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Conglomerates and LBO Associations: A Comparison of Organizational Forms

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Section I: Frogs and Princes

The 1980s saw the rise of a new type of M&A transaction, the leveraged buyout, or LBO. This type of transaction, in which a public company, private company, or division is bought with substantial amounts of debt financing, arose from relative obscurity at the beginning of the decade to become the most important type of transaction in the merger wave of the 1980s. Over 2300 companies or divisions were bought, with a combined value that has been estimated at well over $150 billion.[2] Throughout the decade, as complex and sophisticated debt financing techniques became increasingly available, the reach of firms organizing these transactions, and the size of deals undertaken, became immense.

An important source of assets for the LBO juggernaught was the corporate conglomerate. Throughout the 1980s, these corporations were criticized for being too diversified, too large, and essentially unmanageable. Chandler (1990) argued that unrelated diversification was an important reason for the decline of American industry in the 1970s.

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1. Harvard Business School. This paper is based on data collected from both public sources and interviews with managers in 15 companies. Most of the firms have not yet agreed to have their names disclosed, nor have they seen the results or confirmed its accuracy. We would like to thank Diana Magnani and Elizabeth Johnson for excellent research assistance, and participants in the Financial Decisions and Control Workshop (July 1994) at Harvard Business School for helpful comments.

2. Long and Ravenscraft (1991) count 2324 LBOs between 1981 and 1990. Blair and Schary (1992) report that the total value of *public company* LBOs in their sample is over $150 billion in 1982 dollars. There are many more LBOs than this, but their sample contains most of the largest.

> More serious to the long-term health of American companies and industries was the diversification movement of the 1960s—and the chain of events it helped to set off. When senior managers chose to grow through diversification—to acquire businesses in which they had few if any organizational capabilities to give them a competitive edge—they ignored the logic of managerial enterprise.

The corporate control transactions of the 1980s, and LBOs in particular, were seen by some as the antidote to this disease. A discussion of a paper by Frank Lichtenberg in *The NBER Digest* (1990) argued that:

> For most of the 1970s, productivity languished, costs soared, and domestic producers' market share shrank. In the go-go 1980s, by contrast, factory productivity rocketed. Bloated payrolls and outsize wage gains went the way of Detroit's gas guzzlers.
>
> What accounted for the turnaround? The tendency, in many . . . "corporate control transactions" to transform fat conglomerate frogs into sleek [LBO] princes—firms focused on just a few core businesses.

Implicit in the criticism of conglomerates was the notion that unrelated diversification was unproductive, that no firm could add value to such a wide variety of businesses. This view held that general management skills and the resources and systems conglomerates commanded had been overvalued and their potential efficacy overestimated. As a result, conglomerates had diversified too broadly and, in the process, squandered shareholders' wealth. LBOs, by breaking them up, were setting things straight.

While the spotlight was on the demise of highly diversified firms and the rise of leveraged-buyouts as individual transactions, a new organizational form was born: the LBO association. While leveraged-buyouts occurred as individual events, many were carried out by the same firms, the same partners, and housed in the same portfolios. After a number of years, these partnerships found themselves at the centers of industrial or retail empires, often with controlling interests in a widely diverse and highly decentralized group of companies. The LBO associations had come to resemble the very conglomerates they were supposed to be disassembling. By the end of the decade, the largest LBO associations controlled firms with sales of many billions of dollars, and would have been, if considered a single firm, among the largest and most diversified firms in the country.

This research focuses on the LBO association as an organizational form, and compares it to the conglomerate form. We attempt to get beyond the obvious differences between these forms (public versus private ownership, capital structure) and explore the acquisition strategies of each type of organization, their structure and governance, and how they control and manage their operating units. The central thrust of our inquiry is: what is the role of the "headquarters" in each of these organizational forms, and how (if at all) does headquarters add value to the operating units which they control? Our main results are:

- The conglomerates and LBO associations in our sample are comparably diversified; if anything the LBO associations are more diversified. Thus the argument that "no firm can add value to such a wide variety of businesses" must be examined more closely.

- Both organizations grow by acquisition, but only the LBO associations regularly divest their operating units. Indeed, the LBO associations are practically forced to divest by the legal requirements of the limited partnerships through which they raise their funds. This difference has important implications for how the two forms operate and are structured.

- Both organizational forms rely on substantial use of pay-for-performance as part of their management compensation system, but the LBO associations are able to use a kind of high-powered incentive, the ownership of levered equity in the operating unit, unavailable to the conglomerates. The fact that LBO associations regularly divest their units is crucial to the value of this incentive mechanism.

