April 2022

Creating value through industry convergence

The grass on the other side is actually greener - but companies have to deploy the right capabilities to enjoy it

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Contents

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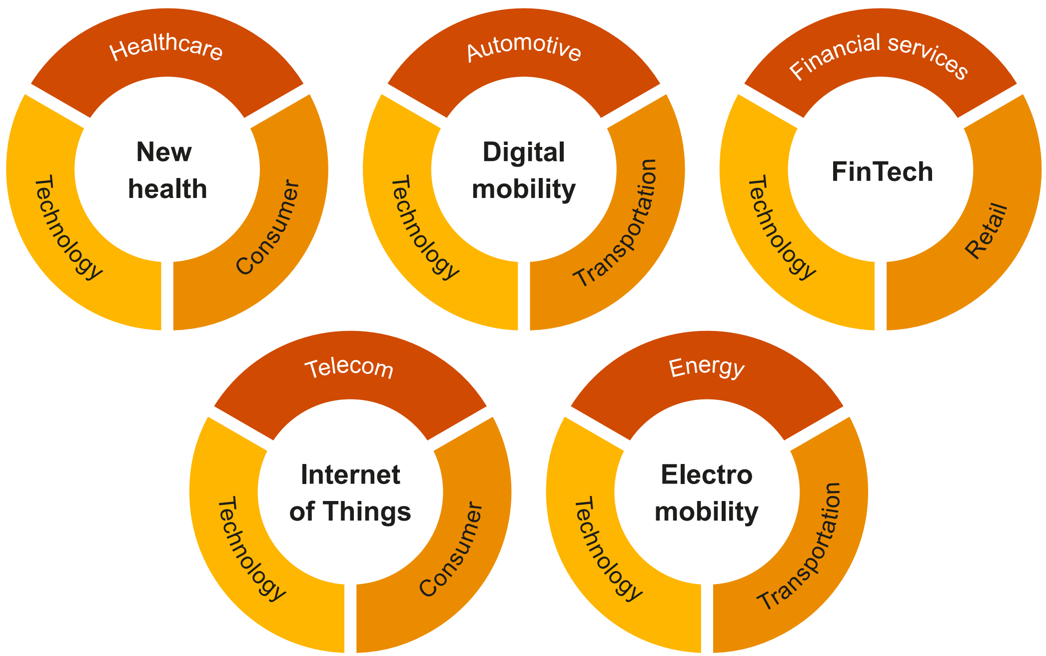
Introduction

The possibilities opened by digitalisation are fuelling new value propositions that do not follow traditional industry conventions and classifications. This is what we call "industry convergence", where companies are rapidly entering previously unrelated industries in order to capture cross-industry synergies. There is value to be captured from convergence, but as we explore in this paper, companies have to deploy the right capabilities to enjoy it.

Figure 1 New market clusters emerging because of industry convergence[1]



1 These were the findings from our earlier study, *Drive or be driven: understanding the third wave of industry convergence*, 2018

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The desire to benefit from emerging market clusters and changing consumer behaviour is the primary driver of convergence. While many companies build new capabilities in-house, often incumbents find it easier and faster to acquire new capabilities through mergers and acquisitions, before venturing into new markets with convergence.

This is reflected in our analysis of industry convergence, which has been steadily growing over the last two decades[2]. We found that there have been three waves of convergence over the last two decades, with the most recent one being much faster and affecting almost all industries to some degree. Faster convergence points towards more cross-industry synergies, more value being created in the industries, but also more competition. While this means more societal welfare creation through more innovation, jobs and profit pools, it could also mean increasing cost of innovation in the new market clusters and more pricing pressure for companies.

These findings emphasise the need for picking the right deals. Deals with the intent of capturing synergies is not enough – they must have a strong capability fit[3] that can drive value growth and an effective integration plan that can help realise that value. Through this paper, we look at the progression of industry convergence, its impact, and reflect on the factors that are crucial to creating value through convergence.

