



Consolidation Index: Critical Success Factors for Industry Consolidation

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1. Critical success factors for industry consolidation

While markets internationalize and at the same time consolidate, companies have to ask themselves if they can develop to one of the market leaders in this broader international market. To give guidance to this question, the business brief introduces the concept of the consolidation index as a framework for developing and validating strategies in this regard and discusses the results of the consolidation index for the European banking and utilities industry.

Strategic questions focus on long-term profitability, which is a result of

- *industry structure*, i.e. market drivers such as bargaining power of customers/suppliers, threat of new entries/of substitutes
- *competitive differentiation*, i.e. a company's uniqueness regarding customers (products, services, pricing) and competitors (costs)

With the deregulation of markets and increasing internationalization, the industry structure gains in importance when compared to competitive differentiation. According to Porter, Sheth/Sisodia and Deans/Kroeger/Zeisel¹ there is a target market structure for profitability in which companies earn the highest return if they either are positioned as niche players or are one of the

¹ Porter, M. Competitive Strategy (1980), Sheth, J./Sisodia, R. The Rule of Three (2002), Deans, G. K./Kröger, F./ Zeisel, S. Merger Endgames (2002).

three leading generalists. Based on this assumption, two central questions for incumbents arise: 1.) Which competences are required to survive as one of the three posted generalists in the new international market? and 2.) Will a company be able to drive the process or will it turn into a follower?

To succeed as a generalist, four competences have to be met:

- *competitive competence*
A company indicates a high competitive competence when it copes with the rules of the market place better than any other competitor. Key performance indicators are productivity per employee and market capitalization.
- *financial competence*
High competitive competence is not sufficient, though, to shape a process of industry consolidation. In addition, financial competence is needed to raise funds, e.g. for takeovers. Key performance indicators are earnings before interest and tax (EBIT), equity, return on equity (RoE), gearing and the structure of investors (in order to raise additional funds).
- *internationalization competence*
As consolidation today refers either to a multinational trade region (EU, NAFTA, APEC, etc.) or a globally driven environment, a company has to assess its preconditions for a successful internationalization process. Key performance indicators are the existing foreign business and the management board's international expertise.
- *change competence*
Consolidation usually imposes heavy reorganization upon a company (due to new business models, rapid internal growth, and/or merger and acquisitions). It is therefore vital to identify reorganization needs in time and to successfully drive the reorganization process. Key performance indicators are the number and size of successfully completed reorganizations.

Given these requirements, the consolidation index serves as a management tool:

- to identify a company's position in a consolidating environment and
- to assess a company's strategy in the light of a larger consolidation process.

So far the consolidation index has been applied to the European banking² and the European utility industry.³ After recent deregulation, both industries are in rather early stages of the consolidation process.

² Burger, C./Hagen, J. Strukturumbruch in der Finanzdienstleistungsindustrie (2007).

³ Burger, C./Holtermann, M. Europäische Konsolidierung in der Energiebranche - Beginn einer zweiten Konsolidierungswelle? (2007)

2. Application to the European banking industry⁴

2.1

Applied criteria for consolidation index

Banking markets have become increasingly deregulated and international in recent years.⁵ This has led to consolidation on a national level resulting in the emergence of dominating generalists. As international deregulation has proceeded, banks have been converging on an international level (Europe, US, and Asia/Pacific). We will presently focus on the consolidation process in Europe, even though the framework is applicable to the global environment as well. Special consideration will be given to the German market (as it lags behind the major European markets).

Within the last ten years European banking has experienced a series of high profile but mostly domestic bank mergers. The result has been a group of dominating national generalists such as HSBC and Royal Bank of Scotland (RBS) in the UK; UBS and Credit Suisse in Switzerland; Unicredit and Intesa Sanpaolo in Italy; Santander Central Hispano (SCH) and BBVA in Spain. As banks have lately started cross-border mergers (e.g. Unicredit/HVB and BNP

⁴ Burger, C./Hagen, J. Konsolidierung europäischer Banken - Weckruf für den deutschen Bankenmarkt? (2007)

⁵ Walter, I.: Mergers and Acquisitions in Banking and Finance (2004).

Paribas/Banca Nazionale del Lavoro), market consolidation in European banking is likely to be the next step. Still, one market stands out as an exception: Germany. Here the four biggest banks have less than 20 percent market share due to the peculiar three-pillar banking structure.⁶

This leads to the following questions:

- Which banks have the potential to drive the consolidation process in the European market?
- How may incumbents be able to achieve a generalist position in the European market?
- How will the German banks and their home market be affected by the European market consolidation?

