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Gulf + Western: A Model of Conglomerate Disinvestment

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Gulf + Western: A Model of Conglomerate Disinvestment

Abstract

[Excerpt] Historically, the great majority of businesses in this industry have been small, and locally (often family) owned. Sometimes a skilled machinist leaves one firm to set up a new one, with a small bank loan and help from family savings. Some of these locally-owned companies are incorporated, for tax purposes, but the mode of management is essentially the same: personal (even paternalistic) and usually relatively informal.

All across the United States, during the late 1960s, there was a wave of conglomerate acquisitions of precisely the most successful of these previously independent or small corporate operations. Giants like Gulf+Western, Textron, Genesco, Litton and a hundred others sent buyers into areas like New England and made offers that those small business owners could not refuse. Every sector of the economy was affected: not only metalworking, but also apparel, shoes, department stores, hotels. In the years following the acquisition, a definite pattern emerged.

Keywords

Gulf + Western, conglomerates

Gulf + Western

By Bennett Harrison

The machining of metal parts and products, and especially the design and production of machine tools, forms the core of every truly developed economy in the world. Along with the capacity to generate power for driving machinery and electronic equipment, the ability to manufacture and repair machinery is the single most important source of new productivity and the key to economic growth. No wonder, then, that every nation on earth is constantly trying to attract metalworking investment or to develop its own metalworking industry.

Metalworking machinery has historically been of the utmost importance to the New England region, ever since the Colonial era. Over the last quarter-century, this industry was the fifteenth most important employer in the region in terms of jobs, out of nearly 300 industries for which data are available (including hospitals, schools, insurance companies, and even computers). Moreover—again on the average since the late 1950s—while New England has had only about 1/20th of the country's population, about one out of every six metalworking machinery jobs has been located here. It may not be as fashionable as computers and biological research, but metalworking is clearly very important to the New England economy's overall economic health.

To workers and their local governments, there are substantial benefits from having access to jobs in this industry. The work involves a great deal of skill, without requiring a lot of paper academic credentials. This makes it particularly attractive for mayors and other local government

officials who are concerned about employment for people in their communities who *haven't* been to college. Moreover, the industry generally pays good wages and significant tax revenues—actually much better than many “high tech” companies. That is beneficial to local merchants, as well as to the city tax collector.

Conglomerate acquisition of metalworking machine shops

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All across the United States, during the late 1960s, there was a wave of conglomerate acquisitions of precisely the most successful of these previously independent or small corporate operations. Giants like Gulf + Western, Textron, Genesco, Litton and a hundred others sent buyers into areas like New England and made offers that those small business owners could not refuse. Every sector of the economy was affected: not only metalworking, but also apparel, shoes, department stores, hotels. In the years following the acquisition, a definite pattern emerged. Research conducted at M.I.T., Harvard, Cornell, and by the staffs of at least two U.S. Congressional committees reveals the following patterns:

A model of conglomerate disinvestment

• instead of reinvesting the new subsidiary's profits back into the business, the conglomerate headquarters commonly siphons them off for their own use, such as reallocation to other businesses in the corporate "family" or into financing still other acquisitions. In the trade, this is called "milking the cash cow."

• the conglomerate refuses to upgrade the (often) old plant.

• central management is unwilling to purchase new, up-to-date machinery and equipment in adequate volume.

• the old machinery is "milked," too, by reducing the frequency of maintenance.

• one hedge against erratic and shifting markets in a highly competitive industry is to maintain a diversified product line: a few standard big-selling items and the capacity to continually produce various special items on demand. Conglomerate managers sometimes run down their subsidiaries by eroding their capacity to produce these "specials." This results from cutting down the engineering department or driving away the local firm's most experienced sales people.

• conglomerate managers have a disturbing tendency to ignore the importance of in-plant training to build up the skills of the younger workers in the shop.

• the home office either interferes excessively in the activities of local plant managers who do know the business (and the local area) well or, more commonly, sends in new managers who, although they have a lot of discretionary power, do *not* know the local conditions very well (and who sometimes don't know much about the business

in general, having been transferred from some totally unrelated industry).

The bottom line is that businesses which were acquired in the conglomerate waves of the past fifteen years have shown an unusually high probability of becoming so weak and uncompetitive that they must eventually be shut down altogether.

What has been the record of conglomerate management in the metalworking industry in New England? Let us contrast it with the performance of the *non-conglomerate* shops in the region. During the 1970s, because of the fall-off of Vietnam-related procurement and a huge world-wide recession in 1975, the metalworking machine shops in this part of the country all had a difficult time. There were a lot of plant closings. Among the non-conglomerate shops, for every 100 new jobs they managed to create between 1969 and 1967 through a new start-up—and at least 300 new shops *did* open during these years—about 140 jobs were destroyed through shutdowns.