2 We measure convergence using cross-industry M&A data. More details on the definition of convergence and the methodology used can be found *here*.
3 We define capabilities as the specific combination of processes, tools, technologies, skills and behaviours that allows companies to deliver unique value to their customers. Think about Apple's design capability, Amazon's retail interface design or Frito-Lay's rapid flavour innovation.

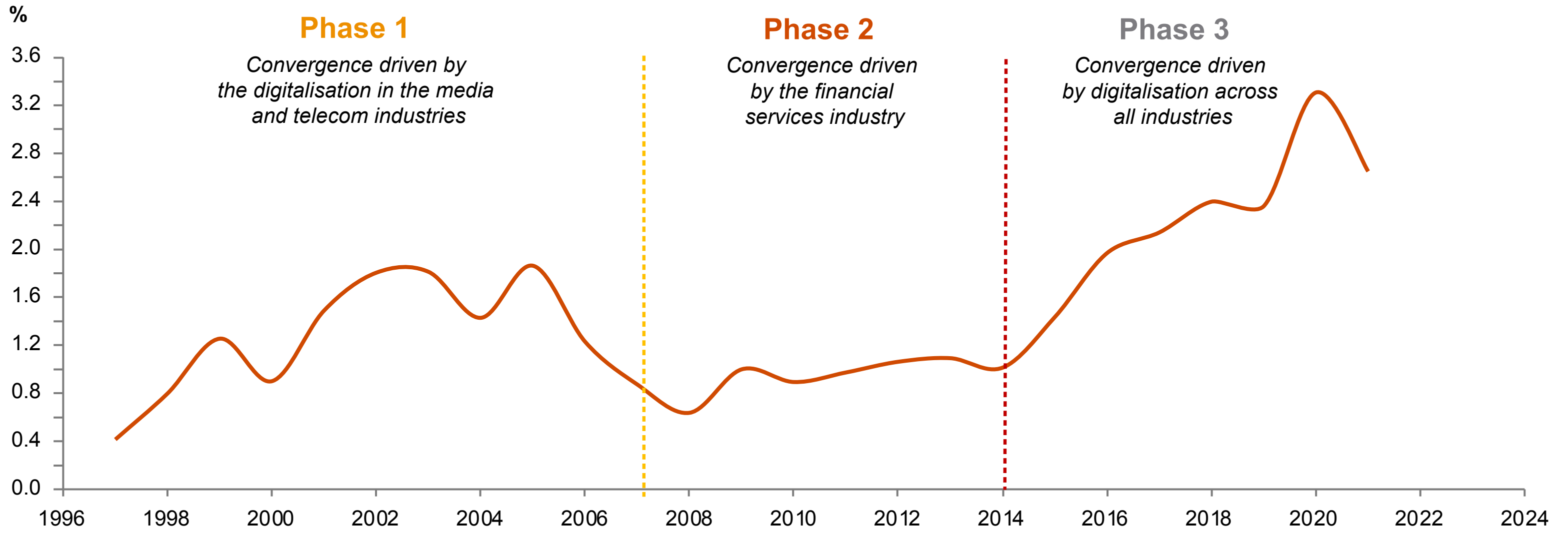
Industry convergence is picking up pace

Convergence activity has been consistently rising over the previous two decades. Over this period of time we have seen three clear phases, each driven by different forces and affecting different industries. In the early 2000s this was driven, to a large extent, by the media and telecommunications industries. Digitisation of music and the proliferation of peer-to-peer file sharing platforms significantly disrupted the media and entertainment industry, while telecoms were affected by the rapid rise in wireless services. The second phase, closely following on the heels of the economic crisis of 2008, was driven by government investments flowing into the fragile financial services industry.

The third and current wave is unique in two distinct ways. Firstly, it is driven by a steep adoption of emergent technologies and has a broad base – being driven by all industries as opposed to previous waves that were driven by just one or two industries. Considering it is also the steepest wave yet, it has significant effects on overall value created by industries, and the competitive intensity in the economy[4].

