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The 5-Cs: A Modern Framework for Consolidation of Fragmented Industries

In this paper, we outline a strategy for successful consolidation of fragmented industries. As background, we present a historical review of waves of consolidation, focusing on the era of industry moguls and the rise and fall of conglomerates. We follow with an analysis of the current boom in consolidation-related mergers & acquisitions, including a profile of the most active participants. We then present the consolidation framework, incorporating examples from current successful and unsuccessful consolidations.

Consolidation remains an effective strategic tool

Consolidation has long been used to achieve and sustain power in the marketplace. Indeed, creating a monopoly position through consolidation can be one of the most effective ways of achieving economic returns through a business venture. This long history does not imply, however, that consolidation strategies have remained the same. Using historical documentation and an analysis of current merger and acquisition activity, we show how consolidation strategies have evolved through the past century, and how they could be improved using a more rigorous framework.

The history focuses on two major waves of consolidation. First, the rise of moguls represents entrepreneurs who seized on the changes presented by the industrial revolution. They seized on relatively unsophisticated industries to build large industrial empires, breaking down regional barriers and improving access to capital. Second, large corporations seeking growth and diversification undertook the conglomeration that began in the 1960's. Although their acquisitions were frequently outside of their traditional lines of business, these conglomerates present a parallel to the modern consolidation strategy of "bundling".

Current trends highlight many similarities and contrasts to the historical periods outlined above. As with the prior waves, consolidation is ultimately encouraged by changes in the external environment, and many factors align to drive the current boom. However, the current wave of consolidation is much broader, spanning industrial *and service* industries. In addition, specialized financial players have joined the traditional consolidators, resulting in even greater market activity.

This note was written by Dean Briesemeister T'98 and Nat Fisher T'98 under the supervision of Professor Sydney Finkelstein. Revised 2002.

In all three waves, individuals and corporations have used consolidation strategies, but without any apparent formal framework. We believe that using a framework would identify new consolidation opportunities and would improve the success of current consolidations. The 5-C's framework incorporates the following ideas: Enhancing capital access is a key leverage point for consolidation strategies, providing an advantage through better financial resources. Cultural and regional concerns must be compatible with the goals of a consolidator. The marketplace of customers and competitors must receive the consolidation strategy without significant disruption. Change catalysts may have provided an opportunity for consolidation, but future change should be unlikely to obsolete the consolidated market. Finally, in light of these factors, the consolidator must identify the ways to create and sustain competitive advantage, either through economies of scale and scope or through the leveraging of management talent.

The remaining sections of this paper explore in greater detail the topics highlighted above.

Two Waves Of Consolidation Created Significant Business Empires

In the history of American business, two major waves of consolidation have swept through industry, resulting in many large and some successful enterprises. The first wave occurred in heavy industries during the late nineteenth and early twentieth centuries, when moguls such as John D. Rockefeller, J. Pierpont Morgan, and Jay Gould created the foundations for the largest corporations in the United States. The second wave occurred from the 1960's into the 1980's, when industrial and consumer conglomerates such as Beatrice, Westinghouse, and ITT amassed portfolios of up to hundreds of semi- and unrelated businesses. In the following sections, we outline the rise and fall of these two waves of consolidation.

Moguls created monopoly power through consolidation[1]

Beginning in the 1870's and continuing until antitrust enforcement and public sentiment turned in the 1910's, entrepreneurs were able to identify industries (generally related to heavy manufacturing) in which mergers and acquisitions could create significant economies of scale through combined operations and superior management. Economies of scale were made possible through the capital intensity created by the industrial revolution.

Among the entrepreneurs were household names like Rockefeller, Morgan, Vanderbilt, and other characters like Jay Gould. In the following pages, we highlight the strategic development and subsequent dismantling of the Union Pacific Railroad, the Standard Oil Trust, and United States Steel Corporation in order to show how individuals can drive industry consolidation.

Jay Gould revolutionized the railroad industry

Prior to 1880, American railroads operated under a principle of local management for small railway systems, almost always under 500 total miles of track. Interregional shipments were accomplished through a loose network of alliances that banded railways together.

[1] Much of the historical information on moguls comes from Martin, 1993; Martin, 1992; Chandler, 1991; and Block, 1993.

Jay Gould was almost single-handedly the catalyst to drive consolidation. After defeating Cornelius Vanderbilt's attempt to buy the Erie Railroad, he added western routes leading to Chicago and St. Louis. He raided and combined multiple railways, moving across the country in an attempt to provide self-contained shipping across the country. He made substantial profits in the trade of railroad stocks, speculating on positions in numerous railroads. Although he built a substantial system in the East through regional consolidation, he was forced to sell part of his system to cover losses on the stock market. He also faced a significant counter-attack by lines owned by other moguls like the Vanderbilts.

In a move to another region, he took control of the Union Pacific railway, one of the two transcontinental lines. During his time in control of Union Pacific, he expanded the railway substantially. He added territory through feeder lines to the main line, and by extending branches from the line's terminus in Ogden, Utah. He annexed the Kansas Pacific, a main competitor, and completed a second route to the Pacific through Idaho and Oregon.