- Much of the value created by the LBO associations happens at the time of "the deal." This value results from a stringent set of external, legally enforceable contracts which form the operating budgets and control systems for the operating units for years after the deal is closed. We argue that the relative difficulty of renegotiation of these contracts compared with the more open-ended arrangements in place in the conglomerates provides insight into the relative strengths and weaknesses of the two forms.

Perhaps the most important generalization to be drawn from this research relates to how and when the two headquarters organizations add value to their operating units. We argue that the LBO associations essentially "outsource" much of the control system, using debt and its associated covenants and repayment requirements to serve as the operating budget, and using management equity ownership as a kind of externally guaranteed "bonus plan." Our labeling of the control system as outsourced should not be taken to imply that the LBO associations do not add value: the appropriate structuring of the deal that sets these externally enforced contracts in place is essential to the success of the LBO association.

In contrast, most of the conglomerates in our sample are deeply involved in the design, implementation, and ongoing adjustment of the control systems that they use to monitor their operating units. They are involved in budgeting and compensation decisions, and retain the flexibility to alter the course of their operating units at lower cost than is possible for the LBO associations.

The paper proceeds as follows. In Section II, we discuss the sample of firms that we use to study these two organizational forms, and how the sample was selected. In Section III, we look at the patterns of acquisitions and diversification for the two groups, while Section IV explores their divestiture policies. Section V examines governance of the LBO associations and conglomerates. Section VI explores how each controls and provides incentives to managers of the operating units. Section VII concludes by exploring how and when these headquarters organizations add value to their operating units.

Section II: Sample and Sample Selection

Our sample consists of 7 conglomerates and 7 LBO associations.[3] The conglomerates range in size from about $400 million to about $3 billion in sales. Figure 1 shows the sales, assets, and employees of our seven conglomerates in 1992. Obtaining comparable numbers for the LBO associations is not straight forward. None of the LBO associations in our sample publish aggregate revenues, assets, or employment for their portfolio of companies. Indeed, they do not think of themselves, nor do they want the world to think of them, as a single entity. We have collected data on the 1992 sales for six of the LBO associations in our sample.[4] As Figure 1 shows, with one exception the LBO associations in our sample have roughly the same revenues as our conglomerates.[5]

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3. We have interviewed partners from 8 LBO associations for this study, and have collected very similar data on one other for an earlier project. However, we do not have complete data from all firms that we interviewed.

4. One sample firm would not provide us with this information.

5. The one exception, with revenues of $46 billion, would have been number 8 on the Fortune 500 in 1992.

To conduct this comparative study, we had to identify samples of each organizational type. The questions of greatest interest to us were qualitative in nature, and related to top-level management practices. Arms-length, large sample research, therefore, was not an option, nor did we want to limit the analysis to a comparison of a single LBO with a single conglomerate. Site selection in that instance would simply weigh too heavily in the results. Instead, we opted to gather information from a small number of each organizational type.

The LBO associations were selected by the following process. We began with the December 1989 issue of *Corporate Finance*, which published a list of the largest LBO funds then in existence. We took the top 56 firms from this list, those with funds greater than $100 million. From this list we excluded all LBO firms that were part of larger, more full-service investment banks, such as the merchant banking groups from Morgan Stanley, Goldman Sachs, First Boston, etc. We eliminated these firms because we felt that the governance of such departments in larger investment banks would differ fundamentally from that of stand-alone LBO firms.

Of the remaining firms—about 25—slightly less than half agreed to talk with us. We interviewed partners in eight of these firms, and then stopped because we felt that we were not learning very much that was new from each additional firm. There are still four firms on our list who have agreed to talk to us, but with whom we have not yet spoken.

Identifying the conglomerates was a less straight-forward task. We quickly learned that there was no commonly agreed-to definition of conglomerate, and little overlap across various listings of so-called conglomerate firms. A journalist at a prominent business publication explained this by saying that his magazine used the conglomerate listing as a residual category. Firms classified therein were those that didn't fit elsewhere.

We adopted a definition of conglomerate that is commonly used in business strategy research: a conglomerate is "a company that has rapidly diversified into several unrelated areas by means of a relatively large number of mergers and acquisitions." (Rumelt 1974) In the spirit of this definition, we looked for companies where a high percentage of their assets were acquired rather than developed internally. This rule obviously favored conglomerates that were active recent acquirers. It tended to exclude very large, older conglomerates like ITT that by 1992, had substantial revenues as a result of internal growth.

