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Results

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Can deal making solve your growth problem?

On our minds

"Strategic deal making argues against the big bang approach of transforming a business through a massive acquisition."

Philippe De Backer
Partner
Bain & Company

Most CEOs today recognize that their businesses can't succeed without acquisitions. Companies need to add new capabilities to find the next wave of profitable growth, and the vast majority will think that an acquisition is the most efficient way to deliver what they are looking for. Yet acquisitions can be treacherous. In buying their way to growth, many companies lose sight of the fundamental rules for making money in their industries.

How do successful acquirers avoid that common pitfall? When we analyzed the performance and deal results of 1,700 companies, our research confirmed that major deals succeed in only two circumstances—when they buttress a company's current basis of competition or when they enable a company to lead or keep up with its industry by shifting to a different basis of competition.

Understanding your business's basis of competition—how it makes money and competes—is the starting point for any successful deal. Typically, companies strive to achieve industry leadership in five ways: through superior cost position, brand power, consumer loyalty, real-asset advantage, or government protection. Dell, for example, is a classic cost leader. For credit card issuers, consumer loyalty is critical, because customer acquisition is so expensive. The edge of Harrods, the venerable department store, comes from its tony London location—its asset advantage. Competing in a regulated industry, GlaxoSmithKline finds its advantage in developing patented medicines and successfully guiding them through the government approval process.

For food multinational Kellogg, brand strength is unquestionably the basis of competition. So when Kellogg's once-crisp business started to grow soggy in 1990s, CEO Carlos Gutierrez focused on how the company could sustain that strength in a rapidly consolidating marketplace. He concluded that Kellogg needed broader distribution, particularly for its growing category of snacks and breakfast bars. The best way to distribute snacks was via a direct store delivery system, which moved products directly from bakeries onto the store shelves, speeding inventory turnover. But building one would be expensive; Kellogg needed to buy one. So it acquired Keebler, the cookie and cracker maker, which already had a strong DSD system in place. The acquisition became pivotal in Kellogg's turnaround, as revenue rose 43 percent from 1999 to 2003 and operating income nearly doubled. The deal succeeded because it bolstered Kellogg's basis of competition, extending its brand strength into new products and channels.

Can a deal solve your growth problem too? In many cases, yes—as long as that deal is built on a sound competitive foundation and anchored in the fundamental way your company makes money. Understand that, and you've taken the first crucial step toward deal success.

For more information on how to target the right acquisitions, please refer to *"Building Deals on Bedrock"*, by David Harding and Sam Rovit, which appeared in Harvard Business Review, September 2004.

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Divide and prosper: unbundling

Management feature

"The value chain is now beginning to break apart, turning generation, trading, transport, distribution, and supply all into separate and discreet businesses with their own particular internal dynamics."

Patrick Demoucelle
Partner
Bain & Company

"For distributors and suppliers, unbundling makes economic sense, allows for better focus, and, hopefully, improved operating efficiencies. The end-consumers should benefit from intensified competition, promising better prices and higher levels of service."

Jean-Charles van den Branden
Manager
Bain & Company

In France's energy market, EDF and Poweo have little in common at first blush. One is the country's largest power utility and serves 40 million companies and households. The other just signed on its ten-thousandth customer in October.

Yet, these opposites both find themselves navigating a critical turn in their industry—the unbundling of supply and distribution.

They're not alone. As a result of the liberalisation and deregulation of European energy markets, most companies in the industry will soon have to understand and carefully manage this market disruption. What has been happening in Belgium portends the shape of things to come. Here, distribution networks have evolved into stand-alone businesses (regulated local monopolies), which are owned entirely or in part by the public sector (municipalities). The Belgian retail supply market has become a competitive battlefield where a dozen suppliers, including Electrabel Customer Solutions (ECS), Luminus, and Nuon, now fight to acquire and retain customers.

"Belgium can be considered a frontrunning example of how energy industries will evolve."

As always, deregulation requires companies to rethink their game plans. By holding distribution and supply together for too long, or by concentrating on one of the businesses in an undisciplined way, companies can create more problems than they solve. Instead, energy firms need to take a hard look at which business they want to compete in, and then build distinctive customer or cost management skills, depending on their choice.

Supply and distribution are two separate businesses with very different needs for managing costs. Supply costs are based on billing and customer service, while in distribution, which continues to operate as a natural monopoly, the main costs are network depreciation and maintenance. For a company like EDF, which continues to participate in all steps of the value chain, there is very limited cost synergy today between the two businesses.