Under consideration are the ten European as well as the three leading German banks. The consolidation competences have been specified as follows:

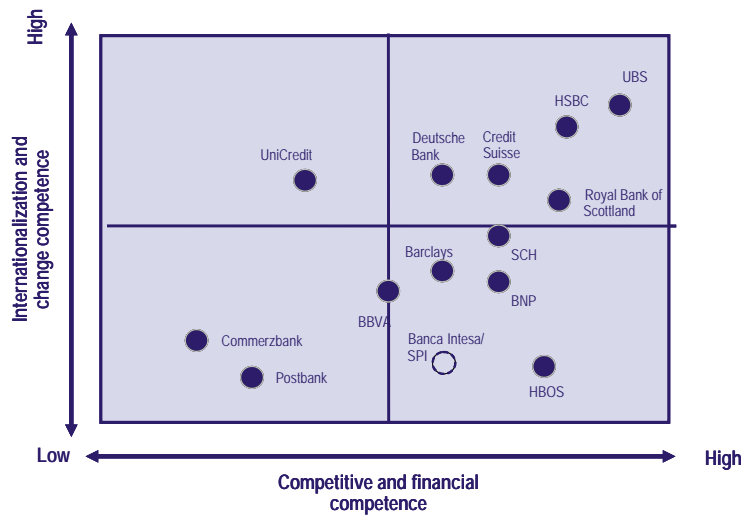
- *competitive competence*
revenues per employee and market capitalization
- *financial competence*
earnings before tax, return on equity (RoE before tax), and tier I capital⁷
- *internationalization competence*
share of "non-home market" revenues and "non-domestic board" representation
- *change competence*
size and number of reorganizations and integrations within the last ten years

Exhibit 1 is based on a rating scheme from 1 (low) to 5 (high) for all four consolidation competences. The results have been plotted in a matrix of competitive/financial competence and internationalization/change competence.

⁶ The German banking market consists of the regionally protected savings and federal state banks, the protected cooperative banking associations, and the private banks.

⁷ Tier 1 capital is the core measure of a bank's financial strength from a regulator's point of view. It consists of the types of financial capital considered the most reliable and liquid, primarily shareholders' equity.

Exhibit 1: Consolidation index for European banks



Sources: Annual reports 2006, Bloomberg, ESMT analysis.

2.2

Consolidation index for European banks

Analyzing the results of the *consolidation index* for the top ten European as well as the top three German banks (cp. exhibit 1) we can draw the following conclusions:

- HSBC and UBS have the best starting positions for developing into European generalists
- a third European generalist has not evolved
- two likely candidates have been identified, however, namely:
 - RBS (has performed strongly but mainly in retail banking)
 - Credit Suisse (strong investment and private banking business across Europe but lacks European retail banking market penetration).

The remaining national incumbents are not large enough to remain generalists although they may still play a significant role in the emerging endgame:

- as already seen with the intended ABN Amro merger, takeovers and/or mergers may propel the mainly national players like BNP Paribas, Unicredit and Barclays into becoming additional candidates for third European generalist;

- Deutsche Bank has a strong international investment banking business and a selected retail presence; however the lack of a strong domestic market presence has left the bank weakened and unable to attain a European generalist position;
- SCH and BBVA focus on Spain and Latin America and are therefore rather unlikely to develop into truly European generalists;
- primarily domestic banks like Intesa Sanpaolo and HBOS may only pursue a niche strategy;
- based on the research from Sheth/ Sisodia, the remaining companies are left with a niche strategy.

2.3

Consolidation index for German banks

The German banks have started from a weak position due to the unique three pillar banking structure. With public sector and cooperative banks shielded from competition, the market has not yet seen significant consolidation yet. Deutsche Bank has reacted with global investment banking combined with a selective European retail and private banking approach. Postbank has turned into a leading niche player in low cost retail banking and as a service provider for payment services. Commerzbank is developing into a niche player in corporate banking for mid-sized companies and retail banking.

- Given the internationalization of competition and the highly fragmented German banking market, focused growth is the only option for German banks in a consolidating European banking market;
- Cost as well as complexity reduction may be achieved by value chain disintegration comparable to other industries. Especially non-core activities (i.e. payment and securities processing) offer efficiency gains by outsourcing to specialized service providers;
- As German banks do not have the resources (i.e. market capitalization) to achieve a generalist European market position, niche strategies are the only viable option. Deutsche Bank and Postbank are already well advanced whereas Commerzbank has only lately moved in this direction.

