PROBLEMS IN INVESTMENT ANALYSIS
OF CONGLOMERATE CORPORATIONS

A Thesis

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by
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CHAPTER I

INTRODUCTION

In the history of business structure and development the 1960's may very well be remembered as the decade of the "conglomerate" corporation. The term has become commonplace in current business literature, and the phenomenon of the conglomerate has become established as a new force in the American economy.

From the investors' point of view the conglomerate has introduced new problems in analysis as well as new opportunities. These investment considerations are the subject of this thesis.

In the following study a workable definition is developed that enables the investor to distinguish between the conglomerate and other types of corporations, and among the various types of conglomerates. The development of the conglomerate and current trends are then explored in order to establish a base from which the relative importance of this form of corporation can be understood.

Chapter three deals with the reasons for conglomerate growth. The motives of the managements involved in the buying and selling of companies are discussed, and the reasons for mergers and acquisitions, and the benefits and advantages to the companies and the principles involved are explored. For the investor, chapter three highlights the forces in management, as well as in the general economy, that tend to cause and support the conglomerate.

Chapter four deals with the accounting problems in conglomerates. While this chapter is not meant to be a basic text on mergers and acquisitions, it does briefly describe how these combinations are developed. This chapter also points out how different types of mergers can affect the financial statements of the conglomerate.

Many of the investors' greatest problems are found in trying to interpret the available accounting statements. It is necessary, for good investment judgments, to be able to see the results of a proposed combination and to interpret the effects a merger or acquisition will have on future profits and earnings.

Chapter five is a brief look at the legal side of conglomerates. The anti-trust and tax laws affecting mergers and acquisitions, and their effect on the development of conglomerates are discussed. It is emphasized that, like the accounting chapter, this legal look into the analysis of conglomerates is in no way meant to be a complete review of the law involved. The purpose of chapter five is to alert the investor to some of the possible legal pitfalls that can confront a merger minded company, and therefore its stockholders.

Chapter six explores the bargaining process between the buyer and the seller. The procedures used in determining the value of a candidate are considered, and the advantages and disadvantages to the parties involved are discussed. By recognizing the surface advantages and disadvantages of a possible merger, the investor is in a better position to make a decision concerning a company involved in a possible combination.

Chapter seven begins with a short general review of basic investment analysis. The idiosyncrasies of conglomerates are then discussed and related to the analysis. Special attention is given to the importance of management, the effects mergers and acquisitions have on earnings and stock prices, and market relationships. This chapter relates all the significant points of the preceding chapters to the procedures used in the analysis of the conglomerate.

Chapter eight is a summary of the investment considerations. It highlights the more important considerations in dealing with conglomerates.

This thesis is designed to alert the investor to the possible problem areas common to conglomerates and to offer insight and technique in the analysis and understanding of and solutions to these problems.

CHAPTER II

CONGLOMERATE - DEFINITION AND DEVELOPMENT

Before an investment analyst can report on his findings he must be sure his readers will understand his language. If he refers to the XYZ Company as a conglomerate, his readers will probably assume it is a large corporation with many, not necessarily related, products. But the term conglomerate can mean much more.

I. WHAT IS A CONGLOMERATE?

There is something of the conglomerate in most large companies. For example, U. S. Steel builds bridges, sells cement and makes steel, but the analyst knows the backbone of the company is its steel operations. If he can predict the demand for steel, figure U. S. Steel's share of the market, and, with this information, compute their returns and profits, he need not be too concerned with the bridge and cement questions.

A general definition will show that the analysts' problems will not be as simple with the conglomerate.

<u>Conglomerate defined</u>. A conglomerate is a multiple industry company with many different, and often unrelated, markets. It is usually managerially decentralized into various profit centers, and usually grows through mergers and acquisitions as well as internally.

<u>Types of conglomerates</u>. While all conglomerates will generally fit the above definition, they can be further grouped into various types.

1. True[1] or multi-industry[2] conglomerates. These are the aggressive companies that are willing to expand into any field that has potential for rapid growth. There may be little or no relation among their varied business interests. The parent comapny functions in the areas of policy and finance. Examples are City Investing, Ogden Corporation, and Gulf and Western Industries.

2. Free form conglomerates.[3] The hallmark of these types are their supporting management genius. Such conglomerates are recognized by their scientific and technical know-how and their ability to find the common ground between their various divisions. They tend to create an environment in which managers are continually encouraged to look for new opportunities. Examples, would include companies like Litton Industries and Textron Incorporated.

3. Homogenous[4] or sector[5] conglomerates. The factor of idenification here is fit. That is, the growth and acquisitions of these companies tend to be logical extensions of present competence and capabilities. Examples would include The Glidden Company in the food and chemical industry and Transamerica Corporation in the finance and consumer services industries.

4. Cornerstone conglomerates.[6] These are the well established companies who use their traditional market as an equity base for diverification into new fields. Cornerstone examples are General Tire and Rubber and Bendix Corporation.

Common to most conglomerates is their willingness to enter into new ventures in their efforts to grow. This growth may be through internal development, but often is accomplished by acquiring other companies.

An example of a diversified, growth oriented conglomerate, and probably the best known, is Litton Industries. The following quote from Business Week provides a good picture of Litton's development.

> "Litton has soared from $3-million in sales in 1954 to $1.5 billion (in 1967). Like almost all conglomerates, it has used mergers as the basic tool of expansion. It has acquired all or part of 55 companies with sales totaling $800-million when Litton scoped them up. From electronics, Litton has moved into a startling number of new fields - ships and submarines, typewriters and cash registers, computers and calculators, steel and wood office furniture, surgical instruments and X-ray equipment, motion picture cameras, space suits, paper mills, and book publishing. Merger with Stouffer Foods Corp. put Litton into the business of food preparation and electronic cooking and the consumer field."[7]

The above example also points out the reason why an ordinary industry-based analysis would be either incomplete, or an impossible task, as a method of analyzing a conglomerate.

II. MERGER CYCLES

The United States has seen three periods of merger growth.[8] By understanding the relationships between business and the social-economic environment during these periods, some insight is gained to help explain the current conglomerate activity. The analyst must be aware of the environmental conditions that influence the economy.

The great merger movement, 1890 to 1904. Unlike today, this period was characterized by combinations among direct competitors. A major vehicle of combination was the holding company. By investing in the shares of a number of operating units the holding company was able to control and dominate the markets in which the units operated. From this period came corporate giants like the Standard Oil Company and United States Steel, and the introduction of anti-trust laws.

From World War I to depression. The second period, starting after the first world war and continuing to the depression, did not have as great an effect on the economy as did the first. The anti-trust laws had been passed which limited combinations tending toward monopoly. Acquisitions during this period were designed to expand the operations of the dominant company.

The modern period, 1946 to present. This period has developed out of the need to diversify, to stay abreast of changing technology, and to strengthen competitive positions. The effect of the combinations of this period on the total economy has been even less than it was during the second period. However, the modern period has seen a shift from the majority of mergers being either horizontal or vertical to the conglomerate or multi-industry type. The Federal Trade Commission estimated that about 70% of the important combinations between 1960 to 1965 were of the conglomerate or multi-industry type.[9]

The rate of merger activity tends to vary with stock prices and the business conditions.[10] Thus, the second merger period ended with the depression, and the recessions of 1948-49 and 1957-58 saw merger activity substantially reduced.

A partial explanation of merger cycles is that reduced business activity usually results in reduced earnings, and earnings are in turn reflected in the price of stocks. As stock multipliers fall, the price the acquiring conglomerate pays for a merger is increased in terms of the number of shares given up to effect the merger.

Recent merger activity. The pace of mergers during the 1950's was, by recent standards, rather slow. The Federal Trade Commission reports that mergers in all corporations, except banks, utilities, rails, and air transport companies, grew from an annual rate of about 700 per year in 1951, to 1050 in 1959.[11]

The rate of merger activity increased in the 1960's and 1,517 were reported by the Federal Trade Commission in 1966. Including all types of combinations, the Chicago based financial consulting firm of W. T. Grimes found the number of 1966 mergers to be 2,377 and gave the 1967 figure as 2,975.[12] The F.T.C. reported that of the 1966 mergers, 60% were across industry lines, and the Grimes study indicated that 595 or 20% of the 1967 mergers involved conglomerates.