Since it owns physical assets—the infrastructure network—a separate distribution business will initially hold more value. In Belgium, for instance, distribution represents 70 percent or more of the combined value of a utility. Energy retailers in Belgium and Holland post low margins in supply, typically around -2 percent on corporations to 4 percent on residential and 7 percent on small and medium-sized enterprises (SMEs).

If recent experience in other industries serves as a guide, customers will not easily switch from one provider to another in the early stages of deregulation, so suppliers will need to focus on building a stable customer base at relatively low acquisition cost to achieve returns worthy of their capital employed.

To pull this off, suppliers will need a complex mix of skills ranging from best-in-class power trading and management at one end to best-in-class customer management at the other. Energy is far and away a supplier's highest cost, accounting for about 80 percent of total costs. As a result, suppliers need exceptional purchasing skills and should evaluate the strategic benefits of integrating backward into power generation.

Top players in the supply business also will need to drill deep for customer insights, managing their customer base with precise segmentation around usage, payment behaviour and loyalty of customer segments. For example, in the Belgian residential market, the segment called "married with children" consumes 30 percent more electricity each year than the group labeled "married without children." Understanding this consumption pattern allows an electricity provider to develop an efficient and more focused customer strategy.

By comparison, winning in the newly unbundled, yet still regulated, distribution business will require operators to develop capabilities that unlock value through lobbying their regulator, controlling costs, and both building some scale in operations and some scope in products.

For instance, European regulators have been reducing the revenues they have allowed distribution system operators (DSOs) to collect by an average of 4 percent per year. The only way DSOs can successfully fight the downward

Europe's energy supply

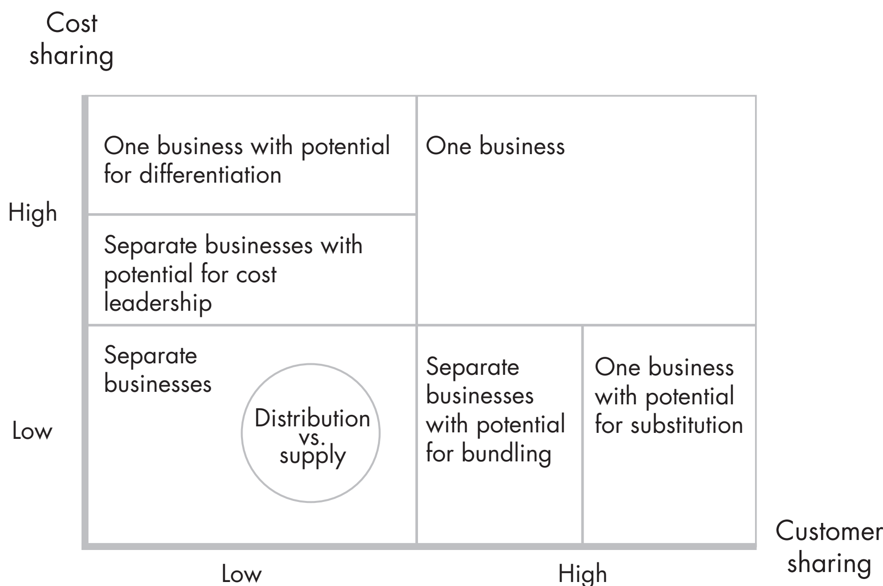

Figure 1:

There is no business rationale for bundling, since cost and customer sharing are limited.

pressure on revenues is to reduce their operating costs at an even faster rate. To outpace regulators, DSOs can focus on redesigning processes according to the best practices in the marketplace. Historically, such benchmarking has proven effective for companies seeking to reduce operating costs in processes such as fault prevention and new connections.

To thrive in this unsettled industry, distribution and supply companies will need to continually refine their focus. Distribution, for example, can be sliced into three separate sub-businesses: asset owners, asset managers and service providers, each of which can be run by separate management focused on different capabilities. In Belgium, asset managers such as Electrabel Netmanagement, combined asset owners and managers such as Sibelga, and full-fledged owners and providers such as Interelectra exist in different regions of the country. At this point, none has emerged as most profitable and efficient.

But the eventual winners will excel at concentrating on the right kind of capabilities. In capital-intense asset ownership, high performers will clearly maximise debt leverage. In asset management, the rewards will go to companies that run the network and manage infrastructure most efficiently, especially through outsourcing. Last, top service providers will cut costs and offer the cheapest service in activities like maintenance or meter-reading.

In supply, companies should focus on designing a business model to consolidate processes and to capitalise on adjacencies that already exist in the minds of customers. Gas and electricity can combine profitably into one business in order to share costs in billing systems and customer management. Moreover, since customers often perceive these two businesses as one, companies can tap the potential for cross-selling, especially when one-stop shopping for gas and electricity is linked to price discounts.

