

2001 Speech by Graham Smorgon

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Competition and Collaboration in the Steel Industry.

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I want to talk to you today, not about competition versus collaboration, but about competition and collaboration. I have found that there is a place—indeed a need—for both.

I am not suggesting a simple formula to follow—indeed every situation is different. But one example, that has confirmed for me the benefits of collaboration, may enable you to draw your own conclusions, and reflect, on how you might approach such issues in your business.

I'll talk about the steel industry, the one I know best, and show you how both competition and collaboration, have brought about some very healthy, and much needed changes in that industry. I want to focus in particular, on my company's recent takeover of Email.

[SLIDE ONE] – PRESS

For those of you who don't know Smorgon Steel, the company is Australia's most integrated steel producer, supplying a wide range of steel products to the construction, mining, transport and agricultural industries. We produce steel reinforcing for building and construction, fencing materials—many of you are probably aware of the Cyclone fencing brand—water pipes, the tubing you see in the roof of Colonial Stadium, railway wagons and wheels and a host of other products. We produced around 830,000 tonnes of steel in 1999/2000 and generated \$2.3 billion in revenue. The group now employs around six and a half thousand people.

Until a few years ago, Smorgon Steel was wholly owned by the Smorgon family. And I'd like to start with the Smorgon family business, because competition and collaboration, are very much part of the family's remarkable success, and its business philosophy lives on in the company today.

[SLIDE 2] – PRESS

It started in the 1930s in meat, and then branched out into paper, glass, plastics and steel. In each case, Smorgon took on large established monopolies—APM, later Amcor, in paper, ACI in glass, and BHP in steel. And we did this successfully and profitably. How?

[SLIDE 3–A] – PRESS

First, Smorgon was very competitive, fast-moving, and customer-focused. This may not seem so unusual today, but it was in stark contrast to the old monopolies, which were slow, bureaucratic, paternalistic and often run by engineers, rather than businessmen.

Secondly, the company always maintained a strong focus on its core businesses, and the opportunities for those businesses. Non-core businesses acquired as part of takeovers, were always divested.

Thirdly, Smorgon was, and remains, market driven. Rather than building manufacturing capacity, and then planning to sell the product, Smorgon has been willing to source from competitors or imports, where this was needed to meet shortfalls in supply. Only when the market was guaranteed, has the company committed, to expanding its manufacturing capacity.

[SLIDE 3B] – PRESS

The other key ingredient for success, was the Smorgon family's decision-making style, now enshrined in, "The Smorgon Way". Strong business ethics were important, but what made the Smorgons different from others, was the collaborative style of decision-making, summed up in two key values:

- First, two heads are better than one, so there has always been consultation and discussion on key issues.
- Second, everyone deserves to be heard, no matter what their position in the company. Ideas could, and did come from anyone, and they would be vigorously argued around the table.

As a result, Smorgon had a lean flat structure, open to ideas and innovation, and able to make and implement decisions quickly.

While those core values have been adapted, as the business has grown and become more complex, they remain at the heart of our business today.

Just 20 years ago, the company was looking for its next growth opportunity, and decided to enter steel, one of the last remaining monopolies. For a company with no previous experience, taking on the Big Australian may have seemed a bit cheeky, but we were convinced that we could make money, by being very competitive in niche markets.

[SLIDE 4] – PRESS

The steel industry in 1981 was dominated by BHP, which had a monopoly over the 10 million tonnes of steel produced in Australia each year, with high tariffs to keep out imports.

Distribution on the other hand, was highly fragmented, with customers only buying on BHP's terms, fitting in with BHP's production schedule ordering 3 months in advance and paying, as the product came out of the mill. Deliveries were often delayed, sometimes by up to three months, and were made only to the railway station or wharf nearest to the customer's site. Customers had to carry six or nine months stock, which was costly, and made it difficult to adjust quickly, to changes in the market place.

So clearly, there were big opportunities for a competitor, that was attuned to customers' needs.

[SLIDE 5] – PRESS

Smorgon Steel's strategy was to create, a vertically integrated company, that would be a viable competitor for the Big Australian, in selected long products markets.

- These products are used to make reinforcing bar and mesh for the construction industry, as well as wire and fencing products. They are made by mini-mills, small, efficient and electrically driven, and using scrap metal, not iron ore, as their raw material input.
- Flat products, on the other hand, are used to make roofing materials, cars, appliances, steel cans, and welded pipes and tubes. They are produced by large blast furnaces, and require extensive capital.