Who are the conglomerates? Each year Fortune magazine lists the 500 largest companies in America according to sales and earnings. In Fortune's 1967 "500" there were 46 companies operating with eight or more different major product categories. This is Fortune's criterion to be considered a conglomerate.[13]

These 46 conglomerate companies are listed on the following page (Table I) with their average annual earning rates for the periods 1961 to 1966 and 1956 to 1966. It is interesting to note that while, as a group, their earnings performance was about the same as the rest of the "500", the earnings for the high-technology conglomerates for the five

TABLE I

CONGLOMERATES IN FORTUNE'S 1967 "500"

Company	Major Product Categories	Average annual growth in earnings * 1961-66	1956-66
Allied Chemical	9	7.54%	3.61%
American Cyanamid	9	12.92	4.90
Am. Machine & Fdry.	10	(5.50)	3.55
Armour	11	-	-
Armstrong Cork	8	10.98	8.63
Avco	9	15.67	-
Bendix	10	8.02	3.17
Borden	9	8.55	5.86
Borg-Warner	12	14.28	2.28
Brunswick	11	(41.87)	(7.48)
Castle & Cooke	8	-	5.71
Chrysler	9	68.99	22.57
Consolidated Elect.	8	14.55	2.08
Dow Chemical	10	15.72	6.15
Du Pont	9	(1.50)	.02
Eagle-Picher Indust.	8	21.98	1.79
Eltra Corp.	11	21.99	19.44
Evans Products	8	-	3.72
FMC Corp.	10	20.54	13.37
Fairchild Camera	8	15.47	24.54
Farmland Industries	8	-	-
Firestone Tire & Rubber	10	9.76	5.00
Ford Motor	8	8.76	9.96
General Dynamics	10	-	3.05
General Electric	14	6.58	4.28
General Precision	8	9.25	11.12
General Tire	17	12.43	15.15
Goodrich	8	9.31	.77
Goodyear	8	8.51	6.16
Grace (W.R.)	12	18.30	7.32
Gulf & Western	8	26.79	-
Int'l Business Mach.	8	19.22	20.65

TABLE I Continued

CONGLOMERATES IN FORTUNE'S 1967 "500"

Company	Major Product Categories	Average annual growth in earnings * 1960-66	1956-66
Int'l Tel. & Tel.	15	17.89	7.55
Johnson & Johnson	8	16.91	9.42
Kaiser Industries	8	28.56	1.18
Kidde (Water)	11	-	4.05
Litton Industries	18	35.09	56.55
Lockheed Aircraft	10	15.76	11.80
Minnesota M. & Mfg.	8	12.15	12.90
National Distillers	9	13.17	4.12
Ogden	9	29.56	1.59
Olin Mathieson Ch.	9	15.15	4.05
Rexall	10	15.45	12.45
Texas Instruments	9	27.09	26.90
Textron	15	27.95	16.15
Universal American	8	5.47	4.77

*(No growth rates are given if companies had a loss in either the first or last year of the period. Figures in parentheses are negative.)

year period 1961 to 1966 was somewhat superior to the rest of the group.

Future trends. The Wall Street Journal has estimated that the number of 1968 acquisitions will be about 5,200.[14] Of these 800 the paper judges about 25% will be accounted for by conglomerates.

The future and significance of the conglomerate as a factor in the economy will, in all probability, be a function of need. This form of business is very well suited to the dynamic and highly technical business environment of today. There is no reason to believe these conditions will be any less demanding in the future.

Their present importance is shown by their representation in the "500", of which only 102 companies operate in only one category. Their importance is also indicated by their increasing participation in merger activity.

If generally good economic conditions prevail, and legal restrictions are not imposed, the conglomerate should continue to grow and play an ever increasing role in the economy.

FOOTNOTES FOR CHAPTER II

[1]Roger O. Wedekindt, "A Study of Selected Conglomerate Companies," A Report Prepared for the Investment Department of the U. S. Trust Company (New York: October 5, 1967), p. 3.

[2]Chris Welles, "The Conglomerate: What is it? Where is it going?," *The Institutional Investor*, (June, 1967), p. 11.

[3]Wedekindt, *op. cit.*, p. 3.

[4]*Ibid.*

[5]Welles, *op. cit.*, p. 11.

[6]*Ibid.*

[7]"Corporations: Where the Game is Growth," *Business Week*, (September 30, 1967), p. 107.

[8]Arthur R. Wyatt, "A Critical Study of Accounting for Business Combinations," A Report Prepared by the American Institute of Certified Public Accountants (New York: 1963), p. 1.

[9]Gilbert Burch, "The Perils of the Multi-Market Corporation," *Fortune*, (February, 1967), p. 131.

[10]"Status and Future of Small Business," Hearings before the Select Committee on Small Business, United States Senate, Ninetieth Congress - First Session (March 15 to 22, 1967 and April 6, 1967), p. 449.

[11]Betty Block, "Mergers and Markets," A Report Prepared by the National Industrial Conference Board Inc. (New York: 1960), p. 110.

[12]A. J. Naylor, "Last Year's Mergers Reach New Heights," *Invest-Dealers' Digest*, (January 15, 1968), p. 2.

[13]Thomas O'Hanlon, "The Old News about Conglomerates," *Fortune*, (June 15, 1967), p. 175.

[14]Dan Dorfman, "Heard on the Street," *The Wall Street Journal*, February 12, 1968, p. 25.

CHAPTER III

MOTIVATIOH FOR GROWTH

All modern corporations strive for more sales, more products, more profits, in short, more growth. Growth can be accomplished in two ways, first, internally by the expansion of present resources and markets as is the case at General Motors or American Telephone and Telegraph, and second, externally by using management skill through mergers and acquisitions.[1] Most conglomerates use both approaches with the emphasis often on the latter.

This chapter considers the economic reasons and management motives underlying external expansion. These factors are critical in analyzing future growth patterns of conglomerates.

I. MERGER MINDED MANAGEMENTS

Equity Research Association has stated that, "Management is to the economy of the twentieth century what industrialization was to the Nineteenth Century."[2] Their point is that, as important as the supply and demand in a given situation may be, the paramount factor in analyzing a company is its management.

This is even more important when considering conglomerates. Here management is dealing with a rapidly changing set of circumstances, and its ability to maintain control and seek opportunity is critical to company success.

<u>Environmental change</u>. The following excerpt from a recent speech

by Mr. Ricciardi, president of Kidde (Walter) and Company, illustrates some basic reasons why conglomerate managers tend to be merger minded.

"If you assume that the world around us is changing more rapidly than it has ever changed before, and that societal changes are taking place at a feverish rate, then clearly one of the responsibilities of management is to be aware of these changes, and to be poised, ready and able to capitalize on them, whenever it makes sense from the point of view of the shareholders, if this means acquiring or buying other companies, then obviously that's what you do.

A conglomerate, in a way, thinks of itself as being responsive to the world in which it lives, rather than constructing a place for itself in the world. Hence, we think it's necessary for management to be alert and attuned to the changes that are taking place in the world, and respond to them with all their corporate resources. The conglomerate form clearly affords this opportunity. Surely no one would believe that in ten years there won't be industries around that nobody ever heard of today. If you're married to one particular industry or one particular line, it's going to be difficult for you to respond to these new opportunities."[3]

Litton's "Lidos." Another reason for external growth is found in the ability and drive in many of today's executives. Given a corporate atmosphere that allows the manager to operate relatively free of restrictions, executives will look outside the company as well as internally for new opportunity. Their motives may be profit, social concern, or ego satisfaction, but common to all is the need for growth.

Litton Industries may have set the stage with their enterpreneurship type operation. Litton ahs encouraged autonomous action to maximize profits. As a result, after many executives have gone as far as they could with Litton, they have left. Many of these "Litton Industries dropouts"[4] now control other corporations and are following the same Litton philosophy. It can be seen then, that environmental change and management ability account for many of todays mergers.

II. MERGERS - THE COMPANY VIEW

For an American business, the choice is often grow or die. Companies must grow to keep even with rising costs. They must grow to maintain their position in the marketplace, and they must grow to be able to take advantage of future opportunities.

The major reasons for choosing external growth are discussed below.

Synergistic effect. Mergers are often entered into in hopes that the strenths and weaknesses, of the companies involved, will be complemented and offset to such an extent that the new company will add up to more than its parts, i.e. $2+2=5$.

An Illustration of the synergistic effect would be a cash-rich, management-poor company, merging with a management-rich, cash-poor company. The new company having good management and funds with which to operate should be in a position to do what both companies could not do when they operated separately.

Strength with diversification. Often the motivation for mergers will come from recognition that there is limited protection in a single product. A merger can serve as a defensive move by providing a hedge for traditional product lines through diversification into other markets. This type of merger can also provide a way to smooth seasonal and cyclical fluctuation and reduce the risk of product obsolescence. With added diversification a company's stronger divisions can often carry the less productive divisions through slack seasonal periods, or developmental stages, or until other problems have been corrected.

Fear of government action.[5] Some of the present wave of mergers are attributed to concern over possible government restrictions in multi-industry combinations. At present there are no laws directly restricting the conglomerate type merger outside the anti-trust and monopoly laws.

Some of this feeling is increased as companies see their competition expanding into new fields, and action is taken to get into the act before it is too late and restrictive laws are enacted limiting multi-industry growth.

