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THE CREATION OF A EUROPEAN COMPANY FROM THREE NATIONAL LEADERS

by

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Overview

Arcelor, the steelmaking group, is the result of a merger between three national companies, Aceralia (Spain), Arbed (Luxembourg) and Usinor (France). This merger continued to rationalise the number of individual steel-producers in each of these countries which had been the case for the last twenty years, and which had been mainly financed by the State, because the steel industry has always had more producers than the number of suppliers and clients. The steel is facing a number of challenges, including having to cope with saturation in the markets of developed countries, the explosion of Chinese demand, and having to react to price margins. Arcelor has to convince its executives of the need to transform the group and harmonise the different management styles in order for this merger to succeed, which, curiously, has been easier with three partners than it would have been with two.

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TALK : Guy DOLLÉ

I would be very happy to discuss the Usinor-Sacilor merger which took place in 1986. However, with a cyclical industry like ours it is certainly more difficult to assess the Arcelor merger three years later. Nevertheless, I shall try to do so, but I should say that this talk represents my own personal view of what took place, and other interpretations are, of course, possible.

The seven deadly sins

The idea to merge stemmed from an assessment of the “seven deadly sins” in the steel industry.

The first deadly sin is that the industry ran at a loss. Over the last decade, the world steel industry’s average return on invested costs was less than the capital invested, with a few notable exceptions. Some steelmaking companies create value but mainly in so-called “non mature” markets, in other words, in developing countries.

The second deadly sin is that it is a very capital-intensive industry. For each Euro invested, either in the form of fixed assets or stocks, there is one Euro in turnover.

The third deadly sin is that the high rate of fixed costs leads to a preoccupation with price margins. Each extra tonne produced is strikingly cheaper than the mean. Therefore one is tempted to assume that the more one produces, the more money one makes. However, this creates overproduction which has a disastrous effect on market prices.

The fourth deadly sin is that the steel industry is not very concentrated. Until relatively recently, we were the only global steel producer, but we only had 4 % to 5 % of the world market. By contrast, our suppliers are very concentrated : the top three iron-mining companies account for 70 % to 80 % of the world market, and in 2005 imposed an increase of 71.5 % in the price of iron ore. Some of our clients are also very concentrated, especially those in major sectors such as the car industry, packaging or the electrical goods industry. Therefore we suffer from a scissors effect (ie. when revenues and expenses move in opposite directions) : over the past twenty-five years and in constant currency, the price of steel has fallen by 1.5 % to 2 % per year, which means that our clients have benefited more from our efforts at productivity than we have.

As a result, we have had to innovate a great deal. Approximately 50 % of the varieties of steels today did not exist four or five years ago. However, the value of this innovation is not fully appreciated : everyone knows that cars no longer become rusty, but the mechanical characteristics of these new steels, which enable cars to be lighter and which also improve security, are totally overlooked by the end customer.

Another important handicap of the steel industry is that it is highly cyclical. The length of ‘piping’, in other words, stocks which separate this industry from the end customer, give rise to considerable speculation on both the likely changes in the economy as well as the likely steel prices. Variation in consumption is only 5 %, and sometimes 10 % for short periods, but variations in sales prices can reach 30 %.

The last deadly sin is that there is a strong correlation between the amount of steel consumption and the wealth of a country (there is a lot of steel in each additional GNP dollar). However, this is only the case at the beginning of industrialisation and until the GNP limit of approximately seven thousand dollars per head is reached. This growth then falls sharply and stabilises at a GNP of twenty thousand dollars per head. In other words, in developed countries, one can only hope for a growth of 1 % or 2 % per year, whereas it is at least 4 % in developing countries : 80 % of the growth in future steel consumption in the world between

now and 2015 will take place in developing countries, of which 60 % are located in the so-called BRIC (Brazil, Russia, India, and China) zone.

Aims of the merger

This merger, like the previous merger, was intended to correct these seven deadly sins. Usinor was the result of the amalgamation of approximately twenty French companies. We wanted to make use of this amalgamation to increase our powers of negotiation with our suppliers and our clients, and to create more value.

Our second aim was to manage our capacities more efficiently. Even without investments, our capacity is increased each year by 1.5 % to 2 %, which covers the European growth. However, in this sector, a fall in price has no impact on the end customer's steel consumption : one does not decided to buy a car or a washing machine simply because the price per tonne of steel falls by twenty or fifty Euros. It is certain that a more concentrated industry forces those who are in it to be more reasonable.

