Conglomerates as an Investment Option

Some of the most successful business groups in India like Reliance Industries Ltd., the Tata Group, Aditya Birla Group and Mahindra Group are conglomerates. The business model of conglomerates thrives on the principle of diversification of risk. A conglomerate enjoys an already existing customer base and can establish a new line of business with more ease than an unknown brand. Leveraging Brand Value is a major selling point for conglomerates. Apart from these, there are advantages of economies of scale and scope, easy access to capital markets etc. However, critics have always maintained that a business house should stick to its core competence and must not risk venturing into totally different business lines. It is also believed that the corporate culture of companies in different industries has its own peculiarities, thus increasing the complications of a conglomerate business. Moreover, brand building is not considered to be a strong argument in business segments where customers make better informed decisions on purchases and need not be brand loyal even across products or services. Conglomeration by merger as an option may also have its pitfalls as it is not easy to accurately value a company especially from a totally different industry. Cultural clashes and trust deficits between different managerial mindsets could also fail such mergers. This article critically analyses the business model of conglomerates and also attempts to understand the similarities among successful conglomerates. The article views conglomerates against the backdrop of different investment options.

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What Does "Conglomerate" Mean?

A Conglomerate, according to Merriam-Webster dictionary, is *"made up of parts from various sources or of various kinds"*. The word, Conglomerate, originates from the Latin word conglomerates which means *'roll together into a ball'*. A business conglomerate

is considered to be a company which is engaged in multiple and possibly unrelated business lines.

Wall Street Words, terms conglomerate as a corporation that manages unrelated businesses. The businesses invariably are in different industries and may have nothing to do with each other in terms of the products produced or for that matter, the services rendered. The main intention of forming a conglomerate is mostly to reduce overall risk by better diversification of investment, leveraging brand identity and better absorption of overhead costs. Some of the most successful business *conglomerates* in India are Reliance Industries Ltd, the Tata Group, Aditya Birla Group, Mahindra Group, etc.

Conglomerates in India

In India the trend of conglomerates began with the emergence of companies like the Tata Group, Reliance Industries Ltd., Birla Group, Bajaj etc. As on today, these companies have established themselves as major brand names in Indian business. These companies are unlike the American conglomerates of the 60s and 70s where these business houses mostly began with one business line and then expanded their businesses to other business lines. These Indian conglomerates expanded their businesses organically and gradually and generally did not prefer resorting to aggressive buying out other profitable businesses. It is believed that Indian conglomerates always have a stable and experienced top management who understood their businesses well and built them over a long period of time. These brands have always had investor confidence over the years irrespective of the cyclical business or economic trends. The Indian conglomerates have managed to build brand value and wealth very well over the years.

The main advantage that Indian conglomerates have enjoyed over the years as opposed to their counterparts in the U.S is that their growth has been significantly backed by the tremendous brand loyalty from the customers and even the retail investors to a great extent. This is probably due to the cultural difference between the people of India and the U.S., that works for the Indian conglomerates.

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What Really Makes a Conglomerate Work?

Is the concept of a conglomerate really a good business model? When many conglomerates in the U.S. failed in the 70s and the 80s how did the successful business models like Berkshire-Hathaway and Richard Branson's Virgin Group of companies do so well? What distinguishes them from the failed conglomerates? How do conglomerates from India work extremely well? What makes the Indian conglomerates a better investment option as compared to the conglomerates in the U.S.? What are the common features between them?

In the analysis that follows, the author examines the business model and theory of a conglomerate business and tries to understand the similarities of successful and not so successful conglomerates. Let us have a detailed overview of the business model of a conglomerate.

What Gives a Conglomerate a Competitive Advantage?