Financial position. A company with a strong cash position may have the choice of expanding present markets or undertaking new endeavors. Due to limited growth potential in their present markets they may decide to enter into new fields. With their liquidity, they may be able to acquire an existing company and avoid the costs associated with starting a new line, thus acquiring the advantages of a going concern.

Technological influence. Due to the rapid change in technology a company wishing to broaden or improve its lines may decide to acquire the advanced technology it needs. This may be especially attractive to a company without the resources to make a purchase, but which is able to effect a merger on an exchange of stock bases. This same situation can apply to companies wanting expanded research and development facilities, or patent rights to products.

Time factor. Typical of many of the new conglomerates is the desire to grow as fast as possible in the shortest possible amount of time. Mergers and acquisitions provide a way for these companies to expand without waiting for slower internal growth. The acquired companies come ready made with their own products, markets, and managements. The risk in this type of growth is in the ability of the acquiring management to maintain control and integrate the new company into existing operations without undue delay and costs.

Market action inducements. As the stock market goes up, a company may find itself in a favorable bargaining position because of the increased market value of its stock. To illustrate, assume Company A would like to acquire Company B with an exchange of stock based on market prices. At present prices A feels the exchange would be too expensive. If however for some reason Company A's stock should double in price while Company B's stock remains constant, A would then need to pay, in terms of numbers of shares, only half as much for B as would have been the case before the market movement.

Summary. In chapter two, conglomerates were defined and the various types were distinguished. It is important for the analyst to determine with what type he is dealing, as this provides a great deal of insight toward understanding the management under consideration.

The chapter also pointed out that the rate of mergers and acquisitions tend to vary with general economic trends and stock market prices. The analyst will need to determine the effects these conditions could have on future earnings of companies being studied.

Chapter three explored the reasons for external growth. Dynamic socieo-economic conditions and management technology were found to be the major reasons for growth from the executive's point of view.

Companies grow externally for many reasons. These reasons include mergers and acquisitions to gain a synergistic effect, to diversify, out of fear of future government regulation, to invest excess funds, because of technical needs, to save time, and because of the conditions of the stock market.

The analysts are concerned with the motives and reasons behind a merger because of what it may reveal of past and future operations of the conglomerate being analyzed.

FOOTNOTES FOR CHAPTER III

[1]"Corporations: Where the Game is Growth," Business Week, (September 30, 1967, p. 102,

[2]John Westergaard, and Richard R. Fields, "Investing in Modern Management: the 'Free-Form' Corporation," A Report Prepared by Equity Research Association (New York: September 20, 1966), p. 1.

[3]E. T. Greeff, and C. W. Fanning, "Walter Kidde & Co.," A Report Prepared by the Research Department of F. A. Smithers and Company (New York: January 22, 1968), p. 5.

[4]"Litton: B - School for Conglomerates," Business Week, (December 2, 1967), p. 88.

[5]Lee Berton, "The Merger Surge," The Wall Street Journal, September 19, 1967, p. 1.

CHAPTER IV

SITUATIONS IN CONGLOMERATE ACCOUNTING

The professional analysts should, of course, have a strong accounting background. In order to comprehend the professionsl's reports, the novice investor should have at least a basic understanding of accounting. To that end, this chapter is designed to consider the more common accounting problems that arise when looking at conglomerates.

To illustrate the scope of the situation, consider Gulf and Western Industries. In the past ten years G&W has acquired over 70 companies, making year to year comparisons all but useless and introducing a steady stream of new factors for the analyst to consider.

The idiosyncrasies of conglomerate accounting generally involve two areas: (1) acccunting for divisions or industrial groups, and (2) accounting for mergers and acquisitions.

I. ANALYZING THE PARTS

The first problem to be faced when studying conglomerates is the lack of available divisional data. It is rare that sales and costs are broken down, to a meaningful degree, for the various segments of the firms' operations. While product line information may be available, information on the costs and contribution of the various lines usually is not.

<u>Current concern</u>. To cope with the problem of how much information a conglomerate should report, an extensive study was undertaken,

in 1967, by the Financial Executives Institute.[1]

Briefly their report suggests the following:

1. Conglomerates should provide about the same amount of information as is required by the Security and Exchange Commission for registration statements.

2. Sales of divisions contributing 15% or more to gross revenues should be broken down separately, and their proportion of total income and earnings should be shown.

3. These data should be provided in the conglomerate's annual reports.

4. Conglomerates should be analyzed by broad industry groupings.

The S.E.C. and the Justice Department have also expressed concern over the growth and accountability of conglomerates. At the time of this writing the S.E.C. was reviewing the above mentioned report submitted by the Financial Executives Institute. Other studies have shown that the corporations themselves are aware of the problem and at least some have begun to improve their reportings.

Andrew Barr, writing in the November, 1967, issue of the Financial Executive discusses this trend.

> "A comparative survey of the 1965 and 1966 annual reports of 241 large companies (sales over $100 million) showed that the number of companies providing a breakdown of sales on a segmented basis increased from 37 percent to 51 percent... In a recent survey of 265 filings (prospectuses) under the 1933 Act, by companies with sales in excess of $25 million, we found that 97 percent of the companies provided breakdown of sales by two or more categories and 17 percent of the companies provided additional

breakdowns on net income or relative contributions to net profit. We believe these data may also be indicative of further improvements in subsequent annual reports....the statistics indicate an increasing awareness by corporate financial officers and accountants of the necessity of providing additional information, as well as a response to the urgings of Chairman Cohen (S.E.C.) and leaders of industry and professional organizations, that more detailed information be provided on a voluntary basis."[2]

Alternatives. The analysts should try to distinguish among the industries represented in the conglomerate. Robert K. Msutz, who is also involved in the appraisal of conglomerate reporting, has suggested the following methods of segmentation and points out some of the weakness of each:[3]

1. Product-lines. Products often overlap and there is no authoritative definition of what should be included in the lines.

2. Broad industry grouping. This method would not fit all conglomerates and would need specific definition each time it is used.

3. Legal entities. The operations of a company often has no significance to the legal entities involved.

4. Market segments. The type of markets need definition, i.e., geographic, domestic or foreign, type of customer, industry served.

5. Organizational divisions. This would vary from company to company and would only be practical if common costs were not to great.

The analyst will have to choose the method that best fits his needs in light of the availibility of information and the type of company with which he is working. If there are enough data available to allow the analysts to weigh the contribution of each of the significant divisions, he would still have the difficult problem of determining the synergistic effect, if any, and of making a judgment about the conglomerate's management.

II. THE MECHANICS AND EFFECTS OF MERGERS AND ACQUISITIONS

The investor considering conglomerates should be aware of the results that corporate combinations can have on earnings. Therefore the two basic methods of corporate marriages, purchase and pooling-of-interest, should be understood.

Examples of the mechanics involved.[4] Assume company B has an appraised market value of $1,250,000, and the following balance sheet figures.

Assets	$1,000,000
Liabilities	200,000
Equity	800,000

Company A plans to acquire all of B for $1,250,000.

If company A acquires or purchases B, for stock or cash, A would enter $1,250,000 on its books. In doing so A has written up the assets of B by $450,000 above B's book value. Company A can then base future depreciation on the fair market price of $1,250,000.

If a pooling-of-interest or merger is decided upon there is no purchase or sale. Company A would exchange $1,250,000 of its stock for B. A would then write up its assets by 800,000, B's book value, and increase goodwill by $450,000.

Effect on earnings. By purchasing B, in the above situation, company A will have $450,000 more to depreciate than it would have had if a pool-of-interest combination was used. It can be seen then that the purchasing method increases cash flow by the amount of added depreciation resulting from the write-up to market value, but it reduces near-term accounting earnings because of the added depreciation charge. On the other hand, the pooling-of-interest method increases near-term earnings, but does not show company benefits from added cash flow.[5]

Conglomerates and leverage. Through combinations conglomerate managers are able to show rapid earnings growth. The stock market, in turn, places a premium on this earnings growth and puts a high price-earnings multiple on the conglomerate's stock.

An illustration of how the process works was given in the March 2, 1968 issue of Business Week quoted below.

"Take for example, a 'go-go conglomerate' appraised on Wall Street at 45 times earnings. With 1-million shares outstanding and $1-million in after-tax profits, its earnings of $1 per share results in a market price of $45. By acquiring another company with $1-million in earnings and a stock selling at a more conventional P/E of 15 - the conglomerate can increase its earnings by $3 for each additional share it issues to consummate a one-for-three swap. This adds 50¢ to its per-share profits; assuming investors still apply a P/E of 45, the merger would raise the price of its shares from $45 to $67.50."[6]

While this illustration may be overly simplified it does show the function leverage. Another example, that of Ling-Temco-Vought Inc., introduces the use of an acquisition plus spinoff techniques.