Furthermore, this strategy allows investments to be rationalised. In the early stages of the merger, each of the three companies had an investment programme of new production lines of galvanised steel, because the price of galvanised steel currently increases at the rate of 5 % to 6 % per year in Europe. The merger enabled us to postpone these investments in order to spread them out better later on, and distribute them according to their markets and their profitability.

The fourth aim was to reduce costs, estimated at seven hundred million Euros until 2007, both through redevelopment plans and by the transfer of good practices. Finally, we hoped to share the costs of research, R&D and marketing.

Preparations

The merger officially took place in March 2002 between Usinor, a group mainly in France, but also in the Walloon area of Belgium, as well as Germany and Brazil ; Arbed, a group from Luxembourg, also located in Belgium, Germany and Brazil ; and Aceralia group, a minority Spanish subsidiary of Arbed.

This merger was the result of lengthy preparations. In August 2000, we began to work with McKinsey in a so-called 'clean team' : each company sent information to a central 'hermetic' team so that in the event of one company abandoning the operation, the information would remain confidential. In November 2000, we reached an agreement concerning the advantages of such a merger. A further two months were necessary to come to agree the parities, and in February 2001, we announced the merger project.

Before implementing the merger, we had to obtain authorisation from the European Commission. We had a nasty surprise : the commission did not consider our agreement sufficiently "binding" from a legal point of view for the commission to be able to examine the project. We reworked the agreement and presented our final project in June 2001. It was accepted in October 2001 by the commission on condition that there would be a certain number of 'remedies'.

In the meantime, in view of the cyclical nature of our industry, the individual performances of Usinor, Arbed and Aceralia had changed and our two partners asked that the parities in share price be changed accordingly. This nearly caused the project to fail. Finally, Francis Mer agreed to renegotiate Usinor's share-holding at a level between that agreed in January 2001 and the subsequent announcements in November 2001, and he accepted a decrease of 2.7 %.

In December 2001, we were therefore able to announce the realisation of the merger. Exchanges of shares exchanges took place, and the new group officially came into existence on March 1st 2002.

Principles of the merger

The first point discussed at the negotiations concerned the location of the headquarters. From the outset, at the first meeting which took place between Francis Mer and Joseph Kinsch, the CEO of Arbed, in July 2000, Kinsch said that the only way in which he could get the go-ahead from his majority shareholder, the State of Luxembourg, would be if the headquarters of the future group were located in Luxembourg. Francis Mer immediately agreed to this while pointing out that this was an enormous concession that he was prepared to make because the stakes merited it.

The principle of a merger between equals was then adopted. In the early stages, people often asked me : « *In the knowledge that one out of two mergers fails and generally speaking there are only two companies, what is the likelihood of a successful merger taking place between three companies ?* » I did not really know what to say, but today, having lived through this experience, I think that it was a positive factor : with three companies involved, there is very little danger of one partner imposing his ideas on the other two.

The type of corporate governance which we chose is the Luxembourg model, with a board of directors and a management. The board of directors had only non-executive members, with a non-executive chairman. At that time, it was agreed that there would be two chairmen on the board of directors, Joseph Kinsch and Francis Mer. The board has eighteen members, six from each company including a trade union representative from the mother country of each company. The management is made up of eight people : originally, there were four members from Usinor, one from Aceralia and three from Arbed. One of the French contingent has subsequently retired, and so there are now three Frenchmen, two Spaniards, two Luxembourgers and a Flemish Belgian. The official language of the board of directors is French with simultaneous translation for the non French-speaking members. In every other situation, we speak English and we are 'lucky' to have very few activities in Great Britain or the United States so that we can speak 'globish' freely !

We chose to take on the role of a strategic architect rather than a corporate operator or even a corporate holding financier. The activity was organised by operational sectors which are virtual profit centres : they do not exist legally even though they regroup a certain number of companies according to the country. The four sectors are flat products (50 % of our activity), long products (20 %), stainless steel (15 %), and retail (15 %). The managing director of each sector is responsible for his sector's results and is present on the management board.

The merger project was headed from the outset by the future management team which was appointed in April 2001 and stayed in place until March 2002.

