Implications of Conglomerate Mergers to Food Distribution in the 1970's

Discussant - Agricultural Economist

Food 70's

Dr. Paul E. Nelson Jr.
Leader Input Marketing Research Group
Marketing Economics Division
Economic Research Service
U. S. Department of Agriculture

Agreement and Enlargement

> - - - - there has yet to emerge an extensive literature of sound, timely merger and acquisition reference material. 2/

Depew's belief is more than justified when it is applied to the broader field of the economics of conglomerate growth. Thus Professor Stout deserves special commendation for providing new insights into this tangled web of economic relationships. He will be among the first to applaud new research to test both his explanatory propositions, and the implications which logically flow from them.

Specifically, Stout delineates nine explanatory propositions, and from them draws six implications of sufficient breadth to cover any industry. Time and space limitations preclude detailed comments upon each. Since I find myself in fundamental agreement my remarks primarily will flesh out his propositions and implications. In short, if Stout has sinned, his sins represent those of omission, not commission.

Explanatory Propositions

Stout correctly assesses that most of his propositions apply to horizontal and vertical, as well as to conglomerate growth. His focus upon facilitating functions as representing the "jugular vein" of the conglomerate beast clears away much of the "mystique" typical of traditional discussions of such growth. If there are unique aspects to conglomerate growth, most of them probably stem from this set of functions.

1/ Agricultural economist, ERS, USDA. These are my opinions. They do not necessarily represent either the policies or the views of the U. S. Department of Agriculture.

2/ Samuel Depew, "A Reader's Guide to Merger's and Acquisitions," Mergers and Acquisitions, 2(2) 60, Winter, 1967.

Nevertheless, these facilitating functions have also been essential for horizontal and vertical coordination. This leads to Stout's proposition concerning "timeliness." Conglomerate growth could not occur: (1) before technology had developed adequate means for information transfer; (2) before disciplines like accounting, finance, marketing and machine languages had developed conceptual foundations for analytical techniques which utilize data to provide needed answers; (3) before institutional investors had funds to enable such massive aggregations of the capital resources which conglomerate growth requires. However, these are necessary, but not sufficient conditions.

Furthermore, for conglomerates to develop we needed experience with horizontal and vertical integration, and product diversification. I stress this point because while a necessary precursor, product diversification is NOT conglomerate diversification. Conglomerate diversification consists of the joining together of disparate economic activities. And, the development of both horizontal and vertical coordination skills was prerequisite, for such coordination skills, and more, are necessary to achieve the total integration of disparate economic functions. Also, conglomerate integration has had to develop within the context of our nation's social, economic and political institutions. Hind sight suggests that all these factors combined in such a manner that the time was ripe for the conglomerate explosion during the 1960's. At least it happened. 3/

Stout hints at a possible role for institutional investors, but does not go as far as the Cabinet Committee on Price Stability when they quote Professors Baum and Stiles respecting the role of control: 4/

> - - - They (insurance cos., university endowment funds, trade union retirement funds, welfare funds etc.) possess large blocks of stock, which can strongly influence, if not ultimately determine, management action. They have the ability, expertise, to evaluate management intelligently. They have financial resources which management seeks for its capital needs, and which can be brought to bear, if necessary, against management. In sum, the institutional investors are in the position to check corporate management. To that extent, they are in the position of controllers.

In theory, they should likewise be in a position to control conglomerates, as well as non-conglomerates. I suspect this control over conglomerates may be more apparent, than real. For instance, Teledyne paid about $84 million to acquire about 2,400,000 active shares of the United Insurance Company of America through a tender offer at $35 per share. An earlier tender offer which yielded

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3/ Cabinet Committee on Price Stability. Studies by the Staff of the Cabinet on Price Stability, U.S. Government Printing Office, Wash., D.C., 1969, p. 77.

4/ Ibid. p. 54, quotes Professors Baum and Stiles from their book: Silent Partners: Institutional investors and Corporate Control, Syracuse University Press 1960, p. 159.

some 1,700,000 shares, together with the above gave Teledyne over 51% of the control. 5/ This acquisition shows the potential for inter-action between large conglomerates, and institutional investors. To date, it remains unclear when institutional and conglomerate investors meet in the securities market, which will be the dog, and which the tail.

