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THE CONGLOMERATE AS AN INVESTMENT VEHICLE

JEROME S. KATZIN*

Regardless of any possible correlation between the level of stock market prices and women's skirts, it is readily demonstrable that there are fashions in investment. So pronounced is the herding impulse among investors, that a more appropriate symbol of Wall Street might well be a sheep instead of the embattled bull and bear.

The transiency of investment popularity is well illustrated by the rise and decline of the "conglomerate" as an investment vehicle. Over the last decade, this group attained separate identification, was accorded a high market multiple as a reflection of wide popularity and expectation, and then fell into disrepute when these expectations began to meet disappointment. The coveted conglomerate (or mini-conglomerate) label was quickly abandoned. Management either took full-page ads in financial journals to explain to analysts why their particular company should have a different classification, or tried to demonstrate by speech and testimony what made them distinguishable from all the others.

Although the conglomerate label is a recent invention, the multi-faceted company is not. Many of the largest industrial concerns engage in a wide range of activities, some of which are quite unrelated to the main area of corporate identification. What characterizes the modern conglomerate is that its primary impetus for growth comes from the acquisition of other companies, usually bearing no operating relationship or industrial connection with each other.

A number of circumstances joined to produce the modern conglomerate. Not least in importance has been the antitrust laws which severely limit acquisitions within the same industry, either horizontally or vertically. Generally, growth into a new area of endeavor can be accomplished more cheaply and safely through acquisition of a going concern than by starting afresh. The difficulties of breaking into a new line, of gathering and proving management, of achieving market acceptance, of attaining profitable levels, and of successfully overcoming all the known and unknown hazards of a new business are avoided if an existing business can be acquired. Not only can companies rapidly and securely change the direction of their business through carefully selected acquisitions, but revenues and profits per share can also be made to increase dramatically. The prestige and other emoluments of size can thereby be achieved with a minimum of peril and in

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fairly rapid fashion through a series of acquisitions. When the law prohibits the joining of companies with a natural affinity, there will be pressure to acquire those without.

The market, during this period, has been particularly receptive to new modes of investment. As the depression-tempered generation passed from responsibility for money management, they were replaced by a new breed of investors who emphasized market performance over stability, earnings over asset value, and capital gain rather than yield. This concentration on market performance created, instead of long-term values, a demand for stocks of companies which were active performers in the market. A company on a dynamic acquisition program commands attention, gives opportunity for quick profit in the premium customarily paid for the acquired company, and the promise of rapid earnings improvement justifies not only higher stock prices but higher multiples as well.

There is, in fact, a good deal of difference in the management and philosophy of companies in the conglomerate group. Some seek to acquire companies with some operating relationship which common ownership can make more efficient, the so-called "synergy." Some get extensively involved in the management of the operating divisions and subsidiaries. Others austere limit themselves to a small, highly proficient money management and supervisory team, leaving the divisions relative autonomy except for money decisions, budgeting, and insistence on meeting performance goals. But, regardless of style, market acceptance and popularity can evaporate quite suddenly if performance falters. A problem division which fails to meet its earnings goals immediately has repercussions, and if the difficulty is deep and lasting, the stock market proves an inconstant corroborator. A loss period, a levelling of the rate of growth, a subsidiary in difficulty, and market deflation follows promptly, affecting not only the particular company, but casting a shadow on the entire group.

The continued prosperity of the conglomerate, of course, depends upon its ability to maintain a high market multiple for its shares, so that its securities can be used as the medium for acquiring companies with a lower market earnings multiple. This permits the acquirer to pay a premium for those earnings, and, at the same time, to augment its own earnings per share, even after allowance for the additional dilution.

This smooth system of escalating the value of earnings through incorporation into the more highly regarded conglomerate comes apart when the market ceases to accord a higher multiple to the combination. This will occur when the inherent inadequacies of any of the acquired companies appear. There is generally a reason for the original lower market valuation of the acquisition. This may be temporarily obscured when the conglomerate takes over. The new management can give the enterprise an improved image. Operations will be closely scrutinized; excess working capital will be

squeezed out and put to work earning maximum yield; loss operations will be pared; personnel cut; there may be accounting changes; and a more aggressive and modern stance will replace the accustomed ways. But if the company is in a mature or troubled industry, its future rate of growth will remain limited. It may require extensive plant modernization and heavy capital expenditures to stay competitive. Unrevealed weaknesses may suddenly emerge. The market's original appraisal of the company is vindicated. After all, a marginal steel company with an 8 times multiple does not by a simple transfer of ownership suddenly become a glamour company entitled to 20 times plus. Doubts arise about the sagacity and miracle-working powers of the conglomerate's management. As there is a falling off in the valuation of the conglomerate, the smooth process of compounding growth and multiple goes into rapid reverse. With a lowered market multiple, opportunities for growth through acquisition diminish; this reduces the rate of growth, and, in turn, the multiple is further lowered. The conglomerate must turn into itself to produce growth and improved earnings. This may prove difficult.

Another factor contributing to the functioning of the conglomerate has been the availability of different accounting conventions. Pooling has permitted acquisitions at a substantial premium *over* underlying book value of assets without requiring amortization of that premium against subsequent earnings. On the other hand, where assets are acquired at *less* than book value, the merger can take the form of purchase which permits the discount to be amortized in a fashion that increases reported earnings, although, in fact, there has been no change in profitability. Until recent changes in reporting for convertible securities and common stock equivalents, it was possible to delay the full dilution effect of an acquisition and temporarily give a further lift to per share earnings.

The conglomerate's emphasis on rising per share earnings as the measure of accomplishment has also created pressures to maximize leverage in its capitalization. As acquisition premiums rise in the competition for companies, the tax-free exchange (using common, preferred, or convertible preferred shares) becomes less crucial and the use of debt, sometimes with convertibility or warrants as a sweetener, becomes feasible. High federal corporate income tax rates with deductibility of interest enables a full return to be paid on the debt, and with the narrower equity base, to report better earnings per share. This becomes even more attractive if an installment purchase, using debt, defers the taxable event until cash is actually received. These devices have now been limited by the Tax Reform Act of 1969, while high interest rates have further discouraged the use of debt securities. The addition of tiers of corporations, each leveraged with debt, and controlled, but not wholly-owned is another aspect of the modern conglomerate which requires examination and clarification. These multiple-level companies

bring to mind the public utility holding companies of the 1920's which produced the corrective restraints of the Public Utility Holding Company Act of 1935.

There is a place in our economy for the diversified corporation. Modern management has proven that it can handle large and diverse operations efficiently and profitably. The dynamics of our economic system will always reward managers capable of producing growth and utilizing assets more profitably. The door should not be closed to mergers and consolidations. They serve an essential purpose in our economy, bringing revitalization to inefficient or backward companies, and offering a home to the small company, the family-owned business, or the undercapitalized venture which can no longer make it alone. Improved reporting, the breaking out of divisional figures, more uniform accounting, and the development of better financial analytical techniques, will assure that with longer experience each company, whether called conglomerate or diversified, will be judged on its individual merit, as it properly should, and not by some vague categorization or the dictates of fashion.