In order to find a name for the new organisation, we employed a company specialising in this area. There were a number of suggestions, mainly poetic since the fashion at that time was for Greek names. Since none of these suggestions appealed to us, we came up with the name 'Arcelor' from 'Ar' for Arbed, 'ce' for Aceralia, and 'lor' for Usinor. Initially, people were slightly disappointed, but today this name has come to be accepted and everyone is happy.

Internal roadshows

All the employees of the group were informed in February 2001 about the merger project, but it was only when the group was created officially in March that we were able to explain the practical details of the operation. To make this easier, we organised internal roadshows which lasted a month during which time we were able to visit almost all of our sites. We held meetings for eight thousand executives in groups of two hundred to three hundred throughout

Europe and also in the United States and Brazil. We presented our programme that could be summed up by four slogans.

«The cash belongs to Arcelor »

The cash generated belongs to Arcelor, and not to the profit centres distributed throughout the different countries. It is the group which manages the resources and reallocates them in the form of investments. This principle may appear to be normal for a large group, but it was not so obvious to understand...

« Margins before volumes »

As I explained when I mentioned the seven deadly sins, the prices and more importantly the margins ought to take priority over the volumes. This was already Usinor's philosophy, but was less so for Arbed or Aceralia, who were the outsiders in the market. In view of their limited market share, agreeing price margins was possible. We had to establish that when the market became difficult, we would be the first to cease production.

« One face to the customer »

The third maxim consisted of keeping just one sales circuit for each sector in order to avoid unproductive competition. I think that this is one of the major factors contributing to the success of this merger.

« Managers belong to Arcelor »

The last principle stipulated that the managers, and in particular the top managers, are managed by Arcelor and not by the business units. Again, this is a logical principle, but which was not obvious to everybody.

Strategic directions

I thought that it was essential that the strategic directions for each of the major sectors should be known very quickly, even though some of my colleagues were reticent about this. When employees know that you are considering restructuring a company, it is important to inform them once decisions have been taken, even if some of these decisions are not implemented for another ten years. This allows everyone to understand what is going to happen and to adapt to it, or find a solution.

One of the first tasks for management was to define our production structure for the period 2010-2015, to announce what was going to happen between 2002 and 2010, and to give some information about what we intended to do after 2010. We had a few problems in the Walloon area because of a factory scheduled shortly for closure. In France, the intended restructuring was due to take place between 2008 and 2010, and therefore there was less reaction. We also set up a European works council of forty people which works well, and whose task was to inform the personnel about the various restructuring plans.

We created a working group which included about forty managing executives who are responsible for handling topics of general interest to Arcelor. A larger body, the managing executive convention, consists of three hundred executives of the seven thousand in the group. The aim is to help develop an Arcelor culture and to spread information.

We debated whether we should create a value charter. The person in charge of the small group which studied the question presented us with a series of six or seven values which we found excellent, and then told us that these were Enron's values... At the end of this presentation, we decided not to declare any values and to stick to the Principles of Responsibility which we had just completed using a code of ethics.

Finally, we set up Arcelor's concept of a sustainable development using the four P's, 'Profit, Planet, People, Partners' and a slogan, « Steel solutions for a better world ».

The results

Today, Arcelor has a turnover of thirty billion Euros and produces fifty million tonnes of steel. 72 % of the group's turnover is generated in Europe. The group employs ninety-five thousand people, 85 % of whom are in Europe. It is listed on the stock exchange and has a float of nearly 90 %. The Luxembourg State owns nearly 6 % of the capital and the Walloon region a little less than 4 %.

The results for 2004 are excellent. Those for the second half of 2005 will not be as good because of the imbalance between production capacity and the boom in Chinese demand which had an impact on the supply of raw materials. Nevertheless, performances are very satisfactory.

We are ahead in our programme of looking for synergies, and we have been reducing our debt of one hundred million Euros every month for the past thirty-six months. We have achieved these results because of good practices, notably stock inspection and investment checks, both of which were Usinor's specialities. The pricing policy which was announced was implemented.

The number of 'lost-time' accidents was cut by a third in three years. The restructuring plans were carried out using the employment models of the three parent companies : professional advice is offered to every person affected by a redundancy programme and there is no enforced redundancy unless it has been impossible to find another solution, for example when an employee will not accept relocation. However ; this situation represents a tiny minority of cases compared to all the other restructuring operations.