By 1881, Gould controlled nearly 15% of the nation's rail mileage, the largest railroad empire in the nation. Through extremely high dividends, he was able to create significant personal wealth. However, he was a lackluster manager of the rail systems. Not all of his routes connected, and he had poor coordination between the various lines. He was unable to capture the economies of scale and scope he sought. In addition, the cash he pulled from railroads like Union Pacific left them in poor financial condition. By the mid-1880's, he pulled out of most of the railroad assets.

His single-handed impact on the railroad industry was substantial. While the lines had previously relied on a loose network for traffic flow, they now each focused on building a self-contained system to deliver freight from point to point. Competitive expansion (resulting in the construction of over 75,000 miles) throughout the 1880's drove many lines to financial failure in the 1890's. Later consolidation by financier J.P. Morgan resulted in the creation of 25 leading lines. The consolidation witnessed in railroads was a prelude of the consolidation to come.

Standard Oil achieved monopoly power through regional consolidation and vertical integration

Like railroad consolidation, mergers in the oil industry began as regional consolidation. John D. Rockefeller started as a refiner in Cleveland, turning crude oil into kerosene. In 1872, he acquired (allegedly through forcible means) all of the other 34 refiners in the "Oil Region" around Cleveland. By the end of 1874, Standard Oil had acquired the next three largest refiners in the nation.

These acquisitions provided Standard Oil with over 90% of the refining capacity in the United States. The incredible industry concentration, combined with the company's sheer size created a dominant position in capital markets, and resulted in substantial economies of scale and scope. The market power ensured significant profits for the company and substantial wealth for Rockefeller.

The greatest threat to the Standard Oil Trust came from potential change imposed by regulatory intervention. The first legal challenge came in 1879, when Standard Oil officials were indicted for violating Pennsylvania antitrust laws. Fortunately for Rockefeller, the case never went to court.

To prevent further legal action, Rockefeller formed the Standard Oil Trust. Created in 1882, the trust allowed the company to legally operate across many state boundaries. The firm used this freedom to capture even greater economies of scope. The trust controlled 80% of the refineries and 90% of the oil pipelines in the nation. The firm also moved into to-the-home distribution of kerosene.

Legal assaults on the company expanded in 1892, with the Ohio Supreme Court prohibiting the trust's control of Standard of Ohio. The company circumvented that regulation, capitalizing on eased laws in New Jersey to establish Standard Oil (New Jersey) as holding company for all of the former trust's assets.

Standard Oil's market strength and incredible profitability continued until 1911, when the U.S. Supreme court upheld a Standard Oil conviction for monopoly and restraint of trade under the Sherman Antitrust Act (passed in 1890 largely in response to the trust's market power). The court ordered Standard Oil to divest 33 of its major subsidiaries. After the split, however, Standard Oil (New Jersey) continued consolidation by acquiring the Humble Oil & Refining Company of Texas, ultimately a core of the Exxon Company.

Standard Oil accumulated over $800 million in profits during the first twelve years of the twentieth century, a true testament to the economic returns of monopoly power. It dominated capital markets, spanned all regions of the United States, prevented competition, and managed the external agents of change. Its long reign ushered in an era of tighter antitrust enforcement.

U.S. Steel gained efficiency and price advantage through aggressive consolidation and operations

Using a strategy of growth similar to Rockefeller's early years, Andrew Carnegie built the country's largest and most powerful steel company by establishing multiple steel plants. J.P. Morgan sought to unify his own steel-related holdings with those of Andrew Carnegie, once again seeking economies of scale and scope. He designed a trust (similar to Standard Oil) in which the Morgan and Carnegie companies would be combined with eight other steel, mining, and shipping firms.

The regulatory environment for consolidation was favorable. President William McKinley approved of business consolidation, limiting the risk of interference by government antitrust regulators. As a result, United States Steel was formed in 1901 with a capitalization of $1.4 billion, America's first billion-dollar corporation. (This was similar to the IPO roll-up strategy, which will be discussed later.) The firm's sheer size led to increased visibility and access to capital markets.

From immediately after its foundation, U.S. Steel launched into an aggressive acquisition campaign. From 1901 to 1910, the company added four major steel companies, shipping and railroad companies, and a host of additional minor steel-related enterprises. These acquisitions provided economies of scale and scope, combining operations across regional boundaries, and creating an integrated approach to serve customers.

U.S. Steel declared a goal of competition through efficiency and price rather than monopoly power. From 1902 until the 1920's, U.S. Steel sales grew from $423 million to over $1 billion, despite significant decreases in market share. The company tried to manage external regulation through a modification of its strategy.

However, Theodore Roosevelt launched an antitrust investigation against U.S. Steel in 1905. A formal charge was made in 1911 during the Taft Administration, but a U.S. District Court decision in 1915 absolved the company from any wrongdoing.