"LTV borrows cash to acquire control of another company. That company then merges with LTV through an exchange of securities. Next, it is split into operating divisions along product lines. These divisions are then reorganized as individual corporations with their own managements....In the final stage, there are public offerings of stock in the new LTV subsidiary corporations; LTV sells 20% to 30% of their shares to the public and keeps the remaining 70% to 80%. LTV capitalizes on the willingness of investors to value a company's common stock at a price higher than its 'book value,' or new worth after substracting liabilities and the cost of redeeming preferential stock from assets. The difference represents a kind of profit for LTV - a profit it uses to help repay the money borrowed to get control of the subsidiaries in the first place."[7]

These examples of leverage, while showing how a conglomerate can grow through merger and acquisition, with the help of a favorable market, also raise the question of dilution and emphasize the importance of management. These questions will be considered in Chapter 7.

The analyst must be aware of the results that a merger or acquisitioncan have on future earnings, and weigh these results on the advantages to be gained. He must also make a judgment as to the stability that a company has that is experiencing rapid external growth.

FOOTNOTES FOR CHAPTER IV

[1]"How Much Data Must Conglomerates Bare?," Business Week, (January 20, 1967), p. 53.

[2]Andrew Barr, "Comments on the Conglomerate Reporting Problems," Financial Executive, (November, 1967), p. 45.

[3]Robert K. Mautz, "Bases for More Detailed Reporting by Diversified Companies," Financial Executive, (November, 1967), p. 53.

[4]Arthur R. Wyatt, "A Critical Study of Accounting for Business Combinations," A Report Prepared by the American Institute of Certified Public Accountants (New York: 1963), p. 13.

[5]David Norr, "Accounting and Analysis," From a Speech before the Phoenix Society of Financial Analysts (October 15, 1963), p. 1.
Gilbert Burch, "The Perils of the Multi-Market Corporation," Fortune, (February, 1967), p. 134,

[6]"Time of Testing for Conglomerates," Business Week, (March 2, 1968), p. 39.

[7]James C. Tanner, "Ling's Empire," The Wall Street Journal, August 18, 1967, p. 7.

CHAPTER V

THE LEGAL SIDE OP CONGLOMERATES

If the investor has some understanding of the possible legal pitfalls and limitations arising frem mergers and acquisitions and a general knowledge of the effects of taxation in corporate marriages, he will be in a better position to make a more sophisticated analysis of the companies being investigated. It is the purpose of this chapter to highlight these legal and tax questions.

I. MERGERS AND MONOPOLY

It has already been pointed out that at the present time there are no laws specifically intended to regulate conglomerates or multi-industry corporations directly. Existing monopoly and anti-trust laws do, of course, apply equally to conglomerates. Therefore, the investor and analyst should develop an understanding of the present state of the legal environment.

Current debate. There are those who, right or wrongly, feel that restrictions should be placed on conglomerates, first because of their importance as an economic force, and secondly before their growth enables them to become so large that controls or restrictions would be ineffective. Reasons that are given to support the case for possible restrictions include the following:

1. Each time a conglomerate acquires a company operating outside its present range of industries, the total amount of available

information for that industry is reduced.[1] This happens when the acquired company no longer publishes its operating results as they are included, in general terms, with those of the larger parent company.

2. Conglomerates may tend to decrease competition.[2] A large conglomerate, using its powerful financial resources, could move into a market previously divided among many small competitions and drive the smaller operators out of business. The conglomerate has the competitive advantage of being able to accept losses in one market by making them up with profits in other markets.

3. The third reason was considered in Chapter 4, and deals with conglomerate reporting and the need for a breakdown of sales and earnings on a bases that would be meaningful to the investor.

To rebut the above reasons and to defend the conglomerate, supporters of the multi-industry company, after stating their case in terms of management ability and socio-economic needs, point to the anti-trust law. They explain that because of the present restrictions on horizontal or vertical unions, i.e. with competitors, customers, or suppliers, the next logical step for the growth-minded firm is with a company outside its present product areas.

The conglomerate position further states that, "although the forces of Antitrust are gathering mountains of evidence for an assult on the multi-market movement, they have not yet proved that conglomerates on balance weaken competition as much as they strengthen it."[3] The multi-industry group explain, that it is because of their size and financial strength that they are able to improve and develop products and markets.

The significance of this debate for the investor is in realizing that there is in fact current concern, that the question is not settled, and that the outcome may affect future conglomerate growth patterns.

Present laws. "American antimerger policy...is based upon the traditional economic view that when a market becomes highly concentrated or oligopolistic in structure, the intensity and effectiveness of competition--and in particular price competition--are likely to diminish."[4] From this tradition came the laws that presume mergers between direct competitors to be unlawful if the markets served become unduly concentrated in the hands of a few firms, or if the merger would increase market concentration.

The Sherman and Clayton Acts are the specific laws that insure the traditional view.

The Sherman Act of 1890 "made illegal any contract, combinations, or conspiracies by which persons or companies restrained trade or by which they would combine with others to create monopolistic positions."[5]

The Clayton Act of 1914, was "passed to prohibit price discrimination, exclusive dealing or tying contracts, and acquisitions of corporate stock where such activities might lead to serious impairment of competition in the market."[6] This act was amended in 1950 to prevent a corporation from acquiring, directly or indirectly, all or any part of the assets of another corporation where the effect would be to lessen competition or to tend to create a monopoly.[7]

Betty Boch, writing for the National Industrial Conference Board, provides the following interpertation of the meaning of the law.

> "A top company in a concentrated market will find difficulty in acquiring larger and possibly medium-sized, companies in its own or closely related markets; such an acquiring company can judge that an acquisition will be relatively safe only if it acquires a failing company or a small company in an unconcentrated market (i.e., if the combined market shares of the acquiring-acquired company run under 20% of the relevant market and concentration for the first four companies runs under 50% of the market) and even then the acquiring company must operate the acquired unit in a competitively blameless fashion to avoid charges of deep-pocket leverage.... A medium or smaller company operating in a fragmented market will have generally safer future if it acquires a medium or small company - provided the acquisition is not part of a merger movement that is eroding formerly distinct market levels."[8]

This explanation points out that even without specific guide lines the smaller the total power of the combined company in terms of its position in the market, the greater the chance that the acquisition will not be considered to lessen competition.

The investor should try to determine if a proposed merger could infringe upon the law. If this appears to be a possibility, the legal costs involved in an extended court case should be considered when weighing the risks and advantages of investing in the company involved.

Cases in point. It would be a mistake to assume that modern corporations are too well versed in the antitrust regulations to fall victim to the law.

The merger between International Telephone and Telegraph and The Columbia Broadcasting System was canceled because of controversy associated with the combination. The Justice Department objected to the merger on the grounds that ITT's foreign investments and business activities could compromise the independence of ABC's news coverage.

In April, 1967, the Supreme Court ordered Procter and Gamble to divest itself of Clorox Company, which P&G acquired in 1957.[10] The court held that a conglomerate type merger is likely to be illegal if the acquired company is a major factor In an industry where a few companies control most of the market and if the acquiring company is in closely related lines. The court further pointed out that because of P&G's financial strength and advertising ability other firms would be less likely to enter the bleach industry. P&G could set prices and other companies would not have the economic where-with-all to compete effectively.

These two cases illustrate the reach of the anti-trust laws. Neither company was acquiring a competitor, but because of the effects they could have on the industries involved the mergers were challenged. The analyst, then, must be cognizant of the probable viewpoint of the anti-trust regulators.

II. TAXES AND CONGLOMERATES

The price a company pays for another company will be influenced by the part taxes play in the transaction. Here again it behooves the analyst to be able to project the effect taxes will have on a proposed merger.

Taxable and tax deferred combinations. A taxable transaction is one in which taxes must be paid for the year of the transaction. This compares to a tax deferred merger or acquisition under which the tax liability is deferred until the sale of the stock received in payment for the acquired company.

All transactions are taxable unless they qualify as a reorganization under the Internal Revenue Service rules. The Internal Revenue Code provides six avenues to corporate reorganization without the incurrence of an immediate tax liability for any of the parties involved.[11] These are:

1. A statutory merger or consolidation that is effected under the laws of the various states.

2. An acquisition by one corporation of the stock of another corporation where the acquiring company gives up voting stock and gains control of the acquired company. In this case, control means 80% of the total of all classes of stock.

3. An acquisition by one corporation of the properties of another for stock. Again, the acquiring company gives up voting stock and gains 80% of the acquired company.

4. A transfer of assets to another corporation for controlling stock. This covers a reorganization wherein a part of an existing corporation is <u>split-off</u> in such a manner that the parent corporation or its shareholders subsequently control the company to which the assets are transferred.