The reasons for success

The success of the operation is primarily due to the fact that everyone was convinced of the necessity for a merger. A merger is much more difficult to carry out when half the executives have doubts about it. The fact that it was a merger between equals was also a determining factor, as well as our clear desire to keep our employees informed. Recently, we organised a second roadshow to meet up again with the seven thousand executives and to explain our strategy for world growth to them.

The difficulties

The main difficulty that we are experiencing at the moment is the reluctance of employees to relocate between business units. This is especially the case in Spain and Germany. It is possible to organise the transfer of good practices in an institutional way, but this works much better when it is carried out by employees who are relocating with the company. As an example, the success of the Usinor-Sacilor merger could be explained by the ease of communication between Dunkerque and Fos, and the absence of language problems and difficulties associated with finding schools for the children of employees. At the present time in Arcelor, in order to solve this problem, we have tried to encourage employees who are away on business for periods of between three and six months, to work there without moving their families on a temporary basis. We are also in the process of creating 'agoras' (from the Greek word for marketplace), in other words, regular meetings between executives on a particular theme involving important subjects.

One of my regrets is that I did not carry out a cultural audit of the different companies which had been my intention in the beginning. I do not believe in the concept of company culture in a group such as Arcelor, and more generally speaking, I do not think that we can change

people's culture. The very best we can do is to try to understand it. The delay in the merger made us postpone this project and once the merger was complete, I thought that it was too late. In retrospect, such an audit would have helped us to understand some of the difficulties we came across in negotiations and later in the final stages of integration. For example, for the Flemish, once a decision has been made, it is implemented ; whereas for the French, once a decision has been made, it is at most an indication and may change subsequently.

Finally, during a merger period, a company tends to be inward-looking and concerned with itself, rather than looking after its clients' interests. It is true that our customer image has not improved as much as we would have liked in all our sectors.

Conclusion

Today, we consider that the integration phase is finished and that we are now starting the transformation phase.

On the macro scale, we hope that we can change the distribution of the turnover, which was 85 % in Europe and 15 % outside Western Europe, to a 50/50 ratio by 2010 ; not by reducing our coverage in Europe in absolute value terms, but as a result of major external growth, in particular in the BRIC zone.

On the micro scale, we want to become leaders in terms of costs, increase the loyalty of our clients, and develop a company spirit for our employees. We want to do this at all levels.

Finally, we are currently considering a change in our organisation which today is focussed on sectors. We would like to take the geographical dimension more into account by coupling it with the sectors.

DISCUSSION

A strategic architect

Question : *What does the function you have given yourself of strategic architect involve ?*

Guy Dollé : The aim was neither to be a holding company nor a simple producer because we wanted to work in a decentralised way. The term 'architect' means that we are interested in all the procedures, acquisitions, and plans which aim to make major changes in the company's performance, including the strategic plan. This specifies that we should not work on a short-term basis but on the medium and long term.

Q : *What methods do you use to achieve this role ?*

G. D. : The allocation of precious resources : investment in equipment and growth and the assignment of key managers.

Three around the negotiation table

Q : *Your comment about the advantages of a three-way negotiation is interesting. Game theory resolves completely the question of games with two players and suggests that the game continues without any difficulty. However, this is far from being the case. With three players, everything changes because each player recognises the benefit of teaming up with another player against the third, and this is true for all three players. Consequently, it is always more advantageous to team up with someone. In a game for two players, if one person wins the other loses. However, if a game has three players the atmosphere of combativeness is reduced.*

Managing the cash

Q : *You mentioned the principle that Arcelor controls the cash. Such a principle is a bone of contention in the large companies with which I am familiar. Imagine a business unit in Bolivia where the manager's sole obsession is to hide the cash in order to have a degree of freedom in his investments.*

G. D. : We redistribute a large amount of cash in the form of resource allocation, but it is sometimes difficult to get European executives to accept that their cash will help towards external growth in China... As far as Brazil is concerned, we showed them that growth occurred because of an increase in capital, and not with the money from our European factories. But this is a one-off. It will be our job to convince them of the usefulness of such global growth. We should also set up efficient systems of control. It is essential that we are able to show that the cash belongs to Arcelor, if only with respect to ranking agencies : at least 85 % of the money has to be managed by the group so that these bodies agree to give a grade.

