Suez-Veolia merger project

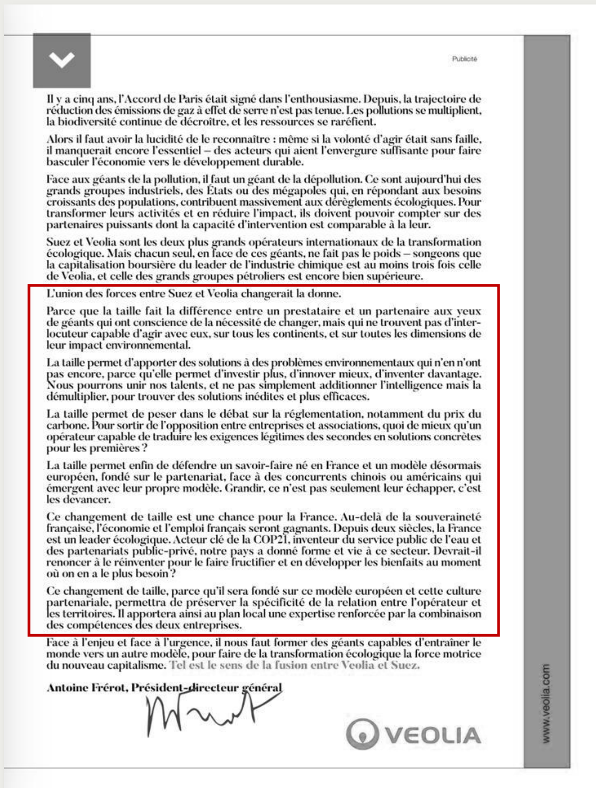
Does the ecological transition necessitate the creation of a “super world champion?”

February 2021

Summary of the report produced for Suez by Altermind with Patrice Geoffron, Professor of Economics at Paris Dauphine University

The aim of this report is to challenge Veolia’s assertion that it and Suez need to grow to remain competitive

- On February 8, 2021, Veolia announced the filing of a tender offer for the 70.1% of Suez’s equity not yet held following the purchase of a 29.9% block of shares from Engie (the "Operation")
- The industrial project underlying the Operation is to create a single "super world champion" which, Veolia maintains, would be better able to innovate, invest and resist the strategic threats of tomorrow than either company could separately
- Aside from the ideas expressed in Antoine Frérot's open letter of January 5, this supposition has not been properly substantiated by Veolia
- The aim of Altermind’s report is therefore to test its validity



Publicité

Il y a cinq ans, l’Accord de Paris était signé dans l’enthousiasme. Depuis, la trajectoire de réduction des émissions de gaz à effet de serre n’est pas tenue. Les pollutions se multiplient, la biodiversité continue de décroître, et les ressources se raréfient.

Alors il faut avoir la lucidité de le reconnaître : même si la volonté d’agir était sans faille, il manquerait encore l’essentiel – des acteurs qui aient l’envergure suffisante pour faire basculer l’économie vers le développement durable.

Face aux géants de la pollution, il faut un géant de la dépollution. Ce sont aujourd'hui des grands groupes industriels, des États ou des mégapoles qui, en répondant aux besoins croissants des populations, contribuent massivement aux dérèglements écologiques. Pour transformer leurs activités et en réduire l’impact, ils doivent pouvoir compter sur des partenaires puissants dont la capacité d’intervention est comparable à la leur.

Suez et Veolia sont les deux plus grands opérateurs internationaux de la transformation écologique. Mais chacun seul, en face de ces géants, ne fait pas le poids – songeons que la capitalisation boursière du leader de l’industrie chimique est au moins trois fois celle de Veolia, et celle des grands groupes pétroliers est encore bien supérieure.

L’union des forces entre Suez et Veolia changerait la donne.

Parce que la taille fait la différence entre un prestataire et un partenaire aux yeux de géants qui ont conscience de la nécessité de changer, mais qui ne trouvent pas d’interlocuteur capable d’agir avec eux, sur tous les continents, et sur toutes les dimensions de leur impact environnemental.

La taille permet d’apporter des solutions à des problèmes environnementaux qui n’en n’ont pas encore, parce qu’elle permet d’investir plus, d’innover mieux, d’inventer davantage. Nous pourrons unir nos talents, et ne pas simplement additionner l’intelligence mais la démultiplier, pour trouver des solutions inédites et plus efficaces.