In any case, the actions of both conglomerate and institutional investors seem associated with the type of "band wagon" effect which Stout labels, "Popularity." If these large investors act as if they have confidence in conglomerate growth their very actions will cause ripples in the Wall Street pool which will so encourage other investors to act in the same manner that the ripples become waves. Boulding calls this kind of action-reaction, "self-justified anticipation," 6/ because the investors' very actions contribute greatly toward bringing about their expectations. Of course, such expectations can work in either direction. The point is that institutional and conglomerate investors, because of their size, can trigger such market action-reaction more readily than can a host of investors, each of whom possesses only a few shares.

The financial gymnastics reported as part of the conglomerate merger surge need no additional comments beyond those Stout quotes from Professor Briloff. However, one analysis of the tender offer technique for "take over," is worth reporting because of the increasing popularity of this tatic. This report analyzes which kinds of firms are most likely to become "take over targets." 7/

> Upon examining those firms that were attached during the 1956-1965 period, we note that operating performance is the greatest single causal force contributing to a firm's attractiveness. The companies being attached simply are not performers and, for the most part, they perform below their industry, sales and earnings-wise.
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> The next greatest area of significance was dividends. The evidence was conclusive, empirically, that targets were not keeping their share holders happy via their dividend policy. We found that most take over candidates were not only paying an unsatisfactory payout of earnings, but also established the fact that dividends as a percentage of earnings posses little stability.
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> The third main factor contributing to a firm's attractiveness for take over appears to be the stock's performance in the market place. In this instance, the target's stock

5/ Unsigned report, "Mergers on Parade," Mergers and Acquisitions, 3(4) 85, July-August, 1968.
6/ Kenneth E. Boulding, Economic Analysis, Harper Brothers, New York, (3rd Edition), 1955, p.97.
7/ Douglas V. Austin, and Jay A. Fisher, "The Tender Take Over," Mergers and Acquisitions, 4(3)10, May-June, 1969.

in general, left a lot to be desired-performance-wise.

> The other variables: book values, liquidity, and the qualitative forces, all appear to be contributing to a firm's attractiveness, but in what degree is very difficult to say.

The character of the companies taken over suggests that financial rather than either economic or technical aspects dominated such actions. In these instances one is hard pressed to join such decisions to attempt to achieve "greater economies of scale."

In his discussion of economies of scale, Stout clearly shows the lack of evidence to support the idea that economies of scale are derived from using the conglomerate approach, at least as far as production-distribution activities are concerned. If economies are derived, they come from the facilitating functions which he discusses at greater length under his caption, "New Management Approach." Besides warning us not to misapply traditional concepts of economies of scale, Stout emphasizes a most important negative point: "if (economies) don't exist in significant proportions they do not constitute an appreciable barrier to entry, and entry would not burden conglomerates with diseconomies in new areas of activity." This concept neatly jibes with the fact that entry seems to be made by obtaining target firms that are not the strongest industry representatives with respect to their performance. This idea also fits the contention made by Dr. Oscar Hoffman in his Kansas City presentation to the North Central Regional Research Committee:[8/]

> It seems to me that as economists, we must accept several propositions not in accord with traditional thinking. The first is that the tendency toward larger and larger corporate enterprise is not self-corrective. Indeed, as I have tried to show, the modern corporation has a built-in motivation toward greater and greater size, not only with respect to economic factors but also the human and psychological.

If there be no further economies to be gained, so what? If the long run average total unit cost curve is essentially asymptotic to the (X) axis over an extended range, then there are no immediate diseconomies to place a constraint on company growth. While there is sparse evidence to suggest that conglomerates obtain additional economies of scale, they may extend the practical range of operation for that flat portion of the long run average total unit cost curve,

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8/ NCR 20 (Leon Garoian, Editor) Economics of Conglomerate Growth, Dr. A. C. Hoffman, "The Economic Rationale for Conglomerate Growth from a Management Perspective," Agricultural ResearchFoundation, Oregon State University, Corvallis, Oregon, Nov., 1969.

so thus, the quantity of output units where diseconomies would show is never reached. (On a particular operation the conglomerate always can divest, if it should reach it). We need more evidence, but such an extensive range of essentially constant costs would help explain why Hoffman insists that he does not see the existence of necessary "self-corrective forces" with respect to the size of corporate enterprises. Note, here we are talking about entire enterprises, not a single establishment, or even a subsidiary. The importance of this difference will be examined in the discussion of implications.