The greatest pressures on U.S. Steel were changes in the economy, the demands of corporations, and technology. The company barely survived these changes, ultimately becoming a takeover target by raider Carl Icahn. The company exists today (in the form of USX corporation), although it has transformed itself into a diversified energy and steel concern.

Conglomerates merged diverse lines within and across industries

Conglomeration occurred in force from the 1960's into the 1980's as firms aggressively sought growth. While many added related businesses as a consolidation play, others ventured into wholly unrelated lines, resulting in the classic conglomerate strategy. Acting as an internal capital market, the conglomerate attempted to provide a lower cost of capital than could be achieved externally.

Firms were often able to appease Wall Street for the short term through consistent increases in earnings. Most conglomerates, however, became disappointments for the market when acquisitions failed to deliver. The firms were unable to reach the capital efficiency of external markets. While some firms ceased to exist through dramatic breakups or implosion, others achieved a return to their core strategies through divestiture and the shut down of unprofitable business lines.

In the following section, we present the profiles of three classic conglomerates. First, we outline how Beatrice's ventures away from food nearly drove the company out of business. Second, we highlight the long transformation processes that have given Westinghouse and ITT coherent strategies.

Beatrice turns full circle as a foods company[2]

Beatrice started in 1898 as a creamery. For the following four decades, it expanded through consolidation and innovation, but remained largely a dairy company. It captured economies

[2] Historical information on the Beatrice Company was obtained from Beatrice, 1992.

of scale through coordinated regional operations. In addition, it attempted to capitalize on consumer perception by branding products that had traditionally been treated as generics.

The company's first step-out acquisition was La Choy in 1943, positioning the company as a broader food supplier. The following three decades were characterized by frequent acquisitions of small growth companies. Although many were in the food industries, others were in luggage, furniture, trailers, yachts, and chemicals. These acquisitions attempted to draw in companies with dramatically different cultures, different customer bases, and requiring substantially different management knowledge.

In 1980, James Dutt took over as CEO, promising to restore Beatrice to a profitable core strategy. Although he spun off dozens of companies, including the trailer and yacht manufacturers, he used the proceeds to finance further acquisitions viewed as questionable.

The final Beatrice acquisition was a leveraged $2.7 billion deal for Esmark, a food and consumer products company. Although it provided some additions to the core business, it also added more new business lines. Beatrice's balance sheet was severely burdened by the debt, lessening its access to capital, and leaving it vulnerable for takeover.

Kolberg Kravis Roberts took over Beatrice and promptly proceeded to dismantle the company. In the following three years, the company sold or spun-off Avis, Playtex, International Foods, Tropicana, and a bundle of smaller specialty food and consumer goods companies.

The remaining Beatrice company represents a tightly-focused consolidation of consumer foods companies. Despite its diversions, Beatrice is again similar to the Beatrice Foods of 50 years ago.

Westinghouse and ITT complete their evolutionary transformations

Westinghouse and ITT represent two of the most prototypical conglomerates. Despite roots in industrial technology, both ventured into financial and other service-related industries. Only in recent weeks have both completed their transformations.

Westinghouse's core business was electric products, expanding into power plant equipment, defense components, and electric appliances. Through the 1960's, Westinghouse launched an aggressive diversification campaign, moving into car rental, motels, land development, and mail-order goods. These acquisitions provided the company with a portfolio of industrial and financial operations, combined with well-known consumer brands.

The diversification program achieved by ITT was even more remarkable. After its beginnings as an international telephone service provider, the company launched into an extensive acquisition campaign. From 1959 to 1979, the ITT added 350 companies including Avis, Sheraton, Burpee Seeds, Continental Baking, and many others. The company was stung by a failed attempt to take over the American Broadcasting Company (ABC), and was then forced by regulators to divest significant assets in order to complete an acquisition of Hartford Insurance. (Gasbarre, 1995) Through these many acquisitions, the long-time CEO of ITT was regarded as one of the masters of the conglomerate era.

Both companies suffered from economic difficulties, as the companies reached out beyond their resources. Customers did not care about the company portfolios. The internal company cultures were incompatible, and the companies often faced more focused competition. ITT was forced to undertake a massive “corporate garage sale” in order to pay down its $4 billion debt. In five years, the company divested 69 subsidiaries for proceeds of $2 billion. (Troester, 1993) The leaner ITT then became a target for hostile takeover. To stave off raiders, the company dumped over 30 additional subsidiaries, resulting in a focused insurance, lodging, and industrial company. To combat its financial pressures, Westinghouse divested 70 businesses and used the proceeds to make 55 related acquisitions, moving towards a focus on economies of scale and leveraged management talent. The company ultimately made a successful bid for the CBS network expanding its scope in media enterprises.

In December of 1995, ITT made the first move in what would become a four-way split of the company into forest products, lodging, insurance, and industrial companies, each with their own management and strategies. ITT Corporation (the lodging company) recently agreed to be acquired, itself the target of a consolidation play. (ITT Corporation, 1997; Gilpin, 1997) Westinghouse exited many of its unrelated businesses in 1992, focusing on broadcasting and electric industries. In November, the company announced plans to divest the remaining industrial units, renaming itself CBS. (Aeppel, 1997)

Each of these companies sought economies of scope and better access to capital through size. However, they attempted to do so through combining businesses that often had incompatible cultures, no similar management talent, and focused competition. They sustained themselves for many years, but ultimately succumbed to the pressures around them.