Since much of the expertise needed to succeed in the supply business is in market segmentation and understanding of the customer, credit and billing, and call-center operations, companies may do well to study and adapt models from outside the energy industry that fit this "skill profile." Tomorrow's energy retail supplier may soon need to look and behave more like a bank or credit card company.

As long as suppliers keep the lights on, customers should be able to see—and appreciate—the difference.

"Winning in the distribution business requires operators to develop capabilities in lobbying, controlling costs, and building scale in operations."

In this holiday season, we at Bain & Company would like to extend our warmest greetings to our network of partners, friends, clients and their families. We wish you all a healthy and fruitful 2005, and sustained growth for many years to come.

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Banking on the future

Guest interview

Interview with
Leonard Schrank
Chief executive officer
SWIFT

On the meeting table in his office – which overlooks his company's large and pastoral La Hulpe domain – Leonard Schrank has a shrink-wrapped bundle of $100,000 in shredded US currency. It is a souvenir from a visit to the US Federal Reserve Bank in New York, but it's also a fitting totem for a man who has helped transform financial transactions from such anachronistic concepts as cash and telexes to an efficient electronic future. Schrank is the CEO of the financial services industry-owned cooperative SWIFT, or the Society for Worldwide Interbank Financial Telecommunication – a name that, Schrank jokes, "sounds right out of Kurt Vonnegut." He is constantly looking for new ways to serve his customers, the world's leading financial institutions. And as president of the American Chamber of Commerce in Belgium, he also has a few ideas about making Belgium more competitive.

"SWIFT is a cooperative society owned by its members. It was founded 31 years ago to automate the telex. In 1973, banks and international banks would send telexes about 'credit this, debit that', internationally. Not very secure. Not very automated. No standards. Imagine getting 10,000 telexes a day. So 239 banks in 15 countries said, 'Let's use computers, and let's try to standardise the way that we talk to each other.'"

"Why have we been so successful? One, we're a community. Every important financial institution is a member. Two, we get together to set standards for how they'll interoperate in payments, trade, treasury and securities. Three, we have the most secure and reliable messaging network on the planet to run those standardised messages for that community."

"In terms of outsourcing, we're not going to run the banks' back office, but they can outsource a large part of their financial messaging infrastructure to SWIFT. One of our biggest goals is reaching out to CIOs and COOs of the banks to help them identify old, legacy messaging systems that they might have built decades ago, that run even SWIFT standards, but are all internal. These were competitive advantages then, but now they are competitive necessities. All that hardware, all that software, all those licenses, all those people—banks can redeploy them and move them onto our advanced IP-based messaging system. They can also harness the new technologies of the Internet to bolt in payments, treasury, trade and securities, to their legacy back-office systems."

"We estimate we are only getting a third of the addressable business. For example, there are still 100 million telexes going around. There is effectively unlimited business, so if I can continue to increase my value proposition and keep my costs competitive and have good relations with these companies, we will eventually draw that business."

"SWIFT chose to locate its global headquarters in Belgium some 30 years ago. Belgium was neutral, offered good fiscal regimes and was less likely to give SWIFT management a local accent the way a big country like France or Germany or England could possibly have done. Today, though, with the highest taxes in the world in Belgium, with social rules, I really think that if we were going to do SWIFT again, we would have to think very hard about putting the headquarters here, as nice and as beautiful as it is. When people talk to us about whether we are considering offshoring, it is certainly something all companies have to consider, if they want to be cost competitive, because you get quality at a third or half the cost."

"Over time, Europe is going to figure it out. But Belgium can either muddle through or Belgium can become the next Ireland. What is it going to be? My vision for Belgium is that if we start doing the right things and really send the signals that Belgium is a business-friendly country, we will attract more companies and generate more revenue as a result. This will generate a virtuous circle. This is easy to fix and we can all agree on it. The problems are all well known—it's the solutions that require real leadership and political courage."

"The unions have to adapt to the 21st century. In the 19th century, the Coal Age, someone who worked in a coal mine couldn't make enough money to feed his family. In the 20th century, the Petroleum Age, you would work on a Model T assembly line, then go home and buy the car. Now in the 21st century, the Information Age, I go home to work, and I come to work to socialise—we're information workers. Part of making Belgium number one is that the unions have to embrace being pro-business. And I think they can; I think the unions have an important role to play, but they've got to get on with the 21st century."

Interview conducted by Craig Winneker