Another unique characteristic of this wave is its relationship with economic cycles. Since industry convergence is highly impacted by overall economic situation, it has historically scaled back when the economy was recessionary or declining.

Figure 2 Industry convergence is growing



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We see this effect gradually weakening. During the last few years, with the COVID-19 fuelled slowdown, the convergence wave saw relatively small drawdowns compared to the ones in the past.

Though convergence is growing from a relatively small base, future waves could get bigger while being more resistant to economic cycles. This indicates that going forward, industry leaders should expect previously unrelated businesses popping up as rivals in their backyard relatively quickly.

Industry convergence defined
Industry convergence refers to the trend of companies entering previously unrelated businesses, in an effort to capture cross-industry synergies. M&As are a common way for incumbents to capture these new markets, but other means are also extensively used – such as partnerships and joint ventures, minority investments, start-up incubators and of course, organic investments.

For the purposes of this report, we measure industry convergence by looking at cross-industry M&As and minority stake purchases (referred to as 'deals' in this report).

We analyse the scale of convergence by looking at the volume of cross-industry deals relative to the size of the industries. Various other adjustments are made to the data to smoothen the effect of overall economic environment.

At the overall level, a 2% convergence in a year can be interpreted as the total volume of convergent deals are 2% of the size of all industries analysed. This includes 12 industries – namely, consumer products and services, consumer staples, energy and power, financials, healthcare, industrials, media and entertainment, real estate, retail, technology, and telecommunications.

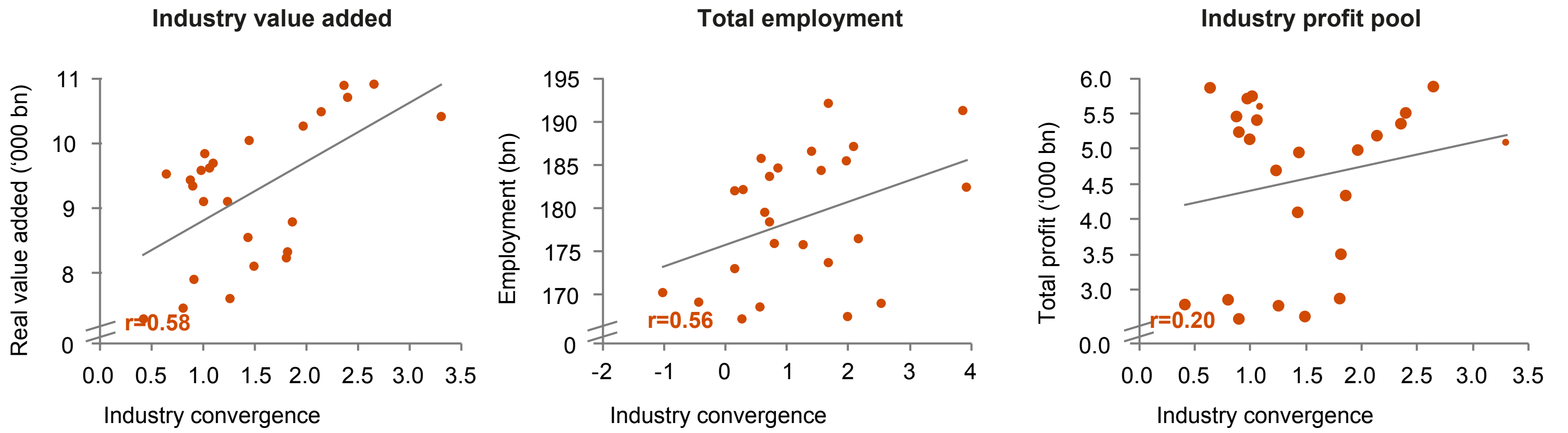
The impact of faster convergence

Though convergence is not a new phenomenon by any means (our analysis covers 25 years), as it grows past the very small base it started with, the disruption across industries starts to become clear.