Consolidation’s third wave builds on the models of the past

The first two waves of consolidation took complementary forms: In the first, entrepreneurs and corporate raiders sought to establish monopoly power through size and scope, as a result of regional and vertical integration. In the second, corporations assembled portfolios of several businesses within and across industry boundaries in an attempt to achieve cheaper access to capital and reach growth targets.

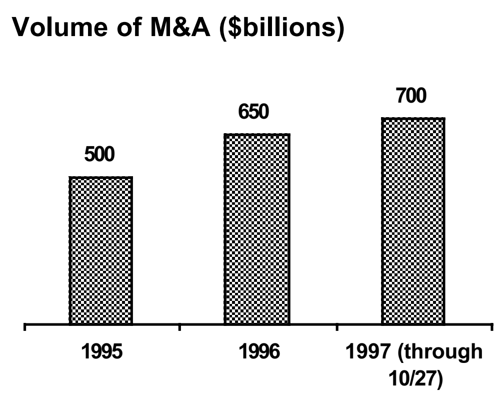
The newest wave builds off of the prior waves, but includes fundamental changes. Entrepreneurs and corporations are still active consolidators. This wave is again driven by underlying market forces. However, consolidators are now better focused on the creation of competitive advantage, as opposed to size or growth. In addition, the players involved include a new mix of financial and strategic players.

Market forces drive the need to merge

Although consolidators ultimately execute merger and acquisition strategies, the level of activity is driven to a large degree by underlying environmental forces. As shown in Figure

1, these forces are now combining to create an unprecedented level of merger and acquisition activity.

Figure 1



Source: Securities Data Corporation

Although not all mergers and acquisitions may be consolidation plays, industry consolidation comprises some of the largest. Some spectacular examples include Starwood Lodging's acquisition of ITT, the merger of Ernst & Young and KPMG (along with Price Waterhouse and Coopers & Lybrand), and Aetna's combination with US Healthcare.

One fundamental driver is the move for industry deregulation exhibited by the White House, dating back to the Carter era. (Smart, 1997) Successive presidents have encouraged a more relaxed approach to anti-trust enforcement, allowing industries to capture greater economies of scale and better compete in world markets.

Consolidation has also been fueled by the tremendous performance of stock markets over the past few years. The continued rise of stock market provides readily available capital for stock-for-stock mergers.

In addition, the tremendous amount of money contributed to mutual funds and the high expectations of their investors have created increasing demand for returns through corporate growth. To achieve this growth, many stagnant industries are turning to acquisitions.

Finally, globalization is driving consolidation both in and outside the U.S. The battle for MCI illustrates the premium that companies are willing to pay for cross-border assets. Consolidations in Europe are on a rapid rise, as privatization, deregulation, and pan-European competition converge. (Rossant, 1997)

Most of these forces have existed to some degree in the past. The current wave of consolidation draws on the increased pressure of all of them.

New consolidation focuses on competitive advantage in diverse industries

Many companies are attempting to capitalize on the current market conditions. In stark contrast to the age of conglomerates, "Today's merger mania is an attempt to build mass around a similar core." (Smart, 1997) Companies seek to gain cost or marketing advantages by finding targets with similar focus. The conglomeration strategy has been focused through a concept of "bundling", or providing related products and services to the same customer base. Even leveraged buyout firms have focused on industry consolidation through platform investments. (For an explanation of LBO consolidation strategies, see the following section).

As with the original consolidation by moguls, action continues in heavy industry, with further consolidation in railroads, steel, and energy. The new wave has also spread to service industries, as companies seek to leverage consistent brands and common operations. Further activity is expected in airlines, telecommunications, and financial services.

Strategic and financial players drive consolidation activity

To accommodate the most recent boom in consolidations, new players have joined the traditional entrepreneurs and corporate consolidators.

Entrepreneurs continue to act as catalysts for consolidation

As with the moguls of the turn of the century, modern day moguls have consolidated industries ranging from office products to trash. Wayne Huizenga, recent owner of the Florida Marlins, was responsible for the consolidations of Waste Management Systems and Blockbuster. He is currently working on a consolidation strategy for the used automobile market. (Pulliam, 1997) The popular press praises his ability to select industries for consolidation, and also comments on his impeccable timing – he got out of both WMS and Blockbuster at their peaks, selling each of them for a substantial premium.

Corporations seek growth through consolidation

Corporate acquirers, attempting to grow and solidify their positions have also joined entrepreneurs. Participants range from Airgas, a supplier of industrial gases and tools to GE Capital, rapidly consolidating the life insurance industry. (Honor Roll, 1997) Corporations are likely acquirers through all phases of the economic cycle, but the current positive environment has further encouraged their activities.

Technology companies play a different twist. Especially in small software ventures, acquisitions can provide a way to acquire technologies and talent, irrespective of the company structure.