[SLIDE 6-A] – PRESS

The company started with a mini-mill at Laverton, with a capacity of 200,000 tonnes. In 1983 it began producing billet, the basic steel product, with an initial output of just over 100,000 tonnes a year.

We had little trouble signing up customers. Unlike BHP, Smorgon was willing to supply on demand, and offered 30-day payment terms. Our sales reps visited customers on site. Within 4 years, Smorgon had achieved 15 percent share of the markets we contested. I should add that BHP did not sleep through all of this. Like APM and ACI before it, BHP responded by improving its own service to customers—a benefit of the increased competition from Smorgon.

We developed new outlets, upgraded our manufacturing capability, diversified into new products such as wire, and expanded our scrap recycling capacity. Famous brands such as ARC and Cyclone fencing, became part of the Smorgon portfolio. In ten years, output quadrupled. Competition had shaken up the steel industry.

[SLIDE 6-B] – PRESS

From October 1994, when I took over as Chairman, the family focus, shifted from being owner/managers, to being investors, and all non-steel businesses were divested.

A strategy was developed over the next few years, to increase the scale and diversity of the steel business, so it could withstand the pressures of globalisation and deregulation, and be competitive, both domestically and internationally.

The takeovers of Welded Mesh, ANI and Metalcop, gave us new manufacturing, distribution and recycling capacity, as well as new markets, and more than doubled the size of the company. In the process, Smorgon became a major force for the steel industry rationalisation, that has occurred in the last five years. The company listed on the ASX in 1999, as part of the takeover of ANI.

When we launched our bid for Email in April 2000, Smorgon's production of long products rivalled that of BHP. We were a leading supplier, and had over 20 percent share, of the total steel distribution market.

The takeover bid for Email, was the start of a very complex and protracted process, that brought about, yet another, transformation in the steel industry. What set this move apart, however, was the collaboration between competitors, which resulted in such a positive outcome.

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Most of you will recognise Email, as the major producer of domestic appliances in Australia, with famous brands, Kelvinator, Westinghouse, Simpson, Chef, Dishlex and Hoover. Our interest however, was only in its metals distribution division, one of the three majors, the other two being Smorgon and BHP.

For Smorgon, Email represented both a significant opportunity, and a potential risk.

- The opportunity lay in strengthening Smorgon's distribution network, and broadening its product range—Email was Smorgon's biggest customer for steel tubing, and steel bar for fabrication. It was also a major distributor of flat products.
- The threat, lay in losing one of our most significant customers, to a domestic or foreign competitor.

Initially, Smorgon sought a joint venture with Email, but when this was rejected, we launched a takeover, which lasted almost a year.

[SLIDE 8] – PRESS

It was not a conventional bid: Smorgon was interested only in Email's metals business, and not prepared to take on the risk of selling the appliances business. We offered a unique combination of cash, plus a specially created share for the appliance business.

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Although the ACCC had no objections to the bid, it was vigorously opposed by the Email board, and, I have to say, received a cool reception in the market. We needed a third party to purchase the appliance business, and the logical buyer was Electrolux, which owned the major brand licences, and already held shares in Email.

Soon, BHP acquired a 14 percent stake in Email, enough to block Smorgon's bid. They were about to divest their long products business, to be known as OneSteel, and actively opposed our bid, in the press and in the market. They wanted to protect OneSteel, and distribution of their remaining flat products business.

Discussions took place among the parties over the ensuing months, to try to resolve these two issues—the sale of the appliance business to Electrolux at a reasonable price, and division of the metals business with BHP.

I initiated talks with BHP, but as the OneSteel spin-off drew closer, there were signs the interests of BHP Steel, and the future OneSteel, were diverging. It became clear that compromise was impossible, so I closed the book, and walked out of the negotiations.

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The situation reached a stalemate.

- Smorgon and BHP/OneSteel were locked in battle, over Email's metals distribution business. BHP had a blocking stake, which it intended to transfer to OneSteel. But it also had an option to buy back, the flat products distribution business, should OneSteel gain control of Email. It also left open the possibility, of bidding for Email itself (although we thought this unlikely).
- On the side was Electrolux, with a stake in the appliance business, and the ability to affect the price, we would pay for the metals business.
- And in the middle was Email, faced with continuing uncertainty about the future of its business, anxious to maximise the return to its shareholders, and no other bidder.

The situation remained deadlocked, until the OneSteel spin-off. Shortly afterwards, the Email Board attempted to break the deadlock, by announcing its intention, to auction the long products business. Should the Smorgon bid fail, they hoped to start a bidding war between Smorgon and OneSteel.