Our analysis indicates that at the industry level, convergence is correlated with higher value added[5], more employment, and higher profits. All these metrics indicate an efficiency benefit, likely due to new applications of technology and other synergies, which lead to innovative products and services, business models and/or customer experience. This does not just benefit the companies driving the convergence, but also pushes incumbents to become more agile, while also benefiting the society at large.

We also observed that this correlation has changed since the early 2000s. As convergence continues getting stronger, it is now more likely to have even higher value added and employment compared to early 2000s, but lower profits for companies. The charts below show the difference in the relationship between wave 1 and the period since then (after 2007).

Figure 3 Convergence is associated with higher value added, employment and profits*



* r refers to the correlation coefficient, which measures the degree to which the movement of two variables is associated.

5 Value added of an industry refers to the contribution that the industry or sector makes to the overall GDP (value of output minus the value of intermediate consumption)

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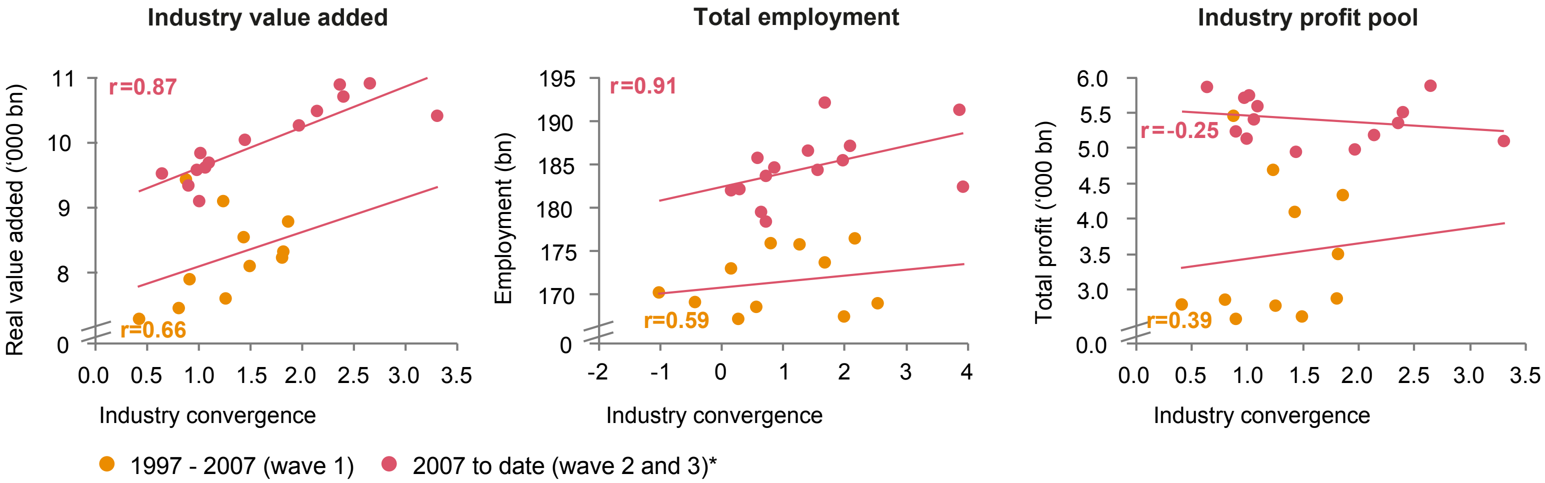
As more and more opportunities of crossing industry lines pile up, the question arises: under what circumstances is it a good idea to explore emerging market clusters?

Figure 4 Convergence in more recent waves is associated with higher value added and employment than in previous years, but with lower profits for companies



* r refers to the correlation coefficient, which measures the degree to which the movement of two variables is associated..