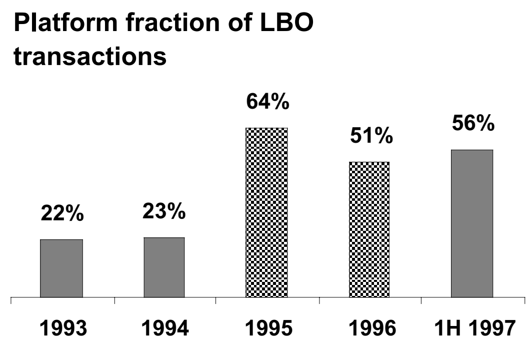
Leveraged buy-out (LBO) shops seek to establish "buy and builds"

Financial buyers have joined the strategic players. As competition for deals has increased in their conventional market, LBO firms have sought creative alternatives such as platform investing, where base acquisitions are supplemented by add-on firms.

Buy and builds, as platform investments can be called, can provide returns attractive enough to overcome currently inflated purchase prices. (Maletz, 1997) "Buyout sources agree [General Partners] today are less likely to rely totally on financial re-engineering or the quick flip of stand-alones for their returns." (Tan, 1997) As a result, some firms, like

Chicago's Golder, Thoma, Cressey, Rauner have focused almost exclusively on the buy and build market. (Brush, 1997) The focus by some shops and the "dabbling" by others have driven up the fraction of all LBO transactions represented by platform deals. After previously hovering in the 20% range, the number has hovered from 50-65% for the past three years.

Figure 2



Source: Buyouts

However, LBO shops have run into difficulties when the must take the role of strategic managers. Firms have underestimated the effort required to merge people, cultures, systems, and equipment. (Zweig, 1995) It remains to be seen how effectively these financial buyers can complete complicated consolidations.

IPO roll-ups provide a new innovation in consolidation

The final "player" in consolidations is a hybrid strategic and financial option. IPO roll-ups provide an opportunity for firms to simultaneously combine and raise capital for further acquisitions. (Leidtke, 1997) A handful of private companies are combined for a public offering. While the deal is lined up, they arrange for additional acquisitions using the anticipated public capital. In the past three years, over 25 IPO's have used this strategy, completing up to 13 simultaneous acquisitions.

Jonathon Ledecky, who built the $1.7 billion U.S. Office Products from 190 office supply dealers using a roll-up, has taken the IPO roll-up one step further. He is currently circulating an offering prospectus for Consolidation Capital, a "poof company" with no revenues, products, or customers. He plans to raise $575 million to seek and consolidate fragmented industries. (Knight & Pressler, 1997; Lowenstein, 1997; Consolidation Capital Corporation, 1997; Knight, 1997) Although he does not state the industries he will attempt, he suggests a few possibilities. Backed by an aggressive investment-banking firm, he has generated significant interest in the offering.

5-C's map successful consolidation strategies

Through the course of our research, we discovered many justifications for consolidation. However, these focus almost exclusively on opportunities to exploit one of two potential advantages: economies of scale or scope and/or leveraging management talent across businesses. What is missing is a systematic means of identifying industries with a more detailed approach than simply targeting one or both of the potential advantages previously mentioned. The current business literature invariably highlights one or both of the advantages above but neglects to mention the additional issues.

Consolidation failures result not only from unrealized advantages in one or both of the aforementioned advantages but also arise from several other issues that may have been overlooked, misunderstood, or simply downplayed. In the course of our research, we recognized that successful consolidators certainly developed rough guidelines and, more often, a keen intuition to help them identify whether consolidation will work in a given industry. However, none that we discovered addressed all the potential issues in depth using a systematic framework. Their skills and intuition are not easily transferable and may lack sufficient depth and breadth.

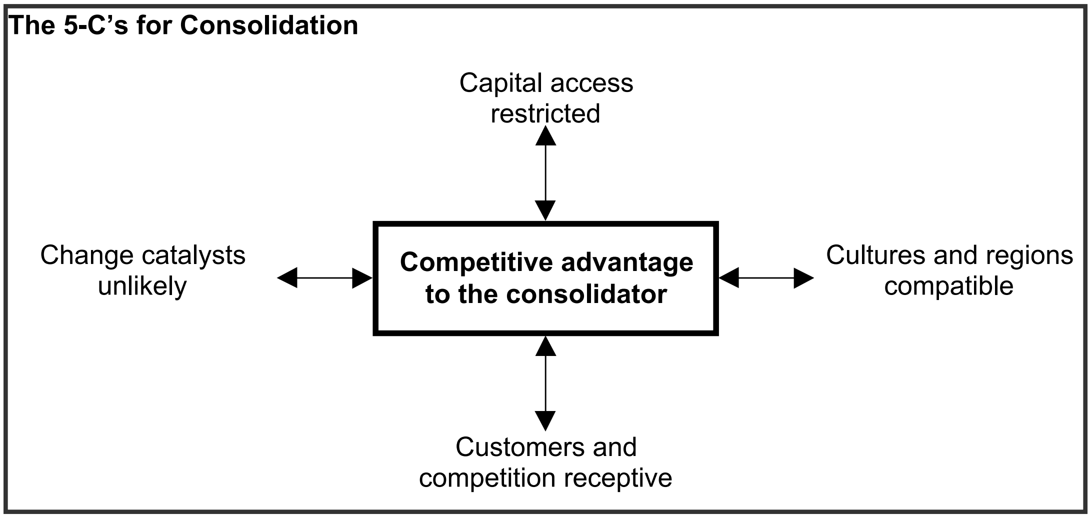
Our framework is meant to be a guide for analyzing consolidation opportunities among fragmented industries. This framework is applicable to fragmented industry consolidations more so than cross-industry bundling. Much like Porter's Five Forces framework, our 5 C's are meant to serve as checklist by which industry issues can be identified and examined.