3. Application to the European utilities industry⁸

3.1

Applied criteria for consolidation index

With respect to the final opening of the European energy markets in July 2007 the national utility incumbents face the risk of decreasing home market shares and growth opportunities in liberalized markets abroad. Having started to internationalize at the beginning of the 1990s (reacting to the privatization efforts in Eastern Europe), the European utilities industry has now entered a phase of international consolidation. The takeover battle of E.ON for Endesa which was then bought by Enel, the successful takeover of Scottish Power by Iberdrola, and of Gaz de France and Electrabel by Suez are recent examples of this development.

The questions arising here are as follows:

- Which utility companies have the competencies to drive the consolidation process?
- Are the current market definitions of integrated gas/power companies still valid in this process or do oil/gas companies have to be included as competitors?
- If no, what does this imply for the utility companies?

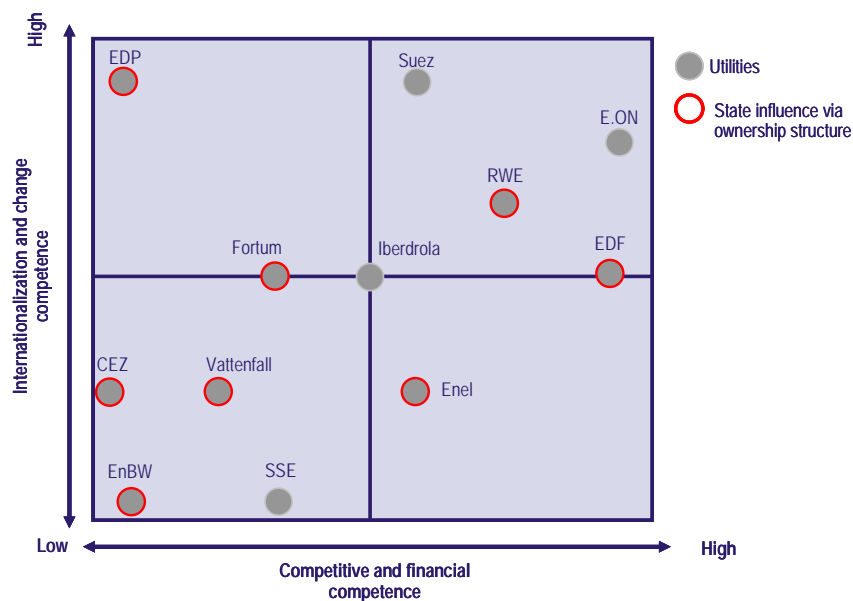
⁸ Burger, C. and Holtermann, M., ESMT Business Brief "Europäische Konsolidierung in der Energiebranche - Beginn einer zweiten Konsolidierungswelle?" (2007)

Under consideration are the ten major European and four leading German utility companies. The consolidation competences have been specified as follows:

- *Competitive competence*
 revenues, EBIT per employee, market capitalization and access to energy resources;
- *financial competence*
 earnings before interest and tax (EBIT), free cash flow (FCF), equity, return on equity (RoE before tax), and net debt/free cash flow;
- *internationalization competence*
 share of revenues outside the home market;
- *change competence*
 size and number of reorganizations and integrations within the last three years.

Exhibit 2 is based on a rating scheme from 1 (low) to 5 (high) for all four consolidation competences. The results have been plotted in a matrix of competitive/financial competence and internationalization/change competence.

Exhibit 2: Consolidation index for European integrated gas/power companies.



Sources: Annual reports 2006, Bloomberg, ESMT analysis.

3.2 Consolidation index for European integrated gas/power companies

Analyzing the results of the *consolidation index* for the top ten European and top four German integrated gas/power companies, we can draw the following conclusions:

- Within the gas/power market E.ON and EDF possess the competences to become one of the three European generalists. E.ON scores with its competitive and financial competence and although only parts of Endesa could be acquired, the company clearly is on its way to internationalization. EDF's competence is backed by its majority shareholder, France;
- Enel/Endesa, Iberdrola and RWE compete with Suez for the position of the 3rd generalist (Suez being the more promising candidate due to its potential merger with Gaz de France). With its takeover of Endesa and its holdings in Russia and Eastern Europe, Enel has been strengthening its internationalization competence. Iberdrola has taken over Scottish Southern Power (SSE) and thus successfully moved from a niche player to a potential third generalist. With its solid cash position, RWE might be an attractive takeover candidate. On the other hand local authorities still holding significant participation in RWE could prevent a takeover and turn RWE into a more active driving force of the consolidation process;
- The remaining companies are left with a niche strategy. EnBW plays in a different league and could be traded by its majority shareholder EDF against another attractive target. Vattenfall, Fortum, SSE, CEZ, and EDP are regional players. Of these companies, EDP with its Latin American holdings shows an interesting profile for a potential buyer trying to obtain some distance from European regulation.