La taille permet de peser dans le débat sur la réglementation, notamment du prix du carbone. Pour sortir de l’opposition entre entreprises et associations, quoi de mieux qu’un opérateur capable de traduire les exigences légitimes des secondes en solutions concrètes pour les premières ?

La taille permet enfin de défendre un savoir-faire né en France et un modèle désormais européen, fondé sur le partenariat, face à des concurrents chinois ou américains qui émergent avec leur propre modèle. Grandir, ce n’est pas seulement leur échapper, c’est les devancer.

Ce changement de taille est une chance pour la France. Au-delà de la souveraineté française, l’économie et l’emploi français seront gagnants. Depuis deux siècles, la France est un leader écologique. Acteur clé de la COP21, inventeur du service public de l’eau et des partenariats public-privé, notre pays a donné forme et vie à ce secteur. Devrait-il renoncer à le réinventer pour le faire fructifier et en développer les bienfaits au moment où on en a le plus besoin ?

Ce changement de taille, parce qu’il sera fondé sur ce modèle européen et cette culture partenariale, permettra de préserver la spécificité de la relation entre l’opérateur et les territoires. Il apportera ainsi au plan local une expertise renforcée par la combinaison des compétences des deux entreprises.

Face à l’enjeu et face à l’urgence, il nous faut former des géants capables d’entraîner le monde vers un autre modèle, pour faire de la transformation écologique la force motrice du nouveau capitalisme. Tel est le sens de la fusion entre Veolia et Suez.

Antoine Frérot, Président-directeur général

VEOLIA

www.veolia.com

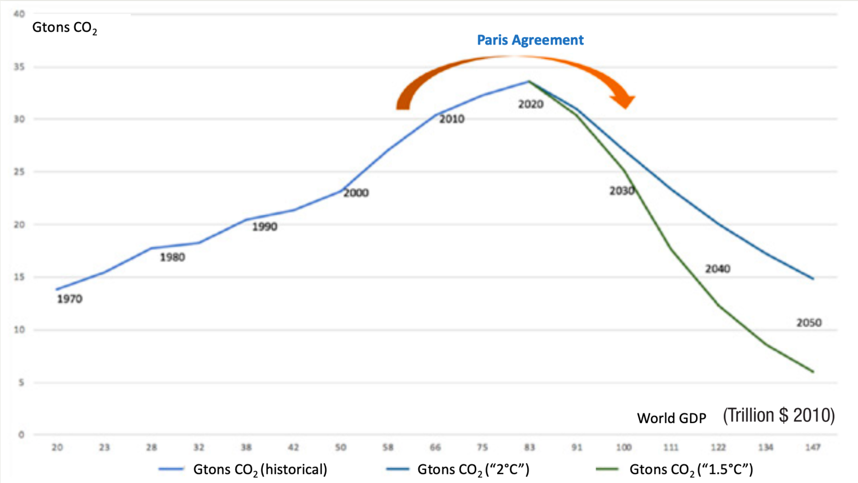
Source : Open letter of January 5, 2021

- The planned merger between Suez and Veolia is taking place at a time when:
  - The European Union (EU) - notably through the Green Deal - aims to play a leading role in the ecological transition. This project is reflected in a growing attention to environmental issues in all its policies, including competition policy
  - The "world champion" argument has been invoked to justify merger operations in other sectors, with very different industrial and competitive dynamics[1]
- To justify the Operation, Veolia argues that the EU's capacity to lead the fight for ecological transition will be strengthened by increasing its size and creating a "super world champion", *even though Veolia and Suez are already the two world leaders in their fields*
- Since Veolia bases the economic rationality of the Operation on the size of the operators, it is important to discuss the scope of the Operation

Note 1: PSA / Fiat-Chrysler to create Stellantis or Alstom - Bombardier to resist Chinese competition

The environmental imperative requires adjustment to current business models in a very tight timeframe

- Veolia and Suez agree that the scale of the climate change and other environmental challenges necessitate innovation and significant adaptation and even disruption of existing business models