Only showing one face to the customer

Q : *PSA adopted a principle which is the opposite of the principle of only showing one face to the customer : the Peugeot and Citroën sales networks not only ignore each other but they are also in competition with each other. The idea is that with a merger of brands, the group would lose the customer loyalty associated with each of its brands. Is it because your product, despite its innovative and professional qualities, remains a commodity, that you have adopted a different strategy ?*

G. D. : One can make a great deal of money and create a great deal of value with commodities ! What is important is to be sure of the strategic advantages that are special to this type of product. The slogan 'One face to the customer' does not apply to the small customers for whom we have kept different brands, particularly in France. On the other hand, for clients who order large quantities, there is just one sales network and one representative. In this industry, an additional ten or twenty Euros for a product which sells for four hundred or five hundred Euros is a huge amount : our net results per tonne of steel in 2004, which was an excellent year, were between thirty and forty Euros... Whereas when we negotiate with a client, we easily lose ten or twenty Euros.

As far as the brands are concerned, we have kept them for the time being, but we will probably decide very soon to name all our factories Arcelor, but perhaps keeping the original name as well. Studies carried out with managers show that they identify themselves with the name Arcelor. It would be a shame not to emphasise it.

Developing entrepreneurship

Q : *How do you intend to develop 'entrepreneurship' within Arcelor ? Patrice Simounet, the director of SODESI, explained to us how the development of spin-offs launched by former employees helped to attract people to the company who had an entrepreneurial spirit.*

G. D. : We have asked our executives to think about this and we have also looked to see what happens in other companies such as Gaz de France's programme "Coup de pousse". I have to say that this is an area where our results are not very satisfactory at the moment.

Q : *It is often said that to be an entrepreneur, you need to have both talent and to be seething with rage. Without talent, one gets nowhere, but if one is not seething with rage, in other words, if one does not have a great need for recognition, one does not necessarily have the capacity to be an entrepreneur. Is this compatible with being employed by a major group such as yours when there are many other ways of being appreciated ?*

Q : *Managers often give contradictory orders to their staff. In this case, it is difficult to ask your executives to become entrepreneurs while at the same time taking away their financial resources which would enable them to take initiatives.*

G. D. : Financial resources are preferentially allocated to those who have shown – through their performance – that they are capable of making them grow. They are given according to strict rules which emphasise profitability and growth.

How long does it take to make a successful merger ?

Q : *You think that the integration phase is now complete and yet you yourself emphasised that it is only after many years that one can evaluate a merger.*

G. D. : It is true that it is a very long process. At Nippon Steel, which merged thirty-eight years ago, employees still systematically regard themselves as part of their original company, Fuji or Yawata. Recently, a Nippon Steel manager was appointed for the first time, in other words someone who joined the company after the merger. I wrote a piece where I compared the transformation of a company to metallurgical transformation : one of the ways of obtaining different types of steel by alloying iron and carbon is to vary the cooling times...

Market position

Q : *It is said that European steel makers knew that the way to keep their large market shares was to start making special steels and by restructuring with the passage of time. The United States has been slow to do this. What is the situation ?*

G. D. : Francis Mer often compared the restructuring projects in Europe, Japan and the United States. He noticed that in Europe, especially in France, that these restructuring programmes were financed by the tax payer ; in Japan, they were financed by the client, since until recently Japanese clients paid prices for steel which were much higher than the international market ; and in the United States, they were financed by share-holders. According to Mer, it was because of its inability to finance the necessary restructuring that the American steel industry, which had been world number one in the 1950s, became obsolete from the 1970s onwards. This was because it had not followed changes in technology such as continuous casting. Another explanation may lie in the very strong unionisation of the work force : this led to the development from the 1980s onwards of the concept of ‘mini mills’ which today produce 50 % of all flat products in the United States. Investment costs in mini mills are lower and they systematically employ non-unionised workers. For all these reasons, the American steel industry is not a true competitive threat to us. We are even debating whether we should be present in North America. Our special feature is that we are well placed in the car manufacturing industry, with 15 % of the world market share, without being physically present in either the United States or Canada which represent a third of the world’s vehicles.

