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A CONCEPT OF THE CONGLOMERATE FIRM

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An apparent lack of relationship among the product lines of conglomerate firms creates a conceptual problem for those who wish to analyze their behavior. Generally, the growth of the conglomerate firm over a period of time produces a record of seemingly unrelated acquisitions and examination of the order in which they were made often fails to provide any sense of a corporate objective or rationale in terms of product lines.

It is the purpose of this paper to present a concept of the conglomerate firm that explains the apparent illogical nature of its product diversity and its acquisition record. This concept focuses upon the objectives of the conglomerate firm, and not upon the price-cost relationships of its specific products. The intent of this paper is to develop this concept; the formulation of hypotheses and the results of testing them with data are not included here.

The central theme of this paper is that in the development phase the conglomerate firm is financially oriented, rather than product oriented, and that its primary objective is rapid growth of earnings. If successful, the conglomerate later enters into a mature stage in which its top management devotes less attention to acquisitions and more to existing product lines.

The following discussion places more emphasis upon the development phase because it is in this phase that the behavior of conglomerates makes them appear different from other firms and creates the problem of an apparent lack of rational economic behavior.

The Development Phase

Several behavioral aspects of the creation and development of conglomerates follow from the propositions that conglomerate management is financially oriented and that its primary objective is very rapid growth of earnings. As long as the primary objective is very rapid growth of earnings, conglomerate management must make acquisitions, for they do not allow themselves the time to build new capital facilities, produce new products, and then establish a place for them through promotional campaigns. Furthermore, in order to realize their primary objective, conglomerate management must make acquisitions at a rate that increases its earnings rapidly enough for the firm to become acknowledged as a "growth" company. This

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means that the developing conglomerate will make many more acquisitions in a few years than a more traditional firm.

In order to achieve its desired rate of acquisitions, the conglomerate does not limit itself to acquisitions that can be financed by retained earnings; instead, the growth of a conglomerate is a financial pyramiding operation. The original assets are used as a base for acquiring additional assets, and the enlarged asset base is used, in turn, to make more acquisitions.[1] Thus, the conglomerate firm builds a financial structure upon its asset base which will maximize its capacity to acquire other firms and thereby maximize its rate of short-term growth.[2]

As a result of the emphasis upon the utilization of the firm's asset base for financial leverage, the management of the conglomerate values potential acquisitions in terms of financial criteria rather than operational criteria. The value of an acquisition is in its capacity to contribute to the conglomerate's financial base rather than in its product lines and their relation to the products of the acquiring firm. The conglomerate management is primarily interested in the effect of the present acquisition on its ability to make future acquisitions.

Several consequences follow from this emphasis:

(1) Conglomerates tend to make acquisitions on a more opportunistic basis than do production-oriented firms or firms engaged in an orderly program of diversification. Consequently, conglomerate management will be less concerned with such subjects as distribution systems and the need to reconcile those systems. It will have little or no reason to relate the products of the acquired and acquiring firms.

Conglomerates, instead, generally seek firms that are profitable[3] or undervalued, or possessing a low price-earnings ratio, large cash reserves, or unutilized tax credits of one type or another. What is sought, in effect, is a firm with a financial position which will permit the conglomerate to enlarge its financial base in greater proportion than the increase in the asset base. It is this increase in the financial base which permits further acquisitions. Thus the criteria for profitable acquisitions is to be found in the effect of the merger on the financial base of the conglomerate. This criteria is in contrast to the mergers of the production-oriented firm, which measures the profitability of a merger in terms of its effect on the long-term operational profit of the firm.

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1 The concept of the financial base used here is slightly different than that in E. ROBINSON, THE STRUCTURE OF COMPETITIVE INDUSTRY (1958). His optimal financial unit is related to the cost of production and is defined in terms of average cost and output. In the present instance, the financial base is related to the growth of the firm.

2 Over a succession of time periods, the conglomerate may be borrowing in both the long- and short-term financial markets, selling equity securities, buying property and leasing it to others, selling property and leasing it back, and so on. Some of the strategies, such as the sale of property and lease-back contracts, may be costly in the long run, but in the short run they provide an immediate expansion in the firm's financial base.

3 BUREAU OF ECONOMICS, FTC, ECONOMIC REPORT ON CORPORATE MERGERS 97 (1969).

(2) The management of the conglomerate firm is financially oriented. In many instances the personnel of the acquired firms continue to provide the operational management. This is particularly true of the conglomerate firm in the initial phases of its acquisition program. In such an instance, the would-be conglomerate may have little in the way of operational management skills. Thus its first acquisitions will, of necessity, have to be managed by the management personnel associated with the acquired firm, while the top management of the conglomerate devotes most of its attention to considering possible acquisitions and to negotiations.