Diversification of risk

There is an old principle in investment: Do not put all your eggs in one basket. The business model of conglomerates thrives on this principle. When a conglomerate invests in multiple businesses, it has the option to channelise its funds towards more profitable business lines and pull funds out of less profitable ones at any point of time. A successful conglomerate understands that different businesses follow different business cycles and a conglomerate can exploit the up side of one line of business and simultaneously escape the down side of another. There could also be a situation when one arm of the business could support the others, thereby changing the very character of the conglomerate. A popular example is that of General Electric (GE) which began as a technological company in 1890 and in about 100 years almost one half of the income of GE was being generated from its financial services wing. Today, the Financial Services wing of GE's business is considered to be one of the largest in the US and has presence in over 100 countries.

Brand building

The most important common factor that brings together the businesses of a conglomerate is the brand. Customers are often loyal to a brand. When

an established brand ventures into a new line of business, it does not have to take an additional effort to build the brand. A conglomerate enjoys an already existing customer base and can establish a new line of business with greater ease than an unknown brand. Brand building is considered to be a major factor behind the success of most conglomerates of the world.

Economies of Scale and Economies of Scope

Four Factors of production in economics - Land, Labour, Capital and Management are required for all kinds of business. For any business, there are certain basic costs that are likely to be common to *all* forms and lines of businesses, e.g. offices and other infrastructure facilities, interest and other credit costs, land (owned or leased), manpower and administrative overheads. As most of these costs are fixed, it becomes easier for these to be absorbed over different businesses at any point of time. As a business organisation gets larger with more and more business, the overhead costs per unit output come down, thus helping the organisation enjoy the economies of scale. Similarly, the conglomerate also enjoys the economies of scope where *average cost of production decreases for having businesses in two or more products or services* as referred by Panzar and Willig (1977, 1981). There could always be common advantages that different product lines of a conglomerate enjoy, the most popular ones being logistical costs, common marketing, research and development expenses etc.

Better access to Capital Markets

Well-established conglomerates have easier access to capital markets given that they might have already complied with all the regulatory requirements in the course of raising capital and establishing their businesses in the past. Therefore, raising additional funds for new business lines will not be as cumbersome in the future. Having complied with the regulatory norms already in the past, turnaround time for raising additional funds (which is often considered an important factor) is also less. This leads to faster availability of funds to meet business opportunities.

Investor psychology

A prudent investor would always want to have a well diversified portfolio of investments. This is to make sure that he can reduce (if not eliminate) risk. In the 1960s and 1970s conglomerates were a popular option for investment for this very reason. Investors wished to invest in a well-established conglomerate rather than in different businesses and track each business simultaneously. Most retail investors have the money but not the time or the inclination or aptitude or skill to follow the industrial trends, company policies, profitability forecasts, regulatory aspects and the effects on the business of each and every investment that they make. They would prefer putting their money in one single diversified portfolio of business called 'conglomerate' and leave it to the experts to make profits for them.

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Flipsides of a Conglomerate

Couldn't reduced risk mean reduced return?

The other way of looking at diversification is just as you reduce risks you also reduce returns. When an established brand ventures into a new line of business or, in other words, attempts to enter the league of conglomerates, it often faces criticism from analysts and experts. Financial experts often argue that the mindset of a business house should not be like that of a retail investor. Retail investor does not have the business aptitude, time, inclination or technical expertise to assess a business. However, the same ***should not be the case*** with a business house. Business houses should have more conviction in their own business line, their business model, technical expertise, organisational and management skills than their investors. Every business line has its ups and downs but it is believed that good business always beats the market in the long run. Diversification of investments is often looked upon by critics as 'in-case-this-business-fails' approach which can be considered a negative mindset. Hence only the extremely successful and established conglomerates that have survived the test of many business cycles are looked upon as a serious investment option by retail investors. Systematic risks or market risks, as we know, cannot be avoided. A conglomerate cannot escape them in spite of all diversifications. So, diversification of risk by having different businesses does not necessarily mean elimination of all the risks.

Is Capital Mobility from one business line to another that easy?

