

The
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Schumpeter

From alpha to omega

Conglomerates are back in fashion, but only the best will thrive

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FEW management fashions have waxed and waned quite as dramatically as that for conglomerates. From the 1960s to the 1980s business gurus praised conglomerates such as ITT of America and Hanson Trust of Britain as the highest form of capitalism. Today they routinely dismiss them as bloated anachronisms.

Companies should stick to their knitting; investors should minimise risk by investing in a portfolio of companies rather than backing corporate megalomaniacs. Peter Lynch, an investment guru, talks about “diworsification”. Stockmarkets routinely apply a sizeable “conglomerate discount” to diversified companies.

To judge by this week’s events, the mood has shifted again. Warren Buffett has been steadily and almost single-handedly restoring the popular appeal of conglomerates. And the positive reception given to the latest deal by his investment vehicle, Berkshire Hathaway, shows how he has succeeded. On August 10th the group said it would buy Precision Castparts, a maker of aerospace components, for \$37 billion, in the biggest deal in Berkshire’s 50-year history. Mr Buffett boasts of running a sprawling conglomerate that is “constantly trying to sprawl further”.

Later that day Google announced a big reorganisation in which, in effect, it admits to being a conglomerate. Larry Page and Sergey Brin, its founders, will run a holding company called Alphabet. Google’s original business—internet search and advertising—will be the largest subsidiary; its “moon-shot” projects, such as those to create driverless cars and extend human lifespans, will become separate companies within the group. A tech blogger has quipped that Alphabet is “Berkshire Hathaway for the Burning Man crowd”. Indeed, Mr Page has acknowledged that he looks to Berkshire as a model of how to run an increasingly diversified company.



Google's transformation into a conglomerate is being driven by two things: technology and cash. The company believes that information technology will transform all manner of established industries, from transport (driverless cars) to education (online courses) to homebuilding (smart thermostats and the like). This means that the company has to put its fingers into all sorts of pies. Google also has a growing cash pile that gives it the luxury to make bets on all sorts of other projects, such as creating artificial meat or delivering internet access through a network of balloons, that might come to nothing or might change the world.

Other tech billionaires are diversifying, each in his own way. Jeff Bezos's Amazon is investing in server farms and drones. He also personally owns the *Washington Post*. Mark Zuckerberg's Facebook is investing in virtual-reality equipment. Elon Musk, the boss of Tesla, an electric-car maker, has separate companies that are investing in space travel and solar-energy systems. They are treading a well-trodden path: General Electric became a conglomerate because Thomas Edison, its founder, was obsessed by electricity's capacity to transform the everyday world. GE produced its first electric fans in the 1890s and then went on to develop a full range of electric heating and cooking devices before becoming an industrial and financial behemoth.

Berkshire's steady evolution into a conglomerate is based on a different idea: that success lies in applying a consistent set of criteria when choosing acquisitions and managing them thereafter. They must be low-risk, easy for Mr Buffett and his team to understand, already be well-run and enjoy a strong market position. Mr Buffett, and his long-term partner Charlie Munger, have repeatedly demonstrated their genius for spotting and buying hidden gems. They also have a talent for giving those companies the right combination of guidance and freedom. They provide long-term capital that lets them ride out market volatility or short-term declines: Mr Buffett says that his ideal holding period is "forever". But the duo do not intervene too much: their empire of more than 300,000 employees is overseen by a team of just 24 at head office.

If GE's core competence is no longer finding new uses for electricity, it is perhaps its ability to select, train and promote general managers. Among other successful conglomerates, Koch Industries—whose interests run from oil and gas to finance, fertilisers and cattle ranching—has a secret sauce with two main ingredients: meritocracy and operational efficiency. Charles Koch, its boss, has organised the company on the principles of democratic capitalism, as laid out in his book, "The Science of Success". Workers can earn more than their bosses. High-school-educated farm boys from Kansas can rise faster than Ivy League MBAs.

The good, the bad and the discounted

The number of companies that command revolutionary technologies or brilliant management skills is limited. Many conglomerates are anachronistic and bloated: the emerging world in particular is teeming with companies that do lots of things badly rather than a few things well,

and which make up for their incompetence by courting politicians. And even the best conglomerates have to engage in a constant fight with flab. GE is trying hard to focus on a few industrial sectors (for example by buying chunks of Alstom, a French rival) and to get rid of other businesses such as NBCUniversal and GE Capital (of which it sold another chunk this week). Around 60% of the group's sales in 2001 came from businesses that it has since got rid of.

But it is now clear that you should not apply the same conglomerate discount to all diversified groups. There are now more examples than ever of a new breed of high-performing conglomerates that bear little relation to the bloated dinosaurs of old. Some possess managerial talents that allow them to achieve rapid growth in an era of stagnation. Others are led by multi-talented entrepreneurs with the ability to revolutionise old industries by applying new technologies. Focused companies may still be safer bets for many investors. But the best conglomerates have the patience and skills to end up changing the world.

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