(3) In order to maximize its short-term growth, the conglomerate makes the maximum use of its financial capacity. In other words, it operates toward the margin of its financial base. Unused financial capacity is regarded as a wasted resource. In contrast to the traditional firm, capacity in the case of the conglomerate is a financial concept. The crucial financial issue is, given an existing stock of assets and a projected flow of income, how large a financial structure can be supported? Further, given the assets and projected income, what structure of financial instruments will yield the optimal financial base?

THE DEVELOPMENT OF A COMPLEX CAPITAL STRUCTURE

The emphasis on rapid rate of growth through acquisitions requires that the company sustain a financial performance that will be favorably assessed by the financial community. The failure to do so jeopardizes the continued success of the merger program, and ultimately, management continuity.

Since the earnings-per-share of common stock is frequently used as a measure of company performance, conglomerates characteristically issue securities that cannot reduce this figure. These issues include debt instruments and equity securities other than common stock. Extensive use of debt as a means of financing acquisitions is indicative of the conglomerate's greater willingness to assume risk. But further, the use of debt lessens the threat to the management by dissident stockholders.

The percentage debt of the total capital structure of the conglomerate also indicates what might be thought of as the maturity of the conglomerate firm. First, a firm obviously cannot continue to increase its debt as a percentage of its total capital structure without limit. But more significantly, it appears that at some stage in the development of a conglomerate this ratio will decline.

THE MATURE CONGLOMERATE

Conglomerate firms cannot continue to develop indefinitely through acquisitions. At some point several factors begin to take effect, each of which serves to limit the external growth of the conglomerate. The first of these factors is the size of the successful conglomerate, *i.e.*, as it grows, larger acquisitions are required to maintain the same relative growth rate in earnings.

A second factor is the diminished supply of companies suitable for conglomerate acquisition. This is a result of the acquisitions made by several conglomerates over a period of years; after a time, few desirable firms remain independent. A third factor is the higher prices which the stockholders and managers of such firms will demand. Finally, the fact remains that at some point capital allocation decisions must be made concerning existing product lines. A time must come when the conglomerate management must decide between using available financial resources for acquisitions or for the modernization, replacement or expansion of capital facilites.[4] Thus, as these factors make it more difficult to maintain an increasing rate of short-term growth, the attention of conglomerate management will shift from the growth objective to operational objectives.

Adversity is one force that has caused some conglomerates to enter into the mature phase earlier than the factors just described. Conglomerates that have encountered a decline in earnings have often sold assets in order to recover as quickly as possible. They have done this because their emphasis upon a rapid short-term growth rate during the development phase precluded the initiation of cost-reduction programs to improve earnings. Furthermore, since conglomerate management operates near the margin of the firm's financial base, it may be impossible to borrow funds to carry the firm through a crisis. Thus, the reaction to adversity by some conglomerates has been not only to become less diversified, but also to change their primary objective toward more concern with the firm's existing product lines.

CONCLUSIONS

What we have described is a concept of a life cycle for the conglomerate firm. It differs from that of the more traditional firm in several respects. The most important difference is in the use of acquisitions to achieve rapid short-term growth in the developing phase. This accounts for the apparent haphazard nature of the product lines acquired by conglomerates. The rationale for the conglomerate is not revealed by its products but, instead, by its use of its financial base as it pursues its objective of rapid short-term growth of earnings. Conglomerates become highly leveraged in the process, and consequently, their capital structures often become complex. During the development phase a characteristic reaction of conglomerates to a decline in earnings is to sell assets. This is consistent with the primary objective of rapid short-term growth of earnings and with their manner of realizing this objective: an emphasis upon the financial value of assets rather than upon their productive uses.

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[4] Reid, *Conglomerate Growth: Consistency with Economic Theory of Growth*, in ECONOMICS OF CONGLOMERATE GROWTH (L. Garoian ed. 1969). A similar observation was made by Harold S. Geneen, President of International Telephone and Telegraph, before the Antitrust Subcommittee of the House of Representatives. Wall Street Journal, Nov. 21, 1969, at 8, col. 2.

After a time, conglomerates that survive the development phase enter into a mature phase. For some conglomerates adversity hastened entry into this phase, causing them to become less diversified and, more importantly, less concerned with making future acquisitions and more concerned with managing their existing product lines. And even if a conglomerate escapes adversity, at some point in time its management must pay more attention to operating affairs and less to new acquisitions.

It is noteworthy that this concept does not cite attempts to innovate or to achieve economies as factors important to the development of conglomerate firms. Although these factors are not ruled out for conglomerates in the mature phase, the development of conglomerates is viewed essentially as a process of utilizing the financial positions of existing firms in order to develop a larger firm through leverage. This concept allows one to regard the development of conglomerates as, in part, a process of taking advantage of imperfections in the market for firms and in financial markets. This thought raises the question of whether conglomerates are more than a temporary phenomenon, for the imperfections in these markets may be overcome or reduced. And it raises the question of whether conglomerates contribute real benefits to the economy.