We certainly recognize that success for a consolidation play relies significantly on implementation. Our 5 C's may suggest that an industry is ripe for a consolidation play only to have the consolidator fail during implementation. Conversely, our framework may suggest that successful consolidation is unlikely but a superior consolidator could overcome the negative issues.

The framework is meant to guide thinking about consolidations and highlight the factors that will ultimately influence success. As depicted in Figure 3, the 5 C's are *Capital access restricted; Cultures and regions compatible; Customers and competitors receptive; Change catalysts unlikely; and Competitive advantage realizable for the consolidator.*

Each element of the framework will be detailed further in following sections, but we first present a quick note on the interaction between the variables. The outer four variables address the major industry issues and highlight potential pitfalls. They are focused on the industry as a whole and should apply somewhat uniformly across individual businesses. They should be examined by asking: *"Is this issue significant in this industry?"* If the answer is affirmative, then consolidation may well be successful. However, the fifth and center variable is more business specific and should be examined by asking: *"Do these opportunities exist and are they realizable?"* Essentially, the ultimate success in a consolidation play relies upon the proper implementation of the fifth variable.

Figure 3



Underlying this analysis must be the broader question of*: "Why is this industry fragmented now and what has changed to make consolidation possible?"* According to Michael Porter in *Competitive Strategy*, industries are usually fragmented for five general reasons. These reasons will be addressed in turn as they pertain to each of our 5 C's but it is useful to summarize them here. They are:

- *Low entry barriers and/or high exit barriers*
- *Lack of power advantages with buyers and/or suppliers*
- *No economies of scale or scope*
- *Regional issues: high transport costs, high inventory costs, or diverse markets*
- *Regulatory issues*

There is some obvious overlap with some of our 5 C's. Porter's reasons are a useful starting point for understanding industry fragmentation but fail to fully cover all potential issues of a consolidation strategy. We highlight his work because it provides a useful foundation upon which to more deeply examine a consolidation play using the 5 C's. In the following sections, we will address each of the 5C's in turn and incorporate the issues that Porter raises into our discussion.

Capital access enhanced

Fragmented industries are populated with businesses that are almost by definition small, private companies. As such, these businesses may face a more expensive cost of capital than they could get from the public markets. Thus, growth and capital reinvestment in these small businesses is limited or at least costly, which explains the evolution of the fragmented industry.

To invest and grow, the businesses would either have enough size to go public or find more favorable private capital. Either way, obtaining a cheaper cost of capital may create an advantage within the industry and allow for growth. This is the attractiveness for consolidators of industries with restricted capital access. A consolidated firm will not face such high transaction and information costs in the capital markets because of the economies of scale it will enjoy. However, industries with few capital requirements and no need for growth may not necessarily need cheaper capital.

Thus, to determine if this variable is both significant within the industry and suggests that industry consolidation will be successful, we need to ask several questions:

- *Do industry players face a high cost of capital that would be cheaper in a consolidated firm?*
- *Is capital a significant enough factor in the industry that cheaper capital would it create a significant competitive advantage?*
- *Will the capital markets support a consolidation play in this industry?*

If the answer is affirmative to all three, then this variable suggests that industry consolidation will be successful. While most industries will suggest an affirmative answer to the first two questions, there may be few industries where cheaper capital is somewhat irrelevant. For example, the beauty salon industry has few capital requirements and is certainly fragmented. Many, if not all, salons are privately owned by small business owners. The industry is near saturation in most markets and thus, there are few opportunities for growth. The retail channels are evolving into the shopping malls but for the most part, capital requirements remain small. Thus, restricted capital access is not a major concern. There may also be an example of a fragmented industry that enjoys cheap capital that could not gain even cheaper capital for a consolidated firm.

The final question is perhaps the most basic but also most important. Currently, the capital markets are strong and willing to support consolidation plays. An economic downturn will sour the market appetite for such plays and could spell disaster for a consolidated firm.

Cultures and regions compatible

Fragmented industries develop for a variety of reasons. These vary from market segments that require specialized businesses and products to the historical evolution of the industry. Using Porter's work, low barriers to entry and lack of a power advantage over buyers and/or suppliers may account for the historical development of fragmentation of this industry. Porter also highlights regional issues, such as high transportation costs, as a reason for industry fragmentation. Another potential reason for industry fragmentation may simply be the personalities of the firm owners, who want to run their own businesses.