Then amazing and unexpected changes took place, where competition, gave way to collaboration. For the first time in the history of the Australian steel industry, two fierce competitors came together, with the knowledge of the ACCC, to work out a sensible resolution. In doing so, we also laid the groundwork, for a much more competitive and vigorous industry.

Our CEO, Ray Horsburgh, met with the ACCC, and outlined our desire to talk to OneSteel, about a break-up of the Email metals business. Professor Fels and his staff understood the gravity of the situation, and it is to their credit, that they were prepared to allow, the parties to work together, to produce a sensible and equitable outcome.

[SLIDE 11] – PRESS

OneSteel's new Chairman, Peter Smedley and I met over coffee, to explore whether a commercial deal was possible. Within half an hour, we agreed the broad structure of a deal, to acquire the steel assets of Email. We shook hands, and the details were then thrashed out by our senior management and advisers.

We insisted that the Smorgon offer terms remain unchanged. As you can imagine, this issue dominated the discussion. This was the first tangible evidence of collaboration. Smorgon and OneSteel agreed on broad commercial principles, for dividing the assets of the metals business, and disposing of the remaining businesses. The long products distribution assets, were divided roughly 50/50 in terms on tonnage and along geographic lines, to get the best synergies for each business. Smorgon obtained most of the flat products distribution.

The costs and benefits of the acquisition, and of the subsequent operation and divestment of the non-metals businesses, were to be shared equally between Smorgon and OneSteel.

A transparent process was established, for operating the businesses in the interim, and legally binding undertakings were made, to preserve commercial confidentiality, and the independence of the separate businesses during, and after divestment. The agreement remained faithful to the original deal I struck with Peter Smedley. As ownership of the bid vehicle remained with Smorgon Steel, an enormous amount of trust and goodwill was demanded from both parties.

With the joint bid announced, the remaining pieces of the puzzle fell into place. Electrolux agreed to buy the appliance business, and the Email Board recommended acceptance, of the joint Smorgon/OneSteel bid—they had no other option left.

Naturally, the ACCC looked very closely at the deal. To protect competition and consumer interests, there were strict limits on information sharing between the businesses. While Smorgon and OneSteel collaborated on this deal, we remain fierce competitors in the marketplace.

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This brings me back to today's theme: collaboration and competition. In this case, collaboration between competitors, has produced a truly win-win outcome all around.

- Smorgon Steel and OneSteel were both clear winners. We avoided a bidding war, that neither of us wanted, but that neither could afford to lose. Under that scenario, the winner would take all, but at a very high price. Instead, both companies got broadly what they wanted from the division of assets, and are both stronger and more competitive as a result.

- Email shareholders were also winners, receiving a fair and reasonable price for their businesses, and an end to the uncertainty.
- BHP steel now has Smorgon, as its largest domestic customer, purchasing more than 500 million dollar's worth of product each year. We are striving to establish a more balanced, commercial relationship with them.
- And the industry and customers, have benefited by having two even stronger and more efficient Australian competitors.

Of equal importance, and quite unexpected, was the change in attitude that made this collaboration possible. In marked contrast to the earlier relationship with BHP, Smorgon Steel and OneSteel management, set aside the baggage and 'war' mentality of the past, and took a commercial approach to the negotiations.

Instead of being determined to win at all costs, each side was prepared to make concessions, recognising that the other would act with integrity. There is a level of trust and respect that did not exist before. The fact that Peter Smedley and I are both loyal Carlton supporters, is purely coincidental to this!

The process of collaboration continues under the watchful eye of the ACCC, as we go about dividing and selling the Email assets. The door is open to discuss other matters of common concern, such as industry standards, with benefits to Australian industry as a whole.

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Where to from here? Smorgon Steel has done what it set out to do 5 years ago; all the pieces of the jigsaw puzzle are in place. Smorgon today is a strong competitor, at all points in the production and distribution chain.

The next steps will come with the proposed sell-off, of what has been dubbed 'TwoSteel', BHP's flat products division. BHP Billiton has decided to get out of steel altogether, a situation we would never have predicted, 20 years ago, or even two years ago.

Given the limited size of the Australian market, and its place in the global economy, we believe further rationalisation of the industry will be required. Smorgon Steel will be part of that process. We are committed to remaining a strong, Melbourne-based, internationally-competitive player in the Australian steel industry.

We proved, competition has served the industry well, and will continue to do so—indeed it is essential for a thriving economy. Our experience has shown too, that in its extreme form, it has the potential to be destructive, both of the competitors themselves, and ultimately the competitive process. In some circumstances, a more measured, collaborative approach can produce better outcomes, for all stakeholders in the market. This is the lesson I would like you to reflect on today.