The data suggests that this is the effect of competition – as more and more companies expand into newer capabilities, the industry value added and employment increases, however, the overall profit pool available and average profitability per company starts to go down. As more and more opportunities of crossing industry lines pile up, the question arises: under what circumstances is it a good idea to explore emerging market clusters? What should companies consider when evaluating such opportunities?

Creating value through convergence

These questions are relevant, since we know that deals don't always produce value. PwC research has shown that 53% of all acquisitions underperformed their industry peers in terms of total annual shareholder return (TSR)[6], over the 24 months following completion of their last deal. This also applies to convergent deals - for it to be successful, various factors need to be considered.

Buying and integrating another company can be a transformational exercise. The first step to success is identifying the strategic direction of the company. Though convergence is growing, it is still a very small part of the overall business and might not always be the strategy to pursue. The next step is identifying the capability that is needed, and the best way to acquire it. Though acquisitions can be the faster way, especially for emerging tech, it needs to create value in the long run. And lastly, the key is finding the right business to invest in. Companies need to ensure a strong capability fit between buyer and target.

Capability fit is key

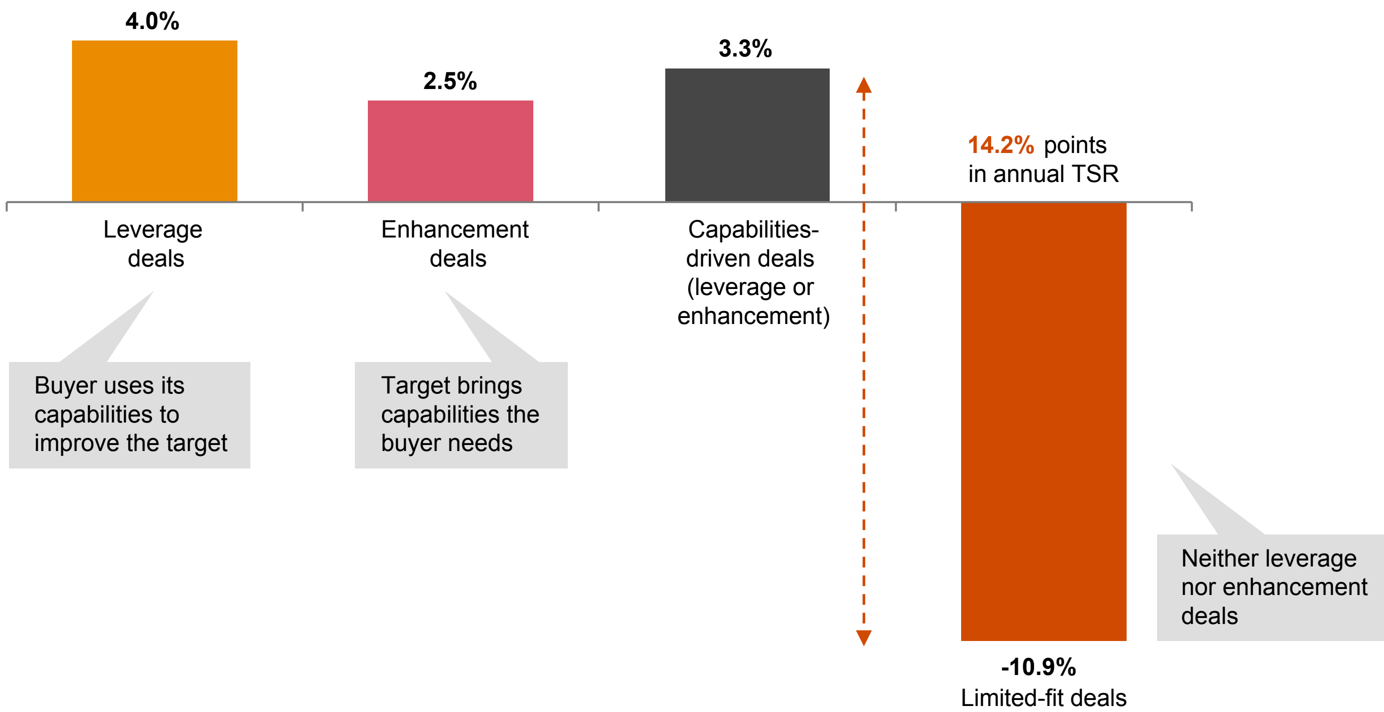
Companies need to be aware of the capabilities required to stay or become successful in the long run, and where they stand with these capabilities. A good fit could be where the target company brings the buyer the capabilities it needs ('enhancement deals'), but also where an acquirer uses its capabilities to improve the target company (we call such an acquisition a 'leverage deal').