- Limiting the temperature increase to 1.5°C in 2050 will require a reduction in CO_2 emissions to around 5 billion tonnes, compared to around 35 billion tonnes today
- The aim is therefore to return to the 1950 level of emissions by 2050, with a drastic increase in GDP and a fourfold increase in population between these two dates

Water management

- 1 billion people without access to drinking water
- 2.7 billion people experience a shortage at least one month a year

Waste treatment

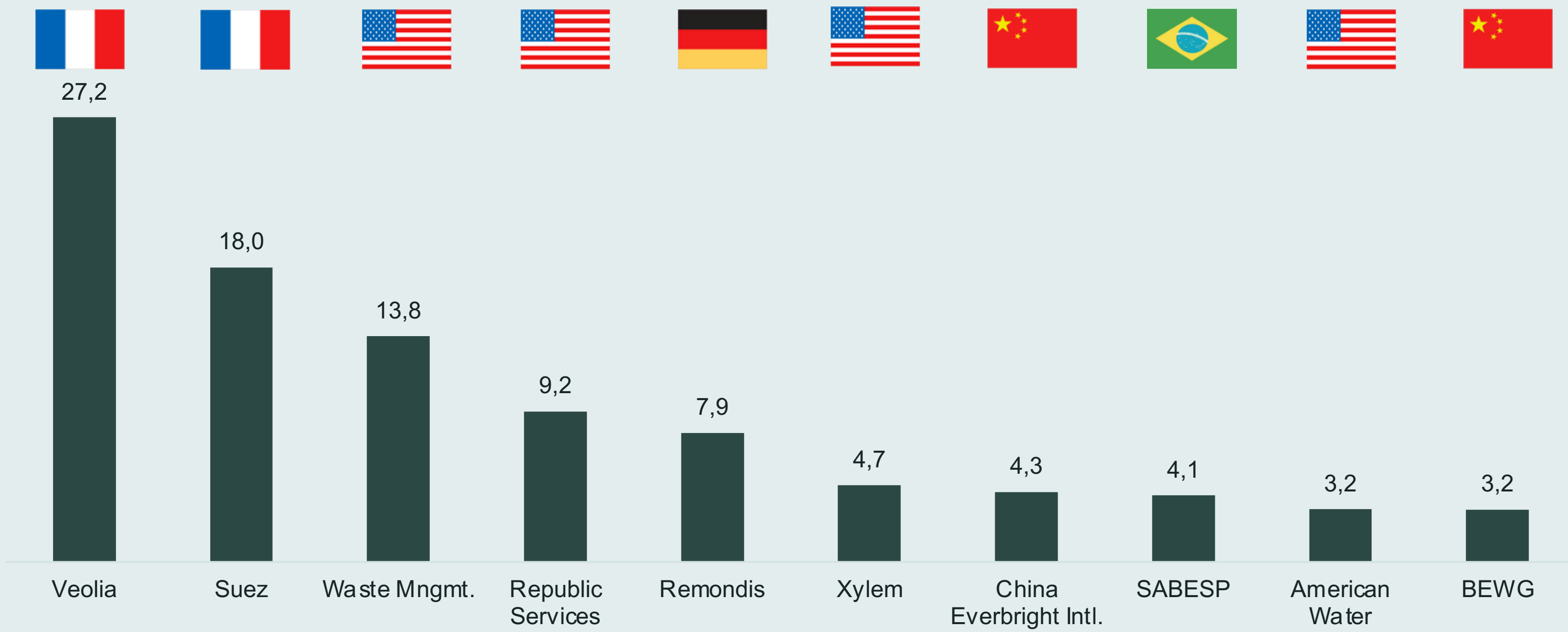
- One third of the plastic produced each year is collected
- By 2050, 15% of global emissions will be plastics-related

Air quality

- 9 out of 10 people breathe polluted air
- c.7m of air quality-related deaths per year

The European Union can rely on two world champions in environmental services

- The two world leaders in environmental services are European
- Suez and Veolia are the only two players to have a presence (i) worldwide, (ii) in all environmental businesses (including, for Veolia, energy activities) and (iii) across the entire value chain
- Chinese actors have not emerged to date. A future significant development outside China remains highly hypothetical at this point (and in particular given the restrictive regulatory measures in Europe)



Revenues of the main pure players in the sector (NB: Veolia and China Evebright International also intervene on the energy market), 2019 data, in € bn. Source : Xerfi, Annual Reports

Does long-term competitiveness in these businesses require the merger of the two largest actors? Would such a merger create value? What would be the competitive effects, particularly in municipal markets? What would be the effects in terms of innovation dynamics?