Capital mobility from one business to another is easier said than done. Invariably, every business vertical is registered as an independent company under the Companies Act with its defined objectives to do THAT business. It is not easy to divert huge funds from one business line to another without satisfying regulatory norms. Moreover, some of the most successful multinational conglomerates will know that regulatory norms for the same industry vary from country to country. Issues like Foreign Direct Investment norms and due diligence from the local security exchange commission and regulatory authorities have their own complications. Getting past all these barriers could be time consuming. Business opportunities may not be able to wait for conglomerates to finish complying with regulatory norms. Competition is intense in today's business world. The niche players would seek opportunities to establish themselves well before the conglomerates and enjoy the first mover's advantage in the business.

Common costs, a fraction of the total

Common cost usually is a very small fraction of the total costs of any business vertical of a conglomerate. Each business vertical has its own business specifications and hence cost structure of each of these business lines would also be specific to the business. Human resources that need to manage each of the business lines would require a high level of expertise and experience specific to that business.

Organisational Structure and Group Dynamics

Organisation structure varies from business to business. One type of organisation structure may suit IT industry but may not be suitable for Real Estate business. Hence, following a consistent organisation structure across business could be complex. Further, it is often believed that each type of business has its own 'corporate culture', which has a significant bearing on the business. For example, a software company's corporate culture will be different from that of a real estate company. Mindsets and group dynamics of employees of each business vertical would be different. Large corporate houses always strive to bring about consistency in corporate culture and value systems across the entire organisation. This could be tough, as bringing about consistency in corporate culture across different business verticals could contradict the mindsets and attitudes of people in each of these verticals leading to internal conflicts.

Even when a merger or an acquisition takes place, we often observe that they can fail mainly because of cultural incompatibility between two business houses. This is true even when both companies are from the same line of business. The HP-Compaq case is considered to be an example where the merger went through a rough patch because of cultural issues. There is a possibility of different business cultures having frictions and non-cooperation. Non-cooperation follows lack of unity that affects team building and in turn the overall performance of the organisation. The top management that oversees all the business lines may not have the same level of expertise that the actual experts that manage these individual businesses have. This might even aggravate the conflict among business lines as it would be tough for the top management, given their dependency on the expert heads.

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Is "Brand advantage" really a strong argument for a conglomerate?

When you talk about new market, it may not necessarily be only in terms of product. It may also be in terms of geography. People of different regions may have different preferences for the same product. Similarly, even if people are of the same region, they may have different preferences for brands of different products. A modern day customer may be "brand loyal" towards a company as far as textiles is concerned and may be "brand loyal" towards another company as far as air travel is concerned. If the textile company starts its own airline, it may not happen that the customer who is loyal to this textile brand make a shift from his existing favourite airline to the new airline business launched by his favourite textile company. The likely reason behind this is, every business has its core competence and a company having expertise in textiles may not be able to deliver in the airline business as well as one which has a proven track record in the airline industry over the years. This, by first principles, is a fair argument.

Pattern and Traits of a Successful Conglomerate

Start with one business line and then diversify

Many successful conglomerates started with one line of business, established their competence and then moved on to another line of business with an intention of tapping their existing brand. Thus, it is harder to start a conglomerate from scratch as brand identity does not exist at all to begin with.

Slow and Steady

In spite of availability of all the experts and funds, it takes decades to establish a successful conglomerate. Hence, it is believed by many experts that investing in a conglomerate is NOT a *short term option* for an investor to get good returns even though the fundamentals of the business are good. However, conglomerates can still manage to outperform niche businesses and the concept of 'slow and steady' is by no means a rule in business. In India, there are successful conglomerates which have over the last few decades consistently outperformed the market.