Actually, Professor Stout strips away all but three coordinated explanations of conglomerate growth. To him, conglomerates grew and will continue to grow because: (1) they can optimize managerial facilitating functions across industries, (2) utilize their combinations of distinct and disparate economic activities to hedge against three very real kinds of uncertainty, and (3) because the conglomerate system requires a new type of aggressive business thinking, uncommon to commodity oriented firms, and industries. Stout's combination makes sense. However, <u>it is the combination</u> rather than <u>any</u> of the component parts which appears unique to conglomerates. The frame of reference of the total approach is the distinguishing feature.

Two illustrations taken in combination present this "gestalt" totality. Stanley Foster Reed argues: 9/

> A conglomerate is interested solely in profits, and not "bigness, per se." They don't give a damn whether they have the lead in sales of dehydrated chicken livers for this year, or any year. They simply are interested in the RATE of growth of profits. - - - That is, earnings growth is the name of the game. Its the only way to command a high P/E.

Then, Fred R. Sullivan, Chairman of the Board of Walter Kidde and Co., goes further: 10/

> - - - in many respects the conglomerate company appears to be quite similar to the diversified company; but I submit there are essential differences.
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> - - - the diversified company seeks to diversify. Its acquisitions, and moves into new industries are DEFENSIVE moves.

9/ Stanley Foster Reed, "How Big, is Big?", <u>Mergers and Acquisitions,</u> 3(6)29, Nov.-Dec., 1968.

10/ Joseph D'aleo, "The Conglomerates: A Wall Street Appraisal," <u>Mergers and Acquisitions,</u> 3(3)53, May-June, 1968.

> The acquisition program of the conglomerate is OFFENSIVE. It is not necessarily seeking balance. Its acquisitions are not limited either to complementary fields, or to new industries. It tries to anticipate opportunities of the future-take advantage of opportunities today, wherever they may be, and whenever they make-sense.
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> - - - the diversified company--does not view a continuing acquisition program as part of its routine activities. Rather, a particular degree of corporate balance is sought; once achieved, there is no strong quest for further acquisitions.
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> The conglomerate-moves and grows with the times; changes, thrust and emphasis as times require, remains plastic, and views its acquisition program as a continuing part of its day-to-day operations.

Just as conglomerates are freed from the constraints of product and industry boundaries, so they are freed from national boundaries. True, nations have their own, unique legal "do's and don'ts," but such differences which are market related, but not market centered, offer opportunities for arbitrage, as well as for bureaucratically based irritations. Conglomerates appear unusually suited for taking advantage of institutionally based situations which are not "open market" in character. For instance, the total information network required to be most successful for covering both market and non-open market dealings, can best be provided by the kind of NASA organization which Stout suggests is analogous to at least some of the more successful conglomerates.

Implications

While I agree with Stout's implications, I wish to amplify one, and to add one. First, if conglomerates are to obtain full success from integrating disparate economic activities, they must be as ready to divest as invest. Reed argues: 11/

> While corporate America seems to have learned how to innovate internally, by supporting research programs; learned to innovate externally, by acquiring other corporations, they seem not yet to have learned to operate their companies as a portfolio of investments. Though one listens to a tiresome series of statements by conglomerate leaders that they are a mutual fund that manages its own investments, still, look at the record. You will find none of them who sell as frequently as they buy-the mark of the portfolio concept-and most of them sell off not at all.

11/Stanley Foster Reed, "Psychological Factors Affecting The Retention of Misfits and Losers in Segmental Operations," Mergers and Acquisitions, 4(1)4, Jan.-Feb., 1969.

Second, society's historic preoccupation with the size and complexity of indirect consequences stemming from actions by "big government" probably will broaden to encompass actions taken by "massive enterprises." Decisions made in conglomerate board rooms can affect local communities, thousands of miles distant. Rarely have local communities been invited to fully participate in such decisions, and the character of most decisions probably prohibits such participation. Nevertheless, the historic anti-trust concerns (pricing, profits, unfair business practices and related legislation) appear too limited in scope to apply to such growing community worries as pollution, and analogous externalities associated with manufacturing and marketing practices. The broadening of the "Public's" performance expectations appears most probable, if as Dr. Hoffman contends, "the present system is not self-corrective."

In some ways, the citizen has more "say" about what "big government" does, than he has about what "massive enterprises" decides to do. As a citizen, he has a vote, and the right to organize groups of voters to back his ideas, and candidates. Unless he owns a huge chunk of "massive enterprises," he will have the weak vote of, "not buying." Such non-purchase protests could leave him frustrated and hungry. "Massive enterprises," might better have been called, "International Everything."