On the other hand, a limited fit deal doesn't improve upon or apply the acquiring company's capabilities system in any major way. This can happen when a company enters a new market cluster by acquiring a start-up with a capability that is an entirely uncharted territory. In such a situation, the acquiring company is in no position to enhance its own capabilities as a result of the deal (no enhancement), and also cannot effectively improve the target company (no leverage).

Regardless of specifics, capabilities-driven deals are likely to generate higher returns than ones that do not have a clear fit. According to our analysis of over 800 deals in 16 industries, capabilities driven deals generate 14.2% higher returns one year post-closing, as compared to limited fit deals.

6 The total annual shareholder return (TSR) is a measure of the performance of companies' stocks over time. TSR as used and referenced in this paper, is calculated as the buyer's annualised TSR over a period ranging from just before the deal's announcement to 12-24 months post-closing. We compare that with the performance of the leading local market index over the same period, to determine deal success.

Figure 4 Average annual shareholder return of various kinds of deals vs. local market index

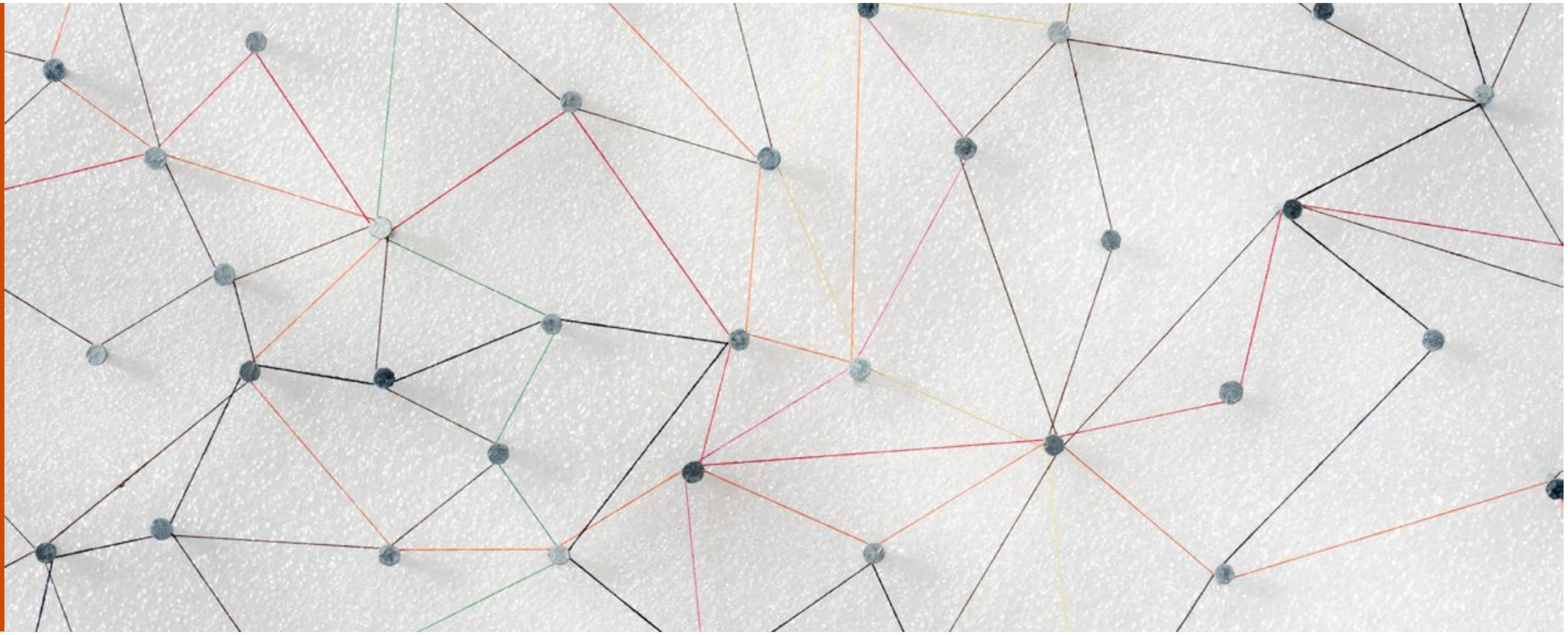


> Capabilities-driven deals are likely to generate higher returns than ones that do not have a clear fit.

Table 1 Some examples of convergent deals with capability fit but with differing overall objectives.

Objective	The deals and their capability fit
Growing an existing (smaller) business line	Microsoft announced its acquisition of Activision Blizzard (gaming) in 2022. The acquisition will bolster Microsoft's gaming business across mobile, PC, console and cloud, with Activision Blizzard's nearly 400 million monthly active players. The acquisition is expected to make Microsoft's Game Pass one of the most diverse line-ups of gaming content in the industry. Upon deal close, Microsoft will have 30 internal game development studios adding to its capabilities. Another example is that of Procter & Gamble (consumer goods) acquiring Merck's consumer health business to improve its over the counter portfolio and footprint across 15 markets. The deal helped P&G gain Merck's strong health care commercial and supply capabilities that complemented its existing consumer health portfolio.