5. A recapitalization of an existing corporation.

6. A change in name, identity, br form.

Generally, payment must be in the form of voting stock for a transaction to qualify for the tax deferred treatment. The purpose of the tax relief is to prevent taxpayers from being forced to liquidate assets received in an exchange in order to meet tax obligations which would arise with an ordinary sale of securities. This policy is based in the belief that mergers and acquisitions are generally good for the economy and therefore are not, in themselves, penalized by immediate taxes. When the securities received in an exchange are disposed of in the normal course of business, the tax due is computed on the same bases as the securities given up in the transaction.

Summary. An understanding of the accounting problems and legal implications involving conglomerates will aid the investor in his analysis. As pointed out in Chapter IV, there is both a need and a lack of divisional information showing the contributions of various industry lines. Fortunately, the current trend is toward providing this information. The analyst should be aware of the earmings and cash flow differences that result from combinations using either pooling-of-interest or purchase techniques. He should also consider the possibility of the "house-of-cards" type of risk found in companies growing through the use of excessive leverage.

In this chapter the anti-trust laws as they apply to conglomerates were considered. The investor should realize that the multi-market companies are being examined and future regulations or broader interpretations of present laws are a possibility. Planned mergers and acquisitions should be studied for their conformity with present laws and any question of conflict should be accompied with a question on the effects a blocked merger would have on growth and earnings. The analyst needs to be aware of the difference between a taxable and a tax deferred transaction. The significance of this point is further developed in the following chapter on bargaining.

FOOTNOTES FOR CHAPTER V

[1]Andrew Barr, "Need for Product Line Reporting," Investment Dealers' Digest, (January 22, 1968), p. 46,

[2]"The Case for Conglomerates," Fortune, (June 15, 1967), p. 164.

[3]Gilbert Burch, "The Perils of the Multi-Market Corporations," Fortune, (February, 1967), p. 131.

[4]Donald F. Turner, Assistant Attorney General in Charge of the United States Department of Justice, From a Speech before the Institute of Advanced Legal Studies, London, England (June 5, 1967) p. 1.

[5]Arthur R. Wyatt, "A Critical Study of Accounting for Business Combinations," A Report Prepared by the American Institute of Certified Public Accountants (New York: 1963) p. 8.

[6]Ibid., p. 9.

[7]Betty Block, "Mergers and Markets." A Report Prepared by the National Industrial Conference Board Inc. (New York: 1967), p. 3.

[8]Ibid., p. 8.

[9]"A Broken Engagement for ITT & ABC," Business Week, (January 6, 1968), p. 26.

[10]W. T. Hudson Jr., "A Precedent for Conglomerate Mergers," A Report Prepared for the Investment Department of the U. S. Trust Company (New York: April 17, 1967), p. 1.

[11]Wyatt, op. cit., p. 59.

CHAPTER VI

BARGAINING FOR GROWTH

The techniques employed by the growing conglomerate in its hunt for firms to acquire are important to the analyst because of the influence they have on future earnings. Therefore a familiarity with the forces and factors involved in buying and selling companies, as well as an understanding of the effects of the method of payment, is important.

I. PLANNING AND NEGOTIATIONS

Just as the seller is interested in the price he can command, the buyer is interested in what the seller is worth and what he can afford to pay. A large corporation Involved in numerous acquisitions may maintain an executive staff with expertise in mergers charges with the responsibility of successful negotiations. Often both the buyer and seller will use the services of an investment banker to negotiate the union.

William Kross, in an article in the June 30, 1966, issue of The Commercial and Financial Chronicle, discribes the function of the investment banker as follows.

> "The investment banker acts as an intermediary, usually representing his corporate client under an exclusive commission agreement. In this capacity he performs several functions. He may initiate the transaction, act as consultant to management in the formulation of plans and in the determination of price and other matters, and assist in negotiations. In order to appraise value properly, he usually prepares an in-depth institutional report on the company and its industry which he also uses with potential buyers or sellers. By

performing these and other functions, the investment banker distinguishes himself from the finder and the mortgage banker."[1]

What ever the method used, successful bargaining is the result of extensive planning by both parties. Environmental factors and internal conditions will also influence the merger process.

The buyer. External growth should be the result of well defined objectives and goals that have been determined in the company's long range planning.[2] The objectives may include diversifying product lines, increasing capacity, stabilizing business fluctuations, expanding market coverage, insuring sources of supplies, acquiring needed talent, utilizing idle capital, and increasing earnings by taking advantage of high price earnings multiples or by the use of leverage by floating bonds or preference stock.

The decision to buy a company should come only after weighing other possible alternatives. These may be the expansion of existing markets for existing products, investing in new products developed internally through research, or investing in a completely new business activity.

Part of the decision to buy should include the evaluation of possible advantages relative to corresponding disadvantages. For example, some of the time saving expected as a result of the merger will be lost in the period of adjustment and co-ordination following the merger. In order to gain the desired profits expected as the result of a merger the acquiring company may pay a premium for the acquired firm and dilute its own stock in the process. In its quest for technical knowledge or management talent, the acquiring company may be overlooking possible anti-trust trouble, labor unrest, or other problems of "fit." Without careful planning, the advantages the acquiring company expects to gain to solve present problems may be at the expense of long-term difficulties as the result of the merger.

The premium required for a profitable company may lower the acquiring company's return on investment to a point where it could be more profitable for the company to start a new business. As in any new venture, the start up and development costs may be extremely high. There is also risk involved in entering a new market. Therefore the premium could be considered a kind of insurance against the risks involved in starting a new business and a small price to pay for an established share of the market. If the investor feels a premium is being paid he should analyze the company's motives and purpose before rendering a judgment.

Once a company has defined its goals and has determined that its objectives will be reached through mergers and acquisitions it should set specific criteria for merger candidates. The following is a list of the major factors to be considered in screening and evaluating acquisition candidates.[3]

Financial and profit condition	Quality of management
Degree of technology	Labor relations
Size of acquisition	Marketing capability
Growth potential	Price earnings ratio
Synergy value	Production capability

Even after the acquiring company has determined its needs in specific terms of product, market, management, or technology, the screening process can be difficult and time-consuming. John Brooks, the president and chairman of Lear Siegler, has stated that for every merger that is completed he starts with a list of about 60 companies and studies some of them for as long as a year before a decision to merger is made.[4]

The seller. Once a company has decided to sell, the procedure to find a buyer involves much of the same type of planning and screening as was described for the buyer. The seller must evaluate his strengths and weaknesses and determine what type of company could benefit from what he has to offer.

Some of the reasons behind a company's decision to sell include providing for management succession, following the advice of investment bankers or management consultants, providing the financial backing necessary for development of technology, or providing for the payment of estate taxes as may be the case in a situation involving a small or family-owned business. Harry E. Figgie, Jr., the chairman of "Automatic" Sprinkler Corporation summed up the position of the small businessman with the following statement.

> "The entire structure of the tax system and of our economy is against the little man. He has to sell through agents, and they can dominate a little company. He has great difficulty in getting financing because the respectable securities houses now often do not want to look at any little guy. Finally, if he is successful and does build up an independent company, estate taxes force him to sell in the end."[5]

II. PAYMENT AND NEGOTIATIONS

Obviously the method and amount of payment will, in the last analysis, be the most important factor to be considered by both the buyer and seller before a merger can be agreed upon.

<u>Determining value</u>. There is no standard formula for finding the amount one company will be willing to pay for another, or for finding the amount the seller will be willing to accept. The acquiring company will be trying to fix a price for what it is buying in terms of the selling company's management, the industry outlook, and the company's position in the industry, the competitive environment, the companies sources of supply, its financial position, its labor conditions, and the value of its patents and copyrights.[6] The seller will compare the buyer's offer to what it has determined it is worth and to other offers from other potential buyers.

The valuation process usually begins with finding a point or amount to work from, such as the selling company's book value. This amount is then adjusted for the company's earnings outlook and growth potential as compared with other companies in the industry. The book value or starting figure may then be further adjusted or capitalized at a desired rate of return based on earnings. Often the buyer and seller will agree to using the company's market value as of a given date or its average market value over a period of time. The method of payment may also influence the price to be agreed upon.

<u>Method of payment</u>. Payment may be in a lump sum made up of securities or cash or a combination of both, or it may be on a deferred basis with the amount to be paid in installments or to be contingent upon some performance test. In 1967, 60% of all mergers were for stock.

36% for cash, and 4% were paid for with a combination of stock and cash. In 1966, just the reverse was true, 60% were for cash, 35% for stock, and 5% were on a combination basis.[7] This may be explained in part by the high price/earnings ratios many merger-minded, growth-oriented companies enjoyed during 1967, making payment in stock relatively pointless. The average price earnings ratio paid in 1967 was 17.6.[8]

Stock versus cash. Payment in stock or other securities usually gives the seller the advantage of deferring tax liabilities. Cash payments would require immediate payment of taxes on any gains realized. This fact may induce the seller to accept securities having a total market value lower than the amount of cash that would otherwise be acceptable.[9] The seller may also want securities, anticipating their future growth.