We also looked for companies whose corporate headquarters had been explicitly designed to manage unrelated diversification. Our aim was to investigate the management of unrelated diversification in "pure form," that is where the systems and context had been created with that intention. We would expect, therefore, that our sample is not representative of companies that have partially drifted into diversification, with vestiges of past strategies and systems influencing their current ways of managing. This criterion also excluded some very diversified firms such as General Electric, whose explicit strategy is to buy and grow interrelated businesses.

To identify the sample, we searched on-line data bases under the heading "conglomerate"; *Nelson's Directory of Investment Research 1991*; *Business Week's* listings of conglomerates in 1990 and 1991, and talked with analysts at Blackstone and Heller. This process yielded a group of 23 firms that fit our criteria. Of these nine agreed to participate; we have spoken with seven.

We conducted interviews ranging in length from two to five hours at each of the 15 sites. In the LBOs these were done with one of the partners of the firm and, in the conglomerates, with the Chief Executive Officer, and sometimes other members of the executive group.

Section III: Patterns of Diversification and Acquisitions Strategy

Figures 2 and 3 show the number of acquisitions and divestitures of the conglomerates and LBOs in our sample.[6] As can be seen, both groups are acquisitive; several of the conglomerates have made over 50 acquisitions in the past 30 years. These figures also make clear that the conglomerates in our sample are older than the LBO associations; with one exception, all of the conglomerates have been around since before 1970, while none of the LBO associations made any deals before 1973.

As described above, the conglomerate sample was, in part, defined by its high level of unrelated diversification. This diversification often came from multiple "core" businesses that had little or nothing to do with one another. In these firms, acquisitions were sometimes of related units that complemented an existing core business, or unrelated

6. Our data for these figures from the LBO associations is incomplete. However, we are confident that our conclusions are qualitatively accurate.

units that brought a new core to the firm. The complementary acquisitions offered the possibility of synergistic integration and consolidation with existing core businesses.

In defining the sample of LBO associations, no constraints were placed on the firm's level of diversification. However, like the conglomerates, most LBOs proved to have very high levels of unrelated diversification. (Two notable exceptions to this will be discussed later.) Table 1 lists the businesses of one LBO association, which is typical.[7] At the level of the individual business unit, LBO firms tended to exhibit even more diversification than the conglomerates. Indeed, our interviews with the managers of LBO associations indicated that they had little in the way of strategic vision with respect to their acquisition strategy, as least as far as its industrial mix was concerned. To the extent that there were patterns in the industrial mix of acquisitions by the LBO associations, they appeared to be the result of the "deal flow." It is clear that the LBO associations get into the deal flow in some industries, develop reputations, and thus become more likely to participate (and successfully execute) transactions in industries in which they have been active in the past.

Typical were the comments of one LBO association manager, whose portfolio was substantially less diversified than many:

> We really don't have strong preferences about industries. While many of our acquisitions have been in one industry, 8 out of 15 are outside this industry. We are victims of our reputation in that industry; we see every deal that comes through. But we will consider anything with certain characteristics: high service content, high value added, non-manufacturing. We aren't into metal-bending, but other than that ....

Conglomerates and LBO associations also differ significantly in how they manage for between-unit synergies. While the conglomerates had few resource flows across groups of businesses, within groups there were some attempts to achieve operating and management synergies. Most conglomerates reported that some of their acquisitions were companies that complemented their existing businesses. In these cases the firms were willing to expend significant resources to consolidate and integrate the businesses in order to achieve some economies of scale or scope.

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7. We are in the process of obtaining the data to calculate standard continuous measures of diversification (based on 4-digit SIC codes) for both the conglomerate and LBO samples.

Table 1

Date Acquired	Industry
1983	Manufacturer of premixed food ingredients
1983	Radio station operator
1984	Bookstore operator
1985	Footwear retail
1985	Jewelry retail
1985	Manufacturer of specialty products for glass manufacturers
1985	Manufacturer of wheel-barrows
1986	Cranberry supplier
1986	Electrical products
1986	Men's clothing
1986	Roofing products
1987	Design, manufacture and marketing of indoor carpeting
1987	Manufacturer of automotive products
1987	Oil & gas exploration
1987	Radio station operator
1987	Railroad operator
1987	Waste management
1988	Manufacturer of food products for fast food industry
1988	Manufacturer of pipe products
1988	Manufacturer of trigger sprayers
1989	Contractual printing services
1989	Manufacturer of underground storage tanks
1989	Retailer
1990	Eyewear retail
1990	Packaging equipment
1991	Manufacturer of air conditioners, awnings
1991	Manufacturer of sports apparel
1991	Tissue paper products
1992	Beer distributor
1992	Quick-service food chain

The LBO associations, in contrast, make no attempt to foster synergies across portfolio firms. The units are bought as separate units, and run as totally independent companies, with no opportunities for cross-subsidization or synergistic integration. Indeed, one LBO association has bought many supermarkets, presenting a clear opportunity for the consolidation of purchasing in order to achieve greater bargaining power with food producers and packagers. However, they have done no centralization of purchasing what-so-ever. Each chain is run completely independently.