Speeding up new business models	Car sharing or digital mobility is an emerging business model for automotive players. Multiple automotive players have acquired or invested in car-sharing/on-demand mobility businesses in the last few years (Volkswagen with Gett, GM investment in Lyft and Toyota's partnership with Uber). Another example is new energy where Shell acquired Savion, a company that specialises in developing solar power and energy storage projects. The acquisition complemented Shell's other investments in zero- and lower-carbon assets and technologies aimed at becoming a net-zero emissions energy business.
Gaining access to specific expertise in the industry	Biopharma and Biotech are good examples of this. For instance, Boehringer (pharma) acquired Abexxa Biologics, gaining access to Abexxa's expertise in targeting cancer-specific proteins. The acquisition complements Boehringer's present approaches to the therapies of hard-to-treat cancers. Relay Therapeutics acquired ZebiAI to gain access to additional technology that applies machine learning to DNA-encoded libraries. At the time of announcement, the company also noted that the combination of ZebiAI's approach and Relay's Dynamo platform has the potential to predict more drug-like chemical starting points and increase the range of programs that can be developed in parallel.
Gaining access to online channels or digital capabilities	There are multiple examples of this in the Fintech space. For instance, JPMorgan acquired multiple fintech companies such as OpenInvest (creating personalised, values-based portfolios), 55ip (automating the construction of tax-efficient portfolios), and Nutmeg (robo-advisor) aimed at boosting its digital banking efforts. Another example is retail, where Ahold acquired bol.com, focusing on its online capabilities that would assist in accelerating Ahold's online growth.

> Doing the right deals is one thing, successfully integrating it is a whole different story.



The importance of integration

Doing the right deals is one thing, successfully integrating it is a whole different story. As underlined by PwC's 2020 M&A Integration Survey 'Evolving with Agility', M&A integration is absolutely critical in delivering value from any deal but needs to be tailored specifically to each deal's unique attributes and characteristics.

Effective integration for convergent deals is even harder, considering the companies come from different industries with potentially different practices. Not doing this well could also lead to value destruction, even if the deal is an otherwise strong capabilities fit.

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