The fundamental outcome of all of these factors is that the cultures and regions of the individual businesses may be very different. Cultural issues can be further subdivided into both regional and industry differences. Regional cultures may seem relatively straightforward but are often subtle and can be often overlooked. Industry cultures include not only the personalities of the operators in the industry but also the personalities and norms of the various individuals and organizations that interact with the industry. Finally, the industry may dictate a need for distinct regional operations that may hinder a consolidator's ability to create competitive advantages.

Consolidators rarely mention this variable. Unfortunately, we suspect it is also one of the primary reasons for consolidation failure. Many times, these issues are downplayed or worse, overlooked. They emerge during implementation and may quickly sabotage other successes. An honest appraisal of the feasibility of consolidation among business cultures and across regions is essential. One must ask the following questions:

- *Are there distinct cultures present within the industry and the individual businesses?*
- *Is there no economic reason for distinct regional orientation?*
- *Are the cultures and regions realistically compatible across businesses?*

An affirmative answer to all three suggests that industry consolidation will succeed. However, assessing compatibility is extremely difficult, primarily because fully identifying and analyzing cultures is so difficult.

The auto service and home contracting industries have historically been attractive areas for a consolidation play. However, the culture of the businesses and the workers in such industries does not lend itself to compatibility.

In the home contracting business, workers operate as individual sub-contractors, generally responsible to themselves only. Home contractors face a continual management challenge to meet deadlines and budgets in the face of all these individuals. A consolidation of such an industry would require a break in the paradigm with which the workers have grown comfortable. The Fortress Group in Washington, DC is attempting to consolidate home building. (Mayer, 1997; Comer, 1997) Their primary obstacle (the main focus of the criticism against them) is that they will be unable to integrate the numerous independent operators into a unified business team.

There are several other examples of industries where consolidation has failed due to cultural and regional issues. The Foster Management Group attempted an unsuccessful consolidation in mental healthcare. Despite the economic benefits of consolidation, the primary roadblock to success was that the psychiatrists were unwilling to give up their autonomy to a large organization.

Finally, the dental industry might, at first, seem like a potential consolidation play. However, many people probably enter dentistry as an opportunity to become small business owners. They are less attracted to the actual work of being a dentist. As such, they are unlikely to be receptive to a consolidation play that will strip away their ability to manage their own business.

In contrast to the consolidations that failed due to culture, Veterinary Centers of America (VCA) has succeeded by taking advantage of the cultures of independent operators. Veterinarians are willing to sell out to, because they are able to unload administrative functions and focus full time on animal care. (Tannenbaum, 1997)

In analyzing regional issues in consolidation, the home healthcare services industry in New England is interesting. Home healthcare services in the rest of the United States are consolidated. However, the industry is not consolidated in New England and it is not due to the lack of interest by consolidators. Inexplicably, consolidators are unable to successfully consolidate this industry just within New England. The fundamental barrier for them is the distinct culture within this region.

Customers and competitors receptive

The historical evolution of fragmented industries has affected the customers and competitors. As Porter would assert, it is likely that there has been little, if any, power advantage over buyers and suppliers. Both the customers of the industry and the competitors within the industry are likely to be comfortable in their expectations. A consolidator entering the industry is likely to rock the boat and thus, the effect needs to be examined closely.

This variable contains several deeper issues as well. With the customers, issues of branding and customer perception and acceptance are relevant. With competitors, issues of response tactics and willingness to be consolidated arise. All issues fundamentally rest on the goal of successfully ascertaining the overall market response to a consolidation play. The following general questions should be addressed:

- *Is this a relatively static industry with set expectations among all participants?*
- *Will customers perceive a consolidator negatively?*
- *Are competitors likely to fight at every turn along multiple fronts?*

An affirmative answer to all three suggests that a consolidator will face stiff opposition and may not be able to successfully consolidate the industry.

In the funeral home industry, for example, the answers to the first two are affirmative. Customers are accustomed to family-owned funeral parlors that are members of the community. A national funeral parlor chain would certainly face negative customer perceptions. A consolidator looking to exploit economies of scale by performing embalming services at a central assembly-line style facility would not be well received. These issues can be resolved, but they must be recognized and addressed early. Service Corporation International has been able to consolidate funeral homes by preserving the compassionate front to the customer despite leveraging economies of scale. (Schreiber & Esty, 1996)

Another example of customer perceptions as potential barriers to consolidation is the current backlash against Health Maintenance Organizations. As a result of consolidations in healthcare and the fallout on customers, big, economically efficient firms are perceived as cold and impersonal. These issues must be overcome for consolidation to succeed.

With competitors, the consolidator will face two issues. First, will the competitive response be strong? While this might seem unlikely in a fragmented industry, there may be underlying relationships or other factors that may be exploited against the consolidator.