Another LBO association owns retail food and convenience stores and several food and consumer packaged goods companies. There are definitely opportunities for significant buyer and seller relationships between the units of this firm. However, this LBO association did nothing to encourage transactions or cooperation between the businesses.

Said a partner of this firm: "We do not even know if any of our portfolio companies buy products from any of our other companies."

Section IV: Divestitures

Both the LBO associations and conglomerates claim to be active acquirers and divestors. Figures 2 and 3, however, reveal the striking fact that while the LBO associations buy and sell companies, the conglomerates only buy. On average, conglomerates have sold only 13% of all the companies they have bought in the last 40 years, and only 10% of those bought since 1970, while the LBO associations have sold 51% percent.

One of the most important reasons that LBO associations sell their portfolio companies in a fairly short time is that the limited partnership agreements under which these firms raise equity force them to. The money that LBO associations use as the equity funding for their acquisitions comes from investors who participate in a limited partnership set up to make such investments.[8] One of the restrictions on such limited partnerships is a limited life: they must be dissolved within a fixed time, usually 7 to 10 years. This means that the LBO association must pay off the limited partners and close down the partnership.[9] The primary way that LBO associations do this is to sell their equity stake in the companies owned by investors in the dissolving fund.[10] That LBO associations sell their units quickly suggests that whatever value the headquarters brings to the operating units is realized in a fairly short time. We will argue below that this is indeed true.

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8. The LBO association serves as the general partner.

9. Since the LBO associations raise several overlapping funds, the closing of one limited partnership does not mean the closing of the LBO association. At any one moment in time, an LBO association may be investing in and managing companies whose investors include participants in as many as three or four separate equity funds.

10. It is important to note in this context that the fact that the LBO association sells the unit does not mean that unit ceases to be a private company or an LBO. Indeed, while there has been no systematic study of disposition of companies sold by LBO associations, Kaplan (1991) has found that over half of all large LBOs were still private after as long as ten years. Many of these companies had been sold by their original sponsor and releveraged in a subsequent transaction. Such a sale is usually undertaken by a firm that has paid down much of its debt, shows a large (non-liquid) capital gain on its equity, and wants to provide liquidity for its original equity investors. In this case, the old equity can be bought by a new LBO sponsor, often in concert with a new, perhaps younger management team. The old equity is bought with cash generated by releveraging the company. Thus, the new company has an ownership and capital structure much like that when the company first went private: all that has changed is the identity of the equity (and often the debt) investors.

Most of the conglomerate managers in our sample repeatedly claimed that they were not emotionally attached to the businesses in their portfolios, and would be willing to sell any one of them at any time. Despite these views, the "buy and sell" strategy was explicitly not pursued by these firms. A writer commenting on one of these conglomerates observed that it was "an opportunistic buyer, but a reluctant seller, of businesses." This description fits well with most of the conglomerates in the sample.[11]

In contrast to LBO associations where the explicit intention is to sell both successful and unsuccessful units, conglomerates, in practice, tend to sell only those units that prove through time to be unsuccessful. So long as a unit continues to meet the conglomerate's profit hurdles, it is unlikely it will be sold.

Conglomerate managers gave several reasons for their reluctance to sell units that they had bought. Perhaps the most frequently mentioned was the tax disadvantage that managers claimed they faced when considering selling a division. The tax consequences of selling a division whose book value is low (due to years of possibly accelerated depreciation) are simple: the company is forced to pay a depreciation recapture (at ordinary income rates) and a capital gains tax immediately upon the sale of the division. This tax expense occurs immediately upon sale, and could be deferred indefinitely by keeping the division and retaining or paying out the profits from the division. However, this tax benefit is largely offset by the fact that any buyer of the division can step-up the tax basis of the division, and receive tax benefits (unavailable to the seller) by re-depreciating the assets. Thus the only tax disadvantage that accompanies selling a depreciated asset is a slight timing one: the seller must pay an immediate tax while the buyer receives the tax benefits over the new depreciable life of the asset.