3.3 Consolidation index for European utilities including oil/gas companies

Looking at the five biggest European oil/gas companies, it becomes obvious that they already monitored and entered the power generation market years ago in view of:

- the possibility of positioning the company vis-à-vis climate protection (i.e. power generation with reduced CO₂ omission);
- the risk diversification in times of increasing nationalization of energy sources;⁹
- the timely positioning in the renewables markets for periods of lower traditional revenues.

⁹ Examples are the nationalization of the oil and gas industries in Bolivia by Evo Morales in 2006, and in Venezuela by Hugo Chavez in 2007, and the ongoing nationalization of the oil and gas sector in Russia.

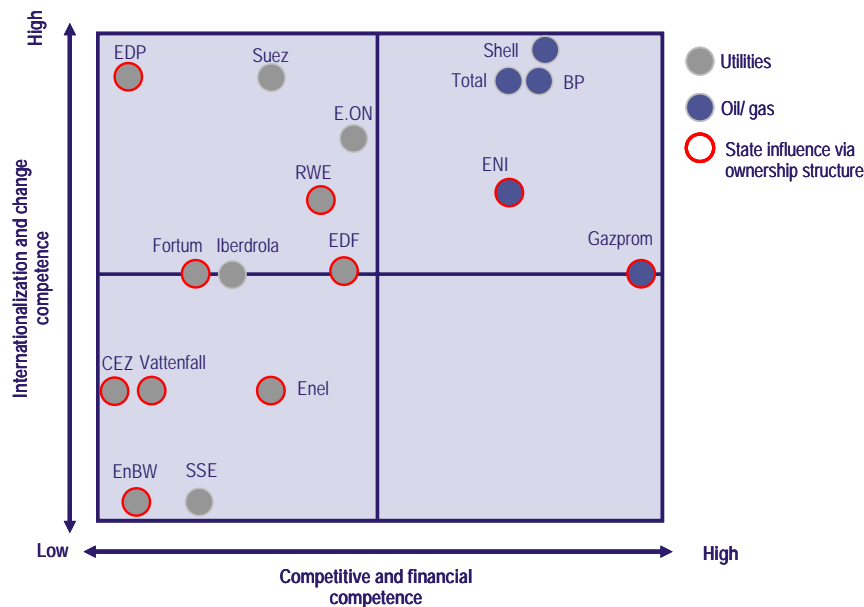
Exhibit 3: Activities in the field of power generation/renewables of the five biggest European oil/gas companies based on publicly available company information

BP	ENI	Gazprom	Shell	Total
<ul style="list-style-type: none"> Business unit gas, power, renewables with revenues of 23 bn. USD in 2006 November 2005: Start of "BP Alternative Energy " with focus on CO2 free power generation via solar, wind, hydrogen and gas-fired power technologies 8 bn. USD investment until 2015 to explore alternative energy generation 	<ul style="list-style-type: none"> Business unit gas, power with revenues of 28.4 bn. EUR in 2006 Strengthening gas & power unit, especially LNG business and diversification of gas procurement Solar villages as foreign aid for China, Mongolia and Tibet 	<ul style="list-style-type: none"> Alexander Medwedew , deputy CEO: "Our core business is energy This also includes power generation. We will not copy the business models of Shell or Exxon, rather the business model of Eon." (Handelsblatt , 11.06.2007) 	<ul style="list-style-type: none"> Business unit gas & power with revenues of 17 bn. USD in 2006 Business unit "renewable energy" with focus on solar, wind, hydrogen and biomass energy At least one of the focused renewable energies shall become a significant business unit 	<ul style="list-style-type: none"> Activities in the field of "electricity & cogeneration " as well as in "Renewable energy" Within renewables , focus on photovoltaics (since 1983) and on wind energy

Given this set of market players, E.ON and EDF suddenly play in a minor league.