Second, and possibly most important, will stiff competitive resistance force a consolidator to pay high premiums for acquisitions? This is certainly less preferred than consolidating an industry where businesses are more eager to sell. Quite simply, the higher the premium the consolidator is forced to pay, the harder it will be to eventually succeed in the industry.

Change catalysts favorable

Change catalysts can be both a positive and a negative issue for a consolidation play. In the positive light, change catalysts can alter a fragmented industry to enable successful consolidation. In the negative, change catalysts either prohibit successful consolidation or worse, disrupt a new or established consolidated industry. (Wilke, 1997)

Regulatory issues and technological changes are the two most important factors in this variable. They are the primary change catalysts that can affect industries. Fragmented industries may have evolved under a particular regulatory or technological paradigm. When this paradigm shifts, with a new regulatory environment or a new technology, the industry may be immediately ripe for consolidation. Thus, the major questions for this variable are:

- *Have change catalysts affected this industry?*
- *Are these change catalysts likely to further affect this industry?*
- *Does a consolidated firm stand to be affected negatively by new changes?*

If the answer to all three questions is affirmative, then a consolidation play will likely be unsuccessful. The key here is that the industry should not be facing a tremendous amount of uncertainty in the future. While a catalyst may have created the opportunity for consolidation, the future industry should be relatively stable and free of major regulatory or technological factors.

A prime regulatory environment for consolidation may occur if there is no natural monopoly already and/or if there is one specific body that regulates the industry. In such a case, a consolidator can be assured that the likelihood of major change catalysts altering the industry is low. It is also useful to examine and understand the interaction between regulation and the fundamental economic forces that determine industry structure and would affect consolidation.

Currently, some of the major consolidation plays have arisen out of the change catalysts. The tower industry, for example, was extremely fragmented in the past. With the utilities deregulation and the explosion of cellular services, the tower industry has been thrust into the limelight as a profitable consolidation play. (Allen, 1997) However, as quickly as these catalysts can create a consolidation opportunity, they can spell doom for a consolidated industry. Telecom deregulation has left AT&T, a former consolidated firm, fighting with Sprint, MCI, and others for market share.

Competitive advantage realizable for the consolidator

Identification and full investigation of the first four primary variables is essential to this fifth variable. While the first four highlight the areas of concern that are not necessarily controllable by the consolidator, the fifth rests on the consolidator's ability to implement successfully. Indeed, potential pitfalls raised among the first four issues may be addressed and overcome given complete analysis and proper implementation of the fifth variable.

The two primary competitive advantages for the consolidator are:

- *The ability to exploit economies of scale and/or scope.*
- *The ability to leverage management talent.*

These advantages are frequently cited in the popular literature today. The major issues that consolidators face, such as branding, tend to fall into one of these two buckets. Given that the nature of these advantages is well documented in strategy texts, we will not explain them in detail here. Suffice to say that properly identifying and realizing these advantages may seem simpler in theory than in practice.

One particular example of successful execution is Wayne Huizenga. He created economies of scale through centralized purchasing and/or management of assets. In the video rental business, he gained scale with Blockbuster to negotiate cheaper video purchase prices. In Waste Management's trash and recycling services, he gained scale to enable cheaper management and maintenance of a trash hauler fleet. Huizenga was able to leverage management by gobbling up mom and pop video stores and immediately converting them to the Blockbuster format with national management. Despite current analyst concerns for the companies, Huizenga's consolidation plays were viewed as highly successful. (Pulliam, 1997) Whether through an actual set of guidelines or just strong intuition, Huizenga has been able to identify potential industries where a consolidation play will work. More importantly, he has been able to implement their identified goals properly.

Success requires careful implementation

Many agents have attempted consolidation over the past century of U.S. business. Some have been extraordinary successes, but some have failed. The new rise in attempted consolidation points to an even greater need for a systematic approach to developing consolidation strategies.

The 5 C's framework should be used for identifying and analyzing fragmented industries where a consolidation play will likely be profitable. It is meant as a guide and tool to structure what is currently intuition and loose guidelines in most minds. The 5 C's framework is a systematic structure in which to answer the following fundamental questions:

- *Why is this industry fragmented?*
- *What are the opportunities and issues that must be addressed?*
- *Who are the industry stakeholders that a consolidation will affect?*
- *Where are the obstacles for a consolidation play?*
- *How can this consolidation best be implemented with these issues in mind?*

As stated previously, implementation will be the key to eventual success regardless of the obstacles or opportunities identified by the framework. Despite the level of industry attractiveness, individual success is highly dependent on the approach and persistence of the consolidator.

Beyond implementation, a final issue remains. How do you continue to succeed and grow beyond initial industry consolidation? This question is certainly beyond the scope of this framework but bears mentioning nonetheless. Slow growth and few opportunities may still characterize fragmented industries where a consolidation play will work. Huizenga has been criticized for bailing out on his ventures when growth of the consolidated company was slowing. The consolidator enters and realizes competitive advantages over other industry players and may even gain most if not all of the market. However, at the end of the day, the consolidator will be left looking for new ways to grow in what may well be a boring dead-end industry.

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