The buyer may want to pay in cash in order to invest excess cash, or to keep from diluting earnings. For example, if the company to be acquired is selling at ten times its earnings of one dollar per share, the buyer can well afford to borrow the money needed at 6% or more. The acquiring company can buy $1 worth of annual earnings for $10, and pays only 60 cents interest a year, or less than 30 cents after taxes, for the $1 In earnings.[10]

The analyst will need to determine the effects payment in either stock or cash will have on the acquiring company's future earnings. If payment is in securities he should be aware of possible earnings dilution. If payment is in cash he will need to consider the effects of added debt, if any, relative to the amount of added earnings that result from the merger.

<u>Summary</u>. The analyst should determine rather or not a company's merger activity is the result of long range planning and direction. The buyer should be acting from a merger strategy that defines specific criteria for merger candidates, and mergers should be evaluated against other alternatives that could be considered to meet the company's goals. The analyst should measure the "insurance" effects of possible premium paid for an acquired company when evaluating the costs of a merger. The advantages to be gained from a merger should be considered relative to possible problems arising as a result of the merger. The analyst should also project the effects the method of payment will have on the future earnings of the acquiring company, realizing that payment in securities may dilute future earnings and that cash payments may create an excess debt burden for the acquiring company.

FOOTNOTES FOR CHAPTER VI

[1]William F. Krass, "Value Determination for Mergers and Acquisitions," The Commercial and Financial Chronicle, June 30, 1966, p. 12.

[2]John J. Fox, "Strategies in the Approach to Mergers and Acquisitions," Lybrand Journal, 48:3, 1967, p.6.

[3]John S. Gilmore, and Dean C. Coddington, "Diversification Guides for Defense Firms," Harvard Business Review, (May - June, 1966), p.130.

[4]"Management Techniques for a Conglomerate," Investor's Reader, (January 24, 1968), p. 27.

[5]"Corporations: Where the Game is Growth," Business Week, September 30, 1967), p. 119.

[6]Krass, op. cit., p. 12.

[7]A. J. Naylor, "Last Year's Mergers Reach New Heights," Investment Dealers' Digest, (January 13, 1968), p. 2.

[8]Ibid., p. 74.

[9]Arthur R. Wyatt, "A Critical Study of Accounting for Business Combinations," A Report Prepared by the American Institute of Certified Public Accountants (New York: 1963), p. 93.

[10]Gilbert Burch, "The Perils of the Multi-Market Corporation," Fortune, (February, 1967), p. 132.

CHAPTER VII

ANALYZING AND INVESTING IN CONGLOMERATES

Security analysis begins with a basic approach such as that found in the "Graham and Dodd"[1] test. Conglomerate analysis, the subject of this thesis, continues this technique to include the problems pertinent to this type of corporation. This chapter briefly reviews the basic approach, and from this base, explores the methods used by some of the professional analysts who deal with conglomerates, discusses the special importance of management and other problems found in conglomerates, and looks at the performance record of conglomerates as a group.

I. THE BASICS

The investor must determine what his objectives are and what he wants or expects from his investments. He starts by determining how much income and/or growth he wants relative to the risks he is willing to assume. He realizes that there is usually less risk in bonds than in equities, and less risk with larger well established companies than with newer and emerging companies.

<u>The industry</u>. The analysis process begins with a look at the whole economic environment and then focuses on those industries that are expected to benefit the most from current economic conditions. Industries are studied by reviewing past and projected growth patterns, the stability of sales and earnings, the degree of permanence in the

industry, the competitive conditions characteristic to the industry, the labor conditions typical of the industry, the government attitudes and regulations effecting the industry, and the immediate or short-term outlook for sales and earnings for the industry.

The company. After the more promising industries have been determined, the analysts must begin to study the individual companies that make up the industry. The size, prestige, leadership, and dominance of the company are considered in order to put it in perspective relative to its competition. The more concrete factors that are considered include the company's brands and patents, its assets and operating situation, its costs, overhead, and profit margins, its working capital position, and its capital structure. The basic intangible factors that are considered include the company's growth rates, its diversification, its sales and earnings outlook and their degree of stability, its dividend record and outlook, and its management situation.

The securities. After the general characteristics of the firm's competitive, operating, and financial conditions have been determined, the analysts determine the strength of the company's individual secutities. The analyst may choose to examine the individual securities before analyzing the company, in depth, in order to provide a basic or preliminary indication of the marketability of these securities. By doing this the analyst may be able to eliminate companies whose securities do not meet the requirements necessary for good investor acceptance due to declining earnings, excessive leverage, or extremely high price/earnings ratios.

Factors that are considered for common stocks include earnings per share, past, present, and expected, the price/earnings ratio, dividends and yields, the amount of leverage employed, the market price record and the company's reputation in the market. Preferred stocks and bonds are studied to determine the dividend or interest coverage, the yield, the call price, the cumulation and conversion features, the asset coverage, and their price record and market reputation.

These basic procedures are the first step in analyzing conglomerates. While they were not discussed in detail, because they are common to all security analysis, it is important for the investor to realize that an understanding of these techniques, as well as an understanding of the problems discussed in the preceeding chapters of this thesis, is necessary before a complete analysis of a conglomerate can be made.

II. CONGLOMERATE MANAGERS

A conglomerate's management is both the guiding force directing the company's daily operations and the catalyst required to bring about the synergistic benefits derived from the company's varied fields of endeavor. Of all the factors that should be considered in arriving at an investment decision concerning a conglomerate, the quality and ability of the corporation's management is the most important factor, and the one that can have the greatest effect on the future of the company.

Management has two methods to bring about the growth necessary for good market acceptance and performance. First, the company can grow internally by expanding sales and improving operations, and secondly, growth can be external or through mergers and acquisitions. Walter Kidde's management is dedicated to increasing earnings by 25 to 30% per year.[2] Half of Kidde's growth is expected to come from internal improvements and half from acquisitions. The analyst's problem is to try to determine if the company can reach its stated goals. To do this the company's management must be evaluated.

Evaluating management. The analyst can judge management by their past performance relative to past conditions, and predict future performance by what he has learned of the company, and relate this to his forecasts for future conditions. The U.S. Trust Company suggests the six points listed below be used for evaluating conglomerate managements.[3]

1. The company's record of performance - in terms of the number of successfully completed acquisitions.

2. The methods employed to finance acquisitions, and the effect the financing has on the company's capital structure, and the amount of dilution introduced as a result of acquisitions.

3. The importance of acquisitions on the company's growth rate, with internal growth being considered the better indicator of management capability.

4. The depth of management - the domination by a single man or only a few men being potentially vulnerable.

5. The company's willingness to exploit opportunities in any area.

6. The company's willingness to prune operations that are not up to standard.

By considering these six points the analyst can begin to get a feel as to what can be expected from a company's management based on what they have done in the past. The February, 1967 issue of <u>Fortune</u>[4] points out that the conglomerate justifies its existence only if its divisions perform better and more efficiently as divisions than they could as independent companies. The performance is a reflection of management's abilities and provides a basis from which the analyst can make judgments about the company under consideration.

III. OTHER PROBLEMS OF ANALYSIS

The conglomerate analyst, besides being aware of the broad factors discussed in the preceeding chapters, must also be aware of the more subtle idiosyncrasies common to the conglomerate form of corporation. For example there may be more safety in a conglomerate using conservative accounting practices than in one using more liberal methods. The conservative accounting may be used as a hedge against hard times allowing the company to liberalize it accounting or "manufacture" earnings to maintain growth rates. The analyst will also discover that the most successful conglomerates, in terms of market price appreciation (and vulnerability), tend to be the relatively new companies that chose the multi-industry approach early in their corporate life and have developed in areas involving high technology, rather than the older companies that have diversified in response to problems as a defensive maneuver.[5] Other problems include distortions caused by acquisitions, the question of growth rate maintance, and dilution problems.

Acquisition distortions. A conglomerate's acquisitions may make year to year comparisons and past performance measurements difficult to find and questionable to use. Because of the many industries that may be involved, the diversified markets, and the varying rates of profitability among a company's divisions, the analyst may not be able to separate the company's operations to a degree that would allow meaningful comparisons to be made. Acquisition programs also reduce the usefulness of forecasts, curtail the use of past performance as a guide, and may introduce the need to reconcile the accounting methods used by the acquired and acquiring companies.

In a April, 1967 market letter, E. F. Hutton and Company addressed itself to this problem in the following manner.