Contrast this with the record of the shops that had been acquired by national and multinational conglomerates. Over the same time period, for every 100 new jobs created by a conglomerate-held metalworking machine shop opening somewhere in New England, 460 jobs in existing shops were destroyed through shutdowns. In other words, conglomerates in this region have tended to shut down over four and a half times as many jobs as they create through new start-ups.

In theory, conglomerates have tremendous capital resources. They can afford to draw from

their fastest-growing subsidiaries to subsidize losses in particular lines during tough years, to finance investment in new plant and equipment and thereby help to restore the subsidiary's ability to compete more productively when market conditions improve. But these extraordinary giant corporations also have the power to do the opposite: to literally bleed an acquired business of its capital in order to maximize the parent firm's short-term (in fact, ninety-day) profits and protect the careers of its senior managers, whose promotions and perks depend on how much cash their policies have generated in the most recent accounting period.

The situation at Morse

Because of my own previous extensive research into private corporate investment behavior in the United States and especially in New England*, United Electrical Workers Local 277 asked me to review the consulting report of the Industrial Cooperative Association, to see whether a pattern might be identified here that could assist the union in predicting what might happen to Morse Cutting Tools.

There does indeed appear to be a pattern to the policies of Gulf+Western with respect to its management of Morse. Given what we have learned about conglomerate investment and management behavior in general, there seems to be strong evidence that G+W has been behaving similarly, disinvesting in Morse for a number of years, thereby making it harder for the company to compete for new business or even to hold onto the customers it already has. It is not within my competence to predict whether G+W is literally planning a shutdown here, or whether shutdown is simply an increasingly likely outcome of a long series of bad management decisions. Either way, if there is not a significant change in the policies by which this company is managed, the odds seem very high that, sooner or later, the community of New Bedford is going to lose this plant, with its roughly 700 jobs. The fact that Gulf+Western has just hired Arthur D. Little, Inc., the international consulting firm based in Cambridge, to (among other things) develop a

plan for moving some of the Morse product line to another location, reinforces my worst fears.

This forecast is based upon six findings from the ICA report, and from discussions with several workers from the plant:

(1) Gulf+Western acquired Morse in 1968, at a time when military procurement and a booming general economy were making this particular industry very profitable. In that context, Morse was a likely candidate for the role of cash cow—a business to be acquired and subsequently milked for its cash flow, rather than because of a desire by G+W to break permanently into the machine tool industry. This, of course, is only an informed guess.

(2) At the time of the purchase, Morse had been actively considering moving to a new plant in the New Bedford industrial park. The city had offered financial assistance. Newspapers at the time reported that the company strongly believed it needed the space. The old two-building complex was relatively inefficient. Nevertheless, after it acquired Morse, G+W apparently decided not to go ahead with the construction of a new plant. Now management claims that Morse's plant is "suboptimal."

(3) Over the four year period 1977-1980, the metalworking machine industry-wide level of new capital investment in the country as a whole for a plant about the size of Morse was \$5,464,000. In other words, that's how much the average company spent on new plant and equipment over those four years. Morse itself was allowed to spend only about \$766,000 over five years (1977-1981) on new equipment. (Moreover, some \$250,000 worth of those machines, once purchased, were moved out and sent to another G+W plant out of state.) ICA was unable to learn whether and how much the local management of Morse invested in fixing up the plant, but casual inspection and discussions with the union suggest that it could not possibly have been as much as \$5 million. It would have had to be that much to bring the total up to just the industry-wide average. Since most of the shops in the industry do not have multi-billion-dollar parent firms on which to draw for financial

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assistance, this comparative record of Morse seems especially weak. The sense that G+W is under-investing in Morse is reinforced by ICA's comparison to one of Morse's Massachusetts competitors, Union Twist Drill of Athol, a company of similar size which produces a roughly similar mix of products. Over the past several years, UTD appears to have spent well over \$1.5 million on new machines and parts for the Athol plant: easily three times as much as the *net* new equipment investment at Morse.

(4) the union reports that equipment maintenance schedules have indeed been cut back by management.

(5) the versatility and flexibility of the business do appear to have been eroded by the cutting back on product engineering capability, and by (in their own words) the "driving away" of experienced sales representatives.

(6) there is some evidence that in-plant training programs have also been cut back, e.g. in product engineering and equipment maintenance.

The condition of Gulf + Western

Not counting energy or utility companies, G+W is the 28th wealthiest corporation (in terms of assets) in the world, according to *Business Week*. Its most recent (1981) annual report to the stockholders begins with the words: "We are pleased to report that Gulf+Western Industries, Inc. achieved record sales and net earnings per share in fiscal 1981—the third consecutive year in which operating results have achieved new highs." Sales last year were almost \$6 billion, and net profits (after meeting all expenses) were nearly \$300 million. The corporation owns 119 different businesses, located throughout the United States and in Canada, Japan, Western Europe, Central and South America (in 1981, 44 percent of G+W's before-tax profits came from their foreign operations).