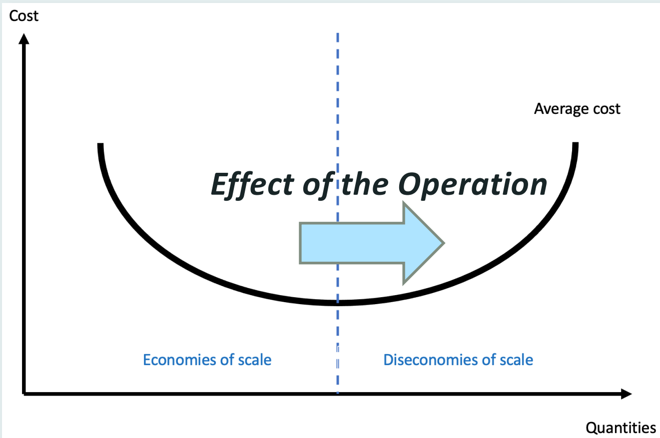
These two champions operate in heterogeneous and fragmented markets

- The markets in which Suez and Veolia operate are fragmented and heterogeneous, due to (i) the complexity of the value chains, (ii) the localised nature of the required services, and (iii) the weak harmonization of regulations
- These markets are highly concentrated locally, but the industry is unconsolidated at the global level

	Water management	Waste treatment
Value chain	▪ Fragmented and involving distinct competences	▪ Fragmented and heterogeneous (landfill, recycling, recovery)
Clients' profiles	▪ Dominated by municipalities ▪ Development of tailor-made / asset-light solutions for industrial customers	▪ Mix of industrial and municipal clients ▪ Local clients
Geography	▪ Local (delimited by municipalities and catchment areas)	▪ Local (associated with local collection areas) ▪ Limited international flows of waste for recycling
Regulations	▪ Heterogeneous, even within the European Union between the Member States	▪ Growth of regulations favouring short and local supply chains

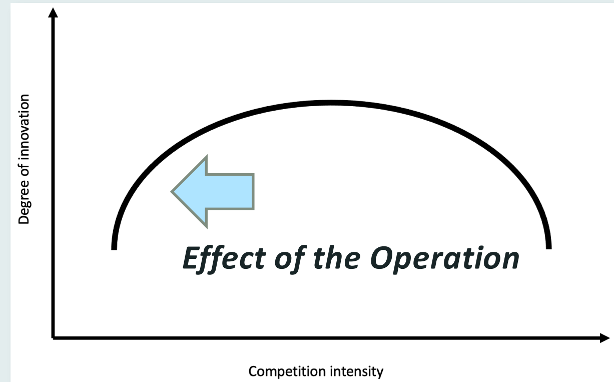
Above a “critical” level, specific to each sector, growing larger no longer contributes to competitiveness

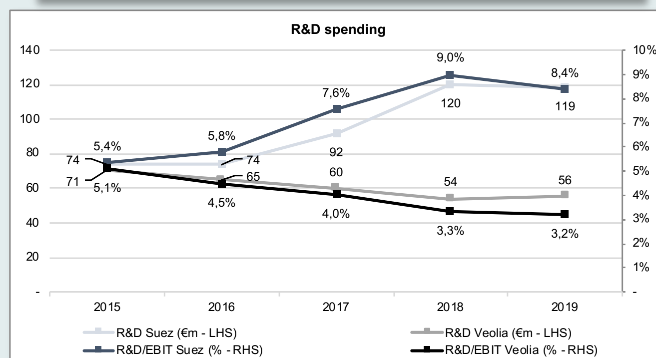
An increase in size eventually leads to "diseconomies of scale" ...