> "Agressive acquisition programs, particularly when unrelated industries are being entered, tend to unsettle company fundamentals.... Under such volatile conditions it is virtually impossible for investors or even trained security analysts to make accurate earnings projections. At the same time, most of these companies do not fit logically into any one specific industry, thus making 'normal' price/earnings ratio ranges unattainable."[6]

It can be seen that the analyst may be required to make subjective judgments about the future of a conglomerate. These judgments should, however, prove to be reasonable forecasts if they are based on objective and factual data gathered in the process of analyzing the company to the degree possible.

Growth rates. It is reasonable to assume that the higher the growth rate being experienced by a company the harder it will be for that company to maintain its rate of growth. This is because of the ever-increasing size and magnitude of the expansion involved. Consider the million dollar company. It can acquire another million dollar company and double its size. When it has grown to a billion dollar company it takes the equivalent of 1,000 million dollar companies to double its size again through external expansion.

Lear Siegler has doubled its sales in the past 13 years six times, growing from $6,500,000 in 1954 to $402,000,000 in 1967.[7] This growth included 40 acquisitions during the period. If the company were to experience the same rate of growth during the next 13 years, i.e. doubling its sales six times, by 1980 Lear Siegler would have sales of about 25 billion. This example points out that part of the analyst's function will be to determine when the growth rates of rapidly expanding companies can be expected to level off. The investor should realize that while above-average growth rates may command a premium in the market, at some point in the future the growth rates will be reduced and this will be reflected in the price/earnings multiple the market will put on the company's stock.

Dilution. In computing the future earnings of a company the analyst must consider any possible dilution that can result from the conversion of outstanding convertible securities. Often part of a merger agreement will include a provision for payment to be in the form of convertible preferred stock or convertible bonds. As these securities are converted the companies earnings must be spread over a greater number of common shares. Earnings projections should be made on the basis of stock presently outstanding, and on a fully diluted basis.

Lear Siegler provides an example of the impact of dilution. As of January 1968 the company had 4,700,000 shares of common stock, earning \$2.25 per share, and 750,000 shares of \$4.50 convertible preferred stock outstanding. The preferred stock is convertible into 2½ shares of common. Therefore if all the preferred was converted it would increase the common stock by 45$. The dilution resulting from the conversion would be much less due to the elimination of the \$4.50 preferred dividend on the 750,000 shares of preferred stock. Full conversion would have lowered fiscal 1967 earnings per common share by 14¢ to \$2.11.[8] As this example shows the impact of dilution should be considered in the analysis of conglomerates when future earnings are being forecasted.

IV. HOW THE PROFESSIONALS DO IT

Because of the newness of conglomerates there is no generally accepted method use in their analysis. Equity Research Associates, for instance, does much of the analysis according to their industry or origin, i.e. Litton Industries is considered in the electroncis industry; International Telephone and Telegraph is considered in the communications industry.[9] Equity Research however does not stop there, realizing that a conglomerate is more than a representative of any one industry. Bear, Stearns and Company approach conglomerates as a team effort guided by the analyst who is studying the company's management.[10] The management analyst calls on the various industry specialists for their appraisal of the conglomerate's parts. Cyrus J. Lawrence and

Sons approach the problem using four basic criteria as a supplement to their normal analysis. These include:

1. The extent and effectiveness of financial administration controls.
2. The potential for creation or maintenance of earnings momentum from existing operations.
3. Acquisition philosophy and methodology.
4. How the corporation desires to be evaluated by the investing community.[11]

Cyrus J. Lawrence and Sons expect a good deal of judgment to be used because, as they point out, the analyst can not capitalize acquisition potential, or measure intangibles such as good management, or really explore and comprehend the maze of a conglomerate operation.[12]

The U. S. Trust Company's method is to consider each component and weigh it in relation to the total, and to consider the rate of profitability of the components to the industry with which they are most closely related. They then make a judgment as to the degree of risk and growth potential relative to the conglomerates current price/earnings ratio. U. S. Trust also agrees that the management factor is all important in the total analysis.[13]

The October 1, 1967 issue of Forbes cautioned against predicting earnings from an analysis of a company's parts because this approach tends to leave out the essential part - management.[14] In the same article the conglomerate analyst from E. F. Hutton agreed and pointed out that earnings will depend on future acquisitions which will again require a judgment on the company's management.

The Robert K. Mautz study for the Financial Executives Institute found, in the responses of questionnaires from analysts, that the majority tried to analyze on a segmented basis.[15] This is the approach used by the First Manhattan Company where the conglomerate is divided into profit centers contributing 10 to 15% of net profit.[16]

These illustrations point out that, while there is no universally accepted method used for conglomerate analysis, there is some agreement in trying to analyze the company by its parts. They also point out that analysis by parts will only be valid if a proper judgment on the company's management is rendered.

V. CONGLOMERATE PERFORMANCE

A knowledge of the market record of the conglomerates should provide some insight into their future performance. It should be noted, however, that past performance is just that, and future performance will be influenced by future conditions.

Are conglomerates synonymous with growth? The June 15, 1967 issue of *Fortune* related that their findings, from a study on the earnings growth of the "500" largest United States corporations, showed that as a group conglomerate earnings grew about the same as those for lesser diversified and single industry companies. The study also showed that a select group of high-technology, acquisition oriented, conglomerates did out-perform the "500."[17] This illustrates that conglomerates, in and of themselves, are not a panacea for the investor. The investor will continue to need to pick and choose and will not be able to depend on a corporate structural forn for automatic investment appreciation.

Conglomerate price stability. In a study (by hindsight) carried out by Bennett S. Kopp, and reported in the March - April, 1968 issue of the Financial Analysts Journal, covering a $2\frac{1}{2}$ year period ending in November 1967, it was shown that a portfolio of conglomerates increased in price 119%.[18] The companies that made up the portfolio were FMC, General Tire and Rubber, International Telephone and Telegraph, Litton Industries, Tenneco, and Textron. The time period covered six distinctive moves of 10% or more in the Dow Jones Industrial Average. The value of the portfolio at the start of the period was $170,000 and at the end it was $372,300. The percentage changes in the portfolio at the high and low points during the period covered were as follows:

1.	plus	27.6%
2.	minus	13.2%
3.	plus	14.1%
4.	minus	11.2%
5.	plus	69.3%
6.	minus	6.7%

The point that the investor can gain from Mr. Kopp's study is that conglomerates are not insulated against general market fluctuations. Furthermore, as the following list shows, price drops can be quite dramatic.

Percent declines in prices as of March 1, 1968, from 1967-68 highs were:[19]

Walter Kidde	- 30%
Gulf & Western Industry	- 35%
Teledyne	- 33%
"Automatic" Sprinkler	- 55%
Litton Industries	- 46%
Ling-Temco-Vought	- 44%

Contrasted to the above declines are the increases registered during the first two weeks in April, 1968. Harris Upham and Company keeps an index of twelve conglomerates which showed a gain in price of 10.1% against 7.7% for the overall market.[20]

The investor is assured of neither price stability nor growth because he has picked a conglomerate. Like any investment, success depends on the long-run results of the company's operations as reflected in its earnings.

<u>Summary</u>. The analysis of conglomerates starts with a basic approach involving a determination of current economic conditions, choosing those industries that appear to have better than average growth potential, picking the outstanding companies within the industries chosen, and fixing a value on specific securities that appear to meet the investors requirements. Of maximum importance to the analyst will be the evaluation of a conglomerate's management, as this should give the analyst some insight into the future methods of the company's operations. Special attention also needs to be given to problems of distortion caused by acquisitions, the ability of a company to maintain its rate of growth, and the

amount of dilution that could arise from conversion of outstanding securities.

The analyst has no established method by which to analyze conglomerates. Most professionals do agree that good judgments concerning the company's management are extremely important.

High-technology, acquisition-oriented conglomerates have performed very well relative to the general market in the past. The past has also shown that conglomerates are not synonymous with growth, and there has been no protection against price fluctuations.

FOOTNOTES FOR CHAPTER VII

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[2]E. T. Greef, and C. W. Fanning. "Walter Kidde and Company," A Report Prepared for the Research Department of the F. S. Smithers and Company (New York: January 22, 1968), p. 1.

[3]David Norr, From a Speech before the Phoenix Society of Financial Analysts on Accounting and Analysis, October 15, 1963, reproduced by Ralph E. Samuel and Company, (New York), p. 6.

[4]Gilbert Burch, "The Perils of the Multi-Market Corporations," Fortune, (February, 1967), p. 131.

[5]Thomas O'Hanlon, "The Old News about Conglomerates," Fortune, (June 15, 1967), p. 177.

[6]Roland B. Williams, "The Trend Toward 'Multi-Industry' Companies," A Report Prepared for the Research Department of E. F. Hutton and Company (New York: April 1967), p. 2.

[7]"Management Techniques for a Conglomerate," Investor's Reader, (January 24, 1968), p. 25.

[8]Ibid., p. 27.