Q : *How do you rate yourselves in terms of quality ?*

G. D. : One should distinguish between technical and total quality : the latter encompasses management, social relations and so on. In terms of technical quality, we are clearly among the best. We often have only four or five competitors : two Japanese, Thyssen and two other Europeans in Germany. In China, for example, Arcelor symbolises the ‘top of the range’ and the best performance. This is why the Chinese would prefer Arcelor to develop in their country rather than Mittal Steel, which is a financier but which has only one quality image. In terms of total quality, some of our executives feel a bit frustrated because on a management level, they think that we have slipped back a bit in comparison with our practices before the merger. We intend to distribute our management model which is particularly efficient with respect to flat products.

Q : *Is there a worry that the European steel industry will disappear in the medium or long term ?*

G. D. : It is true that in Western Europe, we can only predict sluggish growth. Our labour costs are high, we do not have any raw materials and, for the most part, our products are commodities for which the cost criterion is crucial. Therefore, we should make sure that the cost produced at a European port is equal to that of the best Russian, Brazilian, and Indian producers, who have a huge advantage in terms of labour costs, but a large disadvantage in terms of logistics. Furthermore, we should be capable of developing and suggesting steel solutions to our clients that would enable them to differentiate themselves from their western competitors.

This leads us to another question, that of the limits to our industry, both upstream and downstream. In the old days, steelworkers were also miners. Today, this is no longer the case and all the factories are located close to the sea for ease of delivery and transport of the end products to customers. But tomorrow, who will be our clients ? Which industrial clients will still exist in Europe ? The distribution of our products constitutes an important part of our activity, but should we not also develop other services ? Should we become rolling mill workers or stampers ? At present, this is not our strategy because stamping is an activity which is as capital-intensive as the steel industry. On the other hand, we envisage importing semi-finished products which we will produce abroad ourselves, rather than supplying ourselves with ore from Australia or Brazil.

Development in China

Q : *You mentioned development in China. Is the Indian market not just as interesting as the Chinese market ?*

G. D. : In terms of potential, undoubtedly, but the situation is totally different. It took China fifty years to go from a consumption of zero tonnes to one hundred million tonnes of steel ; and then it took four years to go from one hundred million to two hundred million ; and it will take three years to go from two hundred million to three hundred million. Despite this spectacular progress, consumption per capita is still only at two hundred and twenty kilos whereas the average in Europe is four hundred kilos, and six hundred kilos in Japan and Korea. India will certainly be a huge consumer by about 2015, but for the time being, the consumption per capita is only thirty-five kilos, due to the lack of infrastructure there. Being a little provocative, I think that it would be impossible to imagine an increase in steel consumption in a democratic country comparable to that in China today.

Q : *What type of management will you adopt in this country ?*

G. D. : That is a fundamental question. Even in Europe, there are noticeable differences, for example between France and Spain. We have an extremely efficient management model in Brazil, thanks to the quality of the assets, the supervision and the staff. The situation there is similar to that of the Japanese steel industry in the 1970s or of the French steel industry at the end of the war. This industry is growing fast and has a very good image and therefore has no problems in recruitment. How does one transfer this model to China ? We have to adapt ourselves to be like the Chinese in China. At the same time, we want to establish ourselves there, as we do everywhere, together with the Principles of Responsibility which we have already defined.

Stock market quotation

Q : *Since 90 % of Arcelor's capital belongs to investors, is there not a concern that the group may be bought out soon ?*

Q : *From what you have said, it is hard to imagine that share-holders are interested in the steel industry : it does not appear to be a very profitable sector.*

G. D. : For people who have experience of living with cyclical processes and understand their logic, the steel industry represents an interesting investment. Ex-Usinor's shares varied between eight and twenty Euros ; those of Arcelor vary between thirteen and nineteen Euros. Today, all the analysts recommend buying, because they know that our merger is a fundamental step towards the consolidation of our industry on a world scale and towards readjusting our relationships with our suppliers and our clients. Financial circles are reassured about our capacity to deliver good results and to reduce our debt. We should now be successful in our growth in zones which have a great potential for steel and to achieve this, we should revise our steps both to finance this growth and to balance better the parities with the American or Japanese companies. We have to improve the very positive brand image which we already have as far as analysts and share-holders are concerned, by talking about our performances and proving to them that Arcelor is a well managed and responsible group, capable of overcoming cycles and providing a unique service and quality products throughout the world.

Presentation of the speaker :

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