- Above a certain size, "diseconomies" of scale generally undermine companies’ competitiveness
- At the global level, the industries concerned are highly fragmented, with many small local and/or specialized players
- Along with other considerations, the observation that diseconomies could prevail resulted in Veolia and Suez mutually agreeing to abandon an initial merger project in 2012

... and, by reducing competition, lessens the incentives to innovate





- The increase in size through external growth – given the size of the two players – would, if they merged, result in a decrease in competitive intensity and therefore in innovation
- In this context, it should be noted that Suez invests significantly more than Veolia in R&D, both in relative and absolute amounts

Suez and Veolia do not suffer from a lack of size

An examination of the markets and the respective positions of Suez and Veolia does not reveal clear advantages conferred by an increase in size as a result of a merger

	To benefit from a size effect, the Operation would have to generate:	However:
Scale effects	▪ Sharing large equipment to provide more services in volume, significant purchasing synergies, etc.	▪ Markets are fragmented and local ▪ Estimated purchasing synergies amount to €200m, or approximately 0.5% of the cost base
Scope effects	▪ Sharing large equipment to provide a variety of services	▪ Environmental businesses rely on distributed infrastructures of modest size compared to heavy industry sectors
Experience effects	▪ Anteriority effects, by accumulation of experience, to highlight during calls for tenders	▪ Both groups can already claim significant anteriority in all their businesses and verticals
Network effects	▪ Specific synergies within the scope of the new entity	▪ Both groups have built ecosystems of global partners to innovate and/or adapt their services locally

Active international ecosystems contribute directly to a company's capacity to innovate

Example of the internal and external ecosystem led by SUEZ

Internal ecosystems of international research

Key figures

8 R&D centres in France and around the world

9 Centres Labs & Expertise

1,400 Technical experts at Group level

530 Employees in R&D

3,947 National patents

857 Families of patents

Focus on the CIRSEE

Le Pecq, France

26 Ongoing R&I Projects

6 areas of expertise

- Water treatment
- Waste recycling
- Materials recycling
- Water desalination
- Water distribution
- Waste water treatment

Open innovation

Academic and industrial players

Combine expertise and attract funding

The PhD program

- **12** selected projects
- **8** partner labs
- Focus on data
- Focus on new business models

Go Seeds

Promote the development of innovative start-ups

Co-construction

Circular materials

AfterBiochem

€20m of European funding to transform, with the start-up Afryen, through fermentation, agricultural by-products into molecules intended for the pharmaceutical industry, cosmetics, etc.

Air quality

Combin'Air

A solution developed with the start-up Fermentalg which captures the equivalent of the polluting emissions of 550 vehicles on a daily commute in the Paris region

Other Joint-Ventures

Summary: There are four main reasons to challenge the rationale for creating a "super world champion"

- Any additional and significant increase in the size of Suez and Veolia related to the Operation does not make the case for the Operation by itself
- Such an increase in size carries significant risks for both groups, and hence for the EU's "environmental competitiveness"

Thanks to their integrated and global nature, Suez and Veolia **have reached the critical size** beyond which growth in size is no longer a competitive factor	▪ In the environmental sector – multi-local – size is an asset for growth in certain markets, particularly in the construction/management of complex infrastructures ▪ However, once a certain threshold is reached, an increase no longer generates gains, as the effects of scale and/or scope fade away, due to certain specificities of the needs to be covered (local character, local partnerships, etc.) ▪ This threshold has already been reached by Suez and Veolia, the only "world champions" in their fields
The Operation would **reduce incentives for differentiation and innovation**	▪ Competition acts as a spur to quality of service and innovation in environmental sectors, often characterized by calls for tenders with a "bonus at the end of the contract" ▪ The need for innovation is imperative to meet new environmental challenges ▪ However, the Operation raises serious competitive risks, as Suez is not being replaced by players of "critical size", capable of competing with the "super champion"
The quality and **diversity of partnership ecosystems is a key dimension of environmental competitiveness**	▪ The competitiveness of industrial players such as Suez and Veolia depends on their ability to structure and fit into these ecosystems ▪ The evidence is that Suez and Veolia are already building such large ecosystems around them ▪ Conversely, actors who are not of the "critical size" cannot rely on such rich and diverse ecosystems
An M&A operation of this scale **generates specific costs and delays**	▪ The costs of mergers are well documented (dissynergies, increased indebtedness, departures of key executives, incompatibility of corporate cultures, etc.) ▪ The group resulting from the Operation would be burdened by a constraining level of indebtedness likely to affect its capacity to invest and innovate