Expertise, Trust and Prudence of Top management

The top management's wisdom and the intelligence of the expert managers of each business line need to work in good faith with each other. Any deficiency at this point will fail the entire organisation. The top management often leaves it totally to the experts to take a call on business decisions and experts always believe that they will get a fair share of the pie from the top. Each business line has become extremely complex and competitive. The first mover advantage in today's business is often so crucial that late business decisions sometimes are as good as bad business decisions. For a conglomerate to succeed or even survive, the top management needs to be prudent. No matter what the analysts say, it is important for the top management to be convinced about entering a business line. It is not really possible for the top management to have complete expertise in all the lines of businesses that it runs. It has to appoint and keep faith in the experts of each business line and hope that all their long term decisions are profitable. The ability of a good conglomerate is truly represented by the ability of the top management to pick the correct advice from the right set of experts, because the top management can never be more competent than all the business experts put together. The top management will be at the helm of affairs of all business lines and would need to participate in some of the most crucial decisions that each business line needs to make. They need to be smart enough to assess the opportunity and arrive at not just the right decision but also make it fast. It is the top management of the conglomerate that is responsible for the success or failure of any business line that it manages. Wisdom of the top management is a major factor that separates successful conglomerates from the rest.

Conglomerate vs. Mutual Funds

An INVESTOR could also debate that he would rather invest in a mutual fund than a conglomerate as the purpose of diversification gets served in either case. A mutual fund can juggle its portfolio even faster than a conglomerate can juggle its funds across its businesses. However, comparison between mutual fund and a conglomerate is not so simple and obvious. A conglomerate gets in and out of a business more on the basis of long term profitability of the business. These are estimated by business experts in that field. Mutual funds managers enter and exit business more on the basis of their technical analysis. They are less likely to have the same level of expertise about the long term sustainability of a business as the experts who run these businesses themselves. Mutual funds also suffer from the same kinds of market risks and do not guarantee better returns than those of a conglomerate.

How is Conglomerate by merger an option?

As we saw earlier, one of the biggest advantages that gets emphasised in conglomerate mergers is the advantage of brand building. Mergers and acquisition are considered to be faster methods of expansion. Often, we see one company acquire another company which is into a completely different line of business. The most common reasons are, enjoying synergic benefits and opportunities to diversify thereby reducing risks. We often see one conglomerate acquire another business to get exposure to completely new markets.

'Conglomerate by merger' will in any case face the same set of drawbacks of a conglomerate that is built organically. But the fundamental question that one needs to raise before considering merger as an option for a conglomerate is this: How can a company

(a) ascertain the feasibility of business in a totally different line and

(b) ascertain the fair price or fair value at which it must be bought at that point of time?

Despite the advantage of using an established brand name, exploring a business line other than one's core competence is risky enough. Trying to value and acquire an already established business and infusing a

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totally new corporate culture on to an already existing set up is a lot more complicated than just having one's own stream of new business. Conglomerate mergers become a very risky proposition for this reason. Not just that, they take the risk of jeopardising their existing business value itself. In the recent past we have seen instances where established players explored into a totally different business line with their brand name by means of a merger and did not succeed. The most common feature of some of the most successful conglomerates in India like Reliance Industries Ltd., the Tata Group, Birla Group etc., is that they are predominantly organic conglomerates where different business lines were established on the backdrop of the same corporate culture. Even the world famous Virgin Group of companies which is regarded by many as one of the greatest conglomerates has predominantly grown by way of organic growth and not by way of acquiring other established businesses.

Conclusion

From the above analysis, it is clear that there are many aspects to a successful conglomerate. One can also understand the number of pitfalls that an organisation can run into during the process of transforming itself into a conglomerate. Conglomerates are more than just about diversification of risk or economies of scale. Conglomerates need not succeed just by riding on a strong brand image into a new business line or by buying out another company from a different line of business using surplus funds. Good market for a particular line of business does not automatically mean profit opportunity for an established brand. Understanding a business line well is more important than investing without the *right kind of expertise and resources.* A conglomerate usually should have *prudent top management. Long term planning* is essential where *stability is preferred over aggressive short-sighted business decisions.* It needs a *high level of strategic planning and investment* towards building a brand name. It is about *showing the ability to grow steadily and organically* by seizing lucrative business opportunities at the right time in every business line. It also means *high level of faith and trust between the business experts and the top management* thereby cascading down a healthy corporate culture irrespective of the line of business. It also means *team spirit and co-operation* between business lines on the one hand and *healthy competition within the conglomerate* on the other.

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