Instead of using these enormous resources to build up the parts of the corporation that most needed them in order to become more competitive in their particular markets, G+W has systematically disinvested in *all* of its basic manufacturing operations (the division which

includes Morse), and reallocated its capital to other lines with higher short-term profitability. Over the past three years, while overall conglomerate-wide net investment (capital expenditures less depreciation and depletion) was more than \$400 million, net investment in the Manufacturing Segment (defined in the annual report as "automotive products and components, energy products, capital equipment, electrical equipment and control systems, coin-operated amusement equipment, and a number of other products") was *minus* \$2.3 million. To be sure, some of the areas of the corporation receiving new injections of capital involve "manufacturing," too, such as *No Nonsense* panty-hose, Simmons *Beauty-Rest* mattresses, and sugar refining in the Dominican Republic. But the most highly capitalized segment of Gulf+Western remains its so-called "Leisure-Time" activities: the companies which make movies (*Raiders of the Lost Ark*, *Reds*), television shows (*Mork and Mindy*, *Happy Days*), and which operate entertainment centers (like Madison Square Garden in New York City). In the last year, a lot of G+W's investment capital also went into playing the stock market.

Like other conglomerates, G+W sets a target rate of return which each of its subsidiaries is expected to meet; or risk being dumped. The current target rate of 25 percent before taxes and inflation are figured in is not in itself so out of whack, given the rate of inflation over the last three years and the industry-wide average in the country as a whole. What is irrational on the part of G+W management is their apparent insistence upon earning that target rate of profit in every subsidiary in every year, even in a recession. No one realistically expects to achieve the industry-wide long-run average rate of profit during the lean years. In fact, the principal organizational advantage of the conglomerate form is supposed to be precisely that it can afford to "cross-subsidize" sub-average performance in certain years (or parts of the corporation) out of the super-profits it makes in other years (or from other parts of the company—e.g. from those hit movies). Moreover, the achievement of the industry-wide average rate of profit (even in the

best of times) doesn't come free; it requires periodic upgrading of the plant, the purchase of adequate new equipment, and so forth. In light of its poor showing in this regard, Morse Tool's management may quite properly be suspected of demanding wage givebacks from the union at the present time in order to achieve the target rate of profit that it cannot achieve otherwise because the parent firm, G+W, will not invest in the plant.

What happens next?

The evidence from around the country is clear: wage givebacks only prop up the jobs of local managers and provide extra profits to the parent corporation's stockholders. They are hardly ever sufficient to finance the rehabilitation of a business that has been weakened by disinvestment. To turn a shop like Morse around, it will be necessary for *someone* to undertake significant new investment in plant and equipment, to restore the business' image with its distributors and final customers, to more aggressively seek new markets, and to increase the opportunities for the shop's skilled machinists and engineers to develop new products and new manufacturing processes. Of course, I have no way of knowing whether Gulf+Western is willing to make that commitment.

But it will be a shame if *someone* doesn't make it. The long-run outlook for machine tools and parts is basically strong. One need only consider the necessity of the auto industry to downsize and otherwise completely redesign its cars in the years ahead, the construction boom that lies around the corner when interest rates finally go down, the need for more mass transit and environmental clean-up equipment, and the growing industrial interest in robotics and scientific equipment connected with the emerging bioengineering revolution. If Morse is to be "on-line," ready to take advantage of these expanding opportunities, its owners will need to be *patient* with regard to their profit expectations. There has been much casual talk in the past year about the success of the Japanese in building such a productive and expansive industrial system so quickly. An ex-

tremely important part of the Japanese success story lies in precisely this willingness of the leading companies to practice *patience* as they develop new products and new technologies. Japanese companies generally earn considerably lower rates of short-term profit than their American counterparts.

In 1981 alone, Gulf+Western invested \$216 million in its various operations around the world. It would cost less than 5 percent of that amount to build a new plant for Morse, to equip it with the most modern machinery, and to organize new in-plant training programs for the machinists who would work with the new equipment.

A business is more than just the building it sits in. It is the sum of its plant, machinery, good will with its customers and its community, and most important of all, the skills and experience of its workforce. By that larger definition, Morse is almost surely a viable business. I hope you all find a way to save it.

April 27, 1982



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*Some recent and forthcoming books on the subject are: Bennett Harrison, *The Economic Transformation of New England Since World War II* (Cambridge: MIT-Harvard Joint Center for Urban Studies, 1982); and Barry Bluestone and Bennett Harrison, *The Deindustrialization of America* (New York: Basic Books, October 1982).