pervasive presence at customers increase the switching costs for customers: when switching to a new supplier, users would have to be trained, standard operating procedures re-written, and the new equipment would have to be integrated into existing software systems. At the same time, its robust products have a very long technical lifetime, compelling the company to create a replacement need. It does so by successfully

showing its customers the economic case for a replacement, e.g. an increase in their productivity.

### 3. Platform of shared assets

Within its specialist customer community, Mettler Toledo has an extremely strong brand position. For example, the company's brand name is so well recognized that laboratory balances are sometimes referred to as "Mettlers." The company also sells Ohaus-branded products, which are targeted to customer segments that are interested in lower costs, a more limited set of features and less comprehensive support and service.

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In terms of delivery infrastructure, Mettler Toledo has the most extensive global sales and service organization among precision instrument companies. Approximately 5,400 employees (more than half the total) are providing sales and service in 35 countries. In order to reach its specialist customers more effectively, the company has been shifting its marketing investments from trade shows and broad-scale advertising to advanced website designs and industry-specific newsletters.

### 4. Globally integrated

On the commercial side, Mettler Toledo's global market presence confers a competitive advantage toward global customers who look for suppliers who can follow them. For example, in India it has offices at 12 strategic locations across the country, with over 300 employees. On the product side, harmonization of regulatory standards worldwide enables Mettler Toledo to standardize its product lines on a global basis. On the manufacturing side, the company has three manufacturing sites in China in addition to plants in Europe and the US.

### 5. Deeply rooted

The company was created in 1945 by Erhard Mettler, who invented the single-pan balance. In 1973 the company introduced the first-ever fully electronic precision balance. In 1989 Mettler acquired Toledo Scale Corporation, the largest US manufacturer of industrial and retail scales, thus giving



birth to Mettler Toledo. Sticking to its core is a central part of the company's strategy. It will only enter areas that are adjacent to its existing business: same applications for similar customers, or same customers for similar applications, or same customers and applications in different countries. It is by leveraging its existing platform that the company can grow mainly organically (see further) and profitably.

## 6. Global leadership

Mettler Toledo's aim is to be the number one leader worldwide in most domains in which it is active. Today 75 % of its revenues come from products with a global number one position. That ambition drives its decisions, but it doesn't mean that it has to be the number one from the start. Given its long-term orientation, it may be satisfied with, say, the number four position initially, and then work its way toward the number one position, step by step.

Being number one is important simply because it gives a competitive advantage. First and foremost it gets the company in the virtuous circle of more R&D spending in absolute terms, better products, more sales, more R&D, etc. Furthermore, it gives the critical mass required to be a truly global player with a global service network. That in turn creates room for more value-added services, more sales, more R&D, etc. Of the company's approximately 9,500 employees, more than 900 are working in R&D and product engineering.

## 7. Systematic acquisitions

Mettler Toledo is very careful with acquisitions, as growth through M&A is reckoned to be much more risky than organic growth. Of its compound average sales growth of 7 % in the past 10 years (expressed in local currency), only 1 to 2 % came from acquisitions, despite operating in a fairly mature market. Of course the company does make the occasional targeted acquisition. If it does, it should be synergistic with its existing business from a customer and/or product point of view. For example, in 2001 it acquired Rainin, the leading manufacturer of pipetting solutions in North America, yet with almost no export business. However, by leveraging Mettler Toledo's existing

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worldwide service network, their international sales grew fabulously.

## 8. Aggressive cost management

Mettler Toledo is the cost leader in its industry, amongst others as a result of its operations in China, where it has been manufacturing products for 21 years. This long-standing experience has taught the company how to cope with local competitors. While cost leadership gives a competitive advantage, cost management does not occupy the top “share of mind” at Mettler Toledo. What does are innovation and being in the number one position.

Like most good stories, the Mettler Toledo story is apparently simple and powerful. Above all, it is one about single-mindedness. It is about living all the buzzwords that populate the management literature: customer delight, long-term orientation, business focus and leadership.

### Insights for the Executive

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By and large, on the basis of the 10-year analysis, we feel rather confident that the hypotheses about strong performance that we formulated five years ago are increasingly proving real. Sticking to the basics, in good times and bad, bears fruit.

The framework that we put forward five years ago to capture these basics retains its full strength. The eight factors, when combined in a coherent management system, fold into two dimensions: a “solid platform” and “effective multiplication” (see Table 5, next page).

First, the companies studied 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 in order 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.

Table 5		Framework for “back to basics”	
	<p><b>How solid is our platform?</b></p> <ul style="list-style-type: none"> <li>• Do we manage the development of our core <b>technologies</b> purposefully?</li> <li>• How well do we protect and fortify the reputation of our <b>brand(s)</b>?</li> <li>• How far-reaching and integrated are the various components of our <b>delivery infrastructure</b> worldwide?</li> <li>• Are we managing <b>costs</b> sufficiently aggressively across the board (product lines, facilities, processes, etc.)?</li> <li>• Do we ensure <b>disposal</b> of activities that do not support our future business?</li> </ul>	<p><b>How effectively do we multiply?</b></p> <ul style="list-style-type: none"> <li>• How creative are we in identifying new application segments and <b>customers</b>?</li> <li>• How successful are we at leveraging our technologies to originate new <b>products</b>?</li> <li>• How far have we exhausted the <b>service</b> revenue potential from our products?</li> <li>• How well do we ensure that our <b>acquisitions</b> fortify our platform, and that they in turn obtain leverage from the platform?</li> <li>• Do we know when we stray too far from our platform and <b>stretch</b> too thinly?</li> </ul>	
	<p>Source: Arthur D. Little analysis</p>		

We hope to be able to get back to you again five years from now, and bring you “Back to Basics – Again and Again”. In the meantime, we would humbly advocate, as Mettler Toledo has been demonstrating, sticking to the basics.

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