With their activities in renewables and CO₂ sequestration, BP and Shell are well positioned and have significantly more invested in these fields than E.ON or EDF. Nevertheless, E.ON and EDF want to keep up with their competitors. While BP plans to invest \$8 billion by 2015 to explore alternative energy generation, E.ON is determined to invest €5 billion and EDF €3 billion. Gazprom will become one of the world's energy leaders. Whether ENI or Total will be able to enter this race remains to be seen.

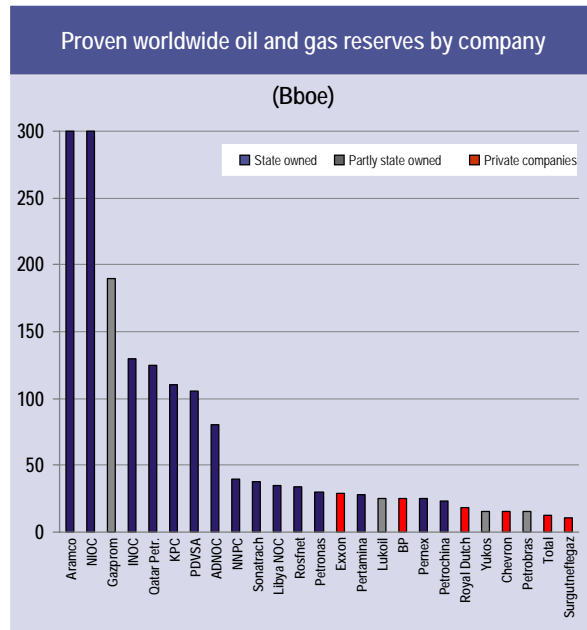
Exhibit 4: Consolidation index for European utilities incl. oil/gas companies



Sources: Annual reports 2006, Reuters, Bloomberg, ESMT analysis.

The picture becomes even more evident when the owners of the biggest fossil energy sources (see exhibit 5) are included.

Exhibit 5: Comparison of state owned and private players in the energy market



Source: IEA 2005; Bboe: Billions of barrel oil equivalent.

When compared to Aramco, NIOC (the National Iran Oil Corporation), and INOC (the Iraq National Oil Company), Exxon Mobile, Shell, BP and Total play far from a dominant role. In the future Gazprom alone will be able to hold a strong position. State-owned companies will exploit so-called cheap oil and gas to maximize their profits and try to win Exxon Mobile, BP and Shell to induce more difficult reserves such as oil sands.

For Exxon Mobile, BP, and Shell, a valid option to diversify risks is to enter the value chain of power generation—a policy Gazprom has been following by exchanging gas fields against downstream holdings. If the leading oil and gas companies enter power generation, a second consolidation wave can be expected.

As to the major German companies' role during the first consolidation wave, the following conclusions can be drawn:

- due to internationalization and a hardly improvable home market share, German companies need to focus on growth strategy that will strengthen their current competitive position within the consolidating European energy market;
- the competence to exchange assets (and hence market share) along the value chain across national borders will be crucial. A prerequisite for this competence is a high degree of internationalization among C-level and senior management and a profit center organization that enables the separate steering of business units.

With regard to a second consolidation wave, two options are viable:

- since German players will only be able to play in the European and not in the world league, they should position themselves as world niche players in the renewables/energy efficiency markets, markets where the technological and know-how advantage of Germany is recognized by the international community;
- although new players will enter the market, long-term strategic cooperation with one of the major oil and gas companies should be taken into consideration. The first mover might achieve the best starting position for the second consolidation wave.

4. Conclusion

This paper complements earlier research by Porter, Sheth/Sisodia, and Deans/Kröger/Zeisel on target market structures in consolidating industries. By introducing the *consolidation index*, a framework for the classification of companies in a consolidation process is provided. This index helps identify future generalists and supports management in determining their market position. It thus serves as a tool for developing and validating strategies as a generalist during a consolidation process.

In a first step the consolidation index has been applied to the banking and utilities industries. Other industries, such as telecommunications, transport, and healthcare may wish to scrutinize their situation with its help as well.

The author

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About ESMT

ESMT European School of Management and Technology was founded in October 2002 on the initiative of 25 leading German companies and institutions. The founders aimed to establish an international business school, based in Germany, with a distinct European focus. As a private institution of higher education, ESMT provides executive education (since 2003) and an international MBA program (since 2006). ESMT headquarters is located in Berlin with a further campus in Cologne. ESMT is fully accredited by German authorities as a private institution of higher education.

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