[9]John Westergaard, and Richard R. Fields, "Investing in Modern Management: The 'Free-Form' Corporation," A Report Prepared by the Research Department of Equity Research Association (New York: September 20, 1966), p. 11.

[10]Herbert E. Goodfriend, From a Speech before a Institutional Luncheon in Detroit, February 7, 1968, sponsored by Bear, Stearns and Company (New York).

[11]Charles Stewart Goodwin, "Conglomerate Commentary," A Report Prepared by the Research Department of Cyrus J. Lawrence and Sons, (New York: January 1968), p. 2.

[12]Charles Stewart Goodwin, "Conglomerate Commentary," A Report Prepared by the Research Department of Cyrus J. Lawrence and Sons, (New York: March 1968), p. 1.

[13]Roger O. Wedekindt, "A Study of Selected Conglomerates," A Report Prepared by the Investment Department of the U. S. Trust Company (New York: October 5, 1967), p. 6.

[14]"New Breed: The Conglomerate Analyst," Forbes, (October 1, 1967), p. 60.

[15]Robert K. Mautz, "Financial Reporting by Conglomerate Companies," Financial Executive, (February 1968), p. 53.

[16]David Norr, "Conglomerate Reporting: The Analysts' Viewpoint," From a speech before the 51st Annual Convention of the American Accounting Association, State College, Pennsylvania, August 29, 1967, Reprinted by the First Manhattan Company (New York), p. 6.

[17]"The Case for Conglomerates," Fortune, (June 15, 1967), p. 163.

[18]Bennett S. Kopp, "Conglomerates in Portfolio Management," Financial Analysts Journal, (March - April, 1968), p. 146.

[19]Goodwin, (March 1968), op. cit., p. 1.

[20]Dan Dorfman, "Heard on the Street," The Wall Street Journal, April 16, 1968, p. 26.

CHAPTER VIII

INVESTMENT ANALYSIS OF CONGLOMERATES: CONCLUSIONS

As the conglomerate form of enterprise emerged into a powerful economic force in the 1960's, the investment analyst was, and is, challenged to find better methods of evaluating the performance of this corporate form. While the accepted techniques of security analysis are useful and necessary, they must be supplemented with new techniques that highlight and emphasize the factors that are required for a more complete understanding of the conglomerate environment. The preceding chapters of this thesis have been concerned with the definitions leading to the understanding of these factors. The purpose of this chapter is to bring these factors together in order to provide the analyst with additional insight that can be used in the evaluation of conglomerates.

I. CONGLOMERATE DEVELOPMENT

The analyst needs to be aware of the conditions that created the need for, and enabled the development of, the conglomerate. A knowledge of these conditions will alert the analyst to possible future developments and provide him with an understanding of the factors supporting conglomerate growth.

Conglomerate growth. Conglomerates are an expression of Americas' dynamic and demanding economy, and of the modern entrepreneur who has been able to bring multiple industry operations together through mergers and acquisitions, to meet the challenges and take advantage of the opportunities present in this environment. Conglomerates can be divided into two broad groups. The first is the high-technology, acquisition-oriented type which tends to be a product of the 1960's and has usually shown better than average growth. Included in this group are the true and free form conglomerates that depend heavily on managerial ability and are willing to expand into any area that has potential for rapid growth. The second broad group includes the homogenous and cornerstone companies where growth tends to follow a logical extension of present competence. Some of the companies of this second group can trace their history back through the great merger movements around the turn of the century and during the 1920's.

The significance of the conglomerate movement today is expressed in recent merger activity, and in the operations of America's largest companies. Mergers are taking place at a current rate of almost 5000 per year, 60% of which are across industry lines. Of the "500" largest United States corporations only about 20% operate in a single industry category.

Growth environment. The present changing environment has produced both the need for a flexible and responsive corporate form and the management acumen to cope with this change. The multi-industry companies that have developed to compete in this atmosphere have done so for various reasons. Many have grown because they have been able to realize the synergistic benefits possible when one operation is combined with others to create a total equaling more than its parts. Other companies have diversified because of a recognition of the limited future in present lines or to combat seasonal fluctuations. Current expansion may also be the result of companies taking action now out of fear of future government action limiting cross-market mergers. The decision to expand may be the result of a strong financial position with an acquisition being the best alternative use for a company's funds. A high price/earnings multiple may induce a company to take advantage of the price of its stock by trading it for stock of other companies with a lower multiple. A company wanting rapid growth can often accomplish it with acquisitions to supplement its internal development. Still other companies expand to keep up with technological changes by acquiring firms with the technology they want.

II. ANALYZING CONGLOMERATES

The conglomerate analyst should be able to evaluate accounting techniques, legal implications, acquisition philosophies, and make judgments concerning a company's management. While there are no universally prescribed procedures used in conglomerate analysis the process begins with the company's published reports.

Conglomerate reporting. It is unusual when the analyst is able to get all the information he needs from published reports, but the current trend in conglomerate reporting is toward more disclosure on a divisional, product-line, or other segmented basis. This trend is the result of demands from investors and pressure from the accounting profession as well as the Security and Exchange Commission, and it is considered necessary if a proper evaluation of a company's operations is to be made.

Accounting for unions. The analyst must weigh the effects of the method used to account for corporate marriages. Combinations involving purchase accounting usually increase cash flow due to higher depreciation charges. The purchase method should be compared to the pooling-of-interest method which often increases near term earnings. The analyst must also be aware of the part leverage has played in a company's growth in order to determine the probable results a market decline would have on curtailing future growth.

Acquisitions and dilution. Acquisitions can create other problems for the analyst. First they can cause difficulty or raise questions in the use of year-to-year comparisons, and secondly they often introduce problems of dilution. The analyst should compute projected earnings on the basis of common stock currently outstanding and also on a fully diluted basis assuming all convertible securities were converted.

Anti-trust implications. The analyst should be aware of the legal environment as it applies to mergers and acquisitions. While there are no anti-conglomerate laws as such, the existing monopoly and anti-trust regulations do apply to conglomerates, and there is pressure to have them more closely regulated. If earnings projections are based on an acquisition that could be questionable from an anti-trust standpoint, this contingency should be included in the projection

Mergers and taxes. If a merger or acquisition qualifies as a tax deferred union the acquiring company may be able to pay less for the company to be acquired. Because the price one company pays for another can be influenced by the tax implications involved, the analyst should project the effects taxes will have on a proposed merger.

Merger policies. A company's external growth should be the result of definite planning and should help meet the company's predetermined needs and goals. The analyst should determine what the specific acquisition criteria of the conglomerate are and how well a proposed expansion meets the specific criteria. The advantages of the merger should be weighed against possible disadvantages arising from a lack of "fit."

The price of expansion. The analyst should calculate the effects the method of payment will have on the future operations of the acquiring conglomerate. If payment is in cash the alternative uses should be considered, as well as the effects on any increased debt as a result of the acquisition. If payment is in the form of securities, future earnings should be projected on the basis of the total amount of stock outstanding after the merger, and the effects of dilution should also be considered.

Analyzing management. Perhaps the most difficult problem in the analysis of conglomerates, as well as the most important, relates to the judgments that must be made about a company's management. Management can be evaluated in part by its past performance in terms of acquisitions, financing capabilities, the company's growth rate, the willingness to eliminate below-standard operations, and the apparent ability to exploit opportunities. But the investor is concerned with future performance and the analyst must make projections relative to the ability of management to perform in the future.

III. INVESTING IN CONGLOMERATES

The market performance record of multi-industry companies as a group has shown that the investor is not insured of above average appreciation or price stability by buying this type of company. The record has shown that acquisition-oriented conglomerates with high technology or growth goals have performed very well relative to the averages. The investor is however, still faced with the problem of choosing the best "growth" conglomerate for his purposes, and only a thorough analysis of the various alternative companies available will aid in the selection.

The conglomerate does have certain Innate characteristics that give it potential strength, and they provide the investor with other advantages that are not found in single-Industry companies. These characteristics are as follows:

1. Temporary weakness in one part of the conglomerate's operations can be offset by the strength in other divisions.
2. Conglomerates provide the flexibility to take advantage of opportunities wherever they occur.
3. Conglomerates often have the financial strength necessary for technological developments that can benefit future earnings.
4. Agressive conglomerates tend to attract superior management talent.
5. Agressive conglomerates tend to be very market conscious.
6. Conglomerates provide the investor with a mutual fund effect in that they operate in more than one industry.

7. The small investor can diversify by buying a few conglomerates relative to buying single-industry companies.
8. The recognized "growth" conglomerates have out-performed the averages.

Because the modern conglomerate meets the needs of the increasingly demanding American economy, this corporate form should continue to be an expanding and developing phenomenon. For this reason the investment opportunities should be at least as fruitful in the future as they have been in the past if the analyst develops and uses the techniques necessary to evaluate conglomerate performance accurately.

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