The double taxation of dividends and other cash distributions (earnings and gains on sale are taxed at both the corporate level and, if distributed to shareholders, at the personal level) was also mentioned as a reason for retaining units. If a conglomerate decides to sell a division and distribute the proceeds, the gain on sale is taxed twice; if the proceeds are retained, the personal tax burden can be deferred. *However, the same is true of the earnings from the unit if it is not sold.* Thus, in theory, double taxation should only affect the conglomerate's decision about whether to pay out or retain earnings and the proceeds

11. The source for this quote is a privately published book on one of the conglomerates in our sample. Since the company has not yet agreed to have its name disclosed as part of our sample, we cannot disclose the exact reference.

of sale, and should not affect its decision about whether to sell or keep a unit. Managers claimed that double taxation does play a role in their decision making. They reported that their willingness to retain proceeds is contingent on the firm's investment opportunities at a given time. If attractive opportunities are not available, building up large cash balances was not viewed as a viable alternative, particularly if it would increase the attractiveness of the firm as a takeover target.

Another reason for the conglomerates' tendency not to sell divisions is managerial preference: some managers of the conglomerates apparently do not feel pressure to maximize the financial value of their firms, and do not want to see their firms shrink. This was particularly true of managers with substantial personal or family stakes in their firm. One conglomerate manager quoted Winston Churchill when asked why he did not divest more of his divisions: "I did not become Prime Minister of the British Empire to preside over its demise." Another said "I wanted to build a company. I'm in the business to leave an institution."

One final hypothesis to explain the conglomerates' tendency not to divest their units is that, in contrast to the LBO associations, the headquarters organizations of the conglomerates provide on-going value added to the units, through performance-improving guidance, monitoring, access to capital, or other services available only at higher prices elsewhere. This hypothesis is one we will address further on in the paper.

Section V: Structure and Governance of Headquarters

The organization structures in the LBO associations and conglomerates differ in ways that are consistent with their different acquisition strategies. Figure 4 shows a simplified organization chart that underscores the differences. The most significant differences have to do with the presence of a "group-level" management layer and a corporate staff in the conglomerates.

Organization Structure in the Conglomerates

Most of the conglomerates in our sample (five of seven) have some sort of intermediate management layer, between the conglomerate corporate officers and the unit operating managers.[12] This intermediate management layer groups the individual operating units along broadly defined industry lines, reflecting the industrial mix and clustering of acquisitions discussed in Section III. These line managers, alternately referred to as group vice presidents or super-subsidiary managers, serve several functions in the conglomerates.

In most of the companies, the group vice presidents perform an important oversight role, serving as a conduit for information and accountability between the operating units and corporate executives. They are in close contact with the operating units, and are held accountable for the results of the consolidated group performance. The group vice presidents also review and approve the operating and capital budgets for the units and, to a limited degree, serve as focal points for synergistic interaction between the operating divisions in their groups. This is most likely to occur when the firm has a sizable commitment to a particular business that stretches across more than one division. In these cases, there may be significant strategic coordination and flows of resources across divisions. While we observed examples of this kind of coordination in several of the conglomerates we studied, nearly all of them have several groups of divisions where there are no coordinated interactions among the units. One conglomerate CEO noted:

> We have a vice president for each group. Each operating unit has a general manager who reports to this group vice president. These groups are mini-conglomerates in their own right. Sometimes the businesses within these groups are related, but not always.

Indeed, in several of the conglomerates the group-level managers were created mainly to alleviate the information overload that would result from having dozens of divisions report to a single CEO. One of the conglomerates CEOs said:

> When I joined the firm, we had 11 or 12 companies. I could visit them all on a regular basis and have an understanding of each. By the time we had 20, I couldn't understand all of them. You need trust, faith and understanding, and I couldn't provide these things, so we created the super-subsidiaries.

Group vice presidents also play a role in the acquisition process. Since they have specific knowledge about the industries in their group, they are often involved in identifying and screening acquisition candidates.

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12. One of the firms that did not have this intermediate layer of management was considering making a change to this sort of structure.

Interestingly, one of the two conglomerates that does not have any group-level organization structure has significant requirements for inter-divisional coordination and cooperation. In this company, inter-divisional transactions are carried out at arms-length, with inter-divisional sales occurring at market-based transfer prices, and no interference from headquarters.

In addition, the conglomerates all have some staff personnel in the headquarters, although the size and responsibilities of these staff organizations varies widely across the conglomerates in our sample. Table 2 shows the number of employees (mostly staff) in headquarters, and the firm's revenue per HQ employee for the seven companies in our sample. As can be seen, the size of the staff organizations, and the ratio of revenue to HQ employment, varies quite widely. The revenue per HQ staff member turns out to be a fairly sensitive measure of how decision rights are allocated at the companies: those with lower revenue per HQ employee tend to retain more decision rights at HQ. The two conglomerates without group-level executives, #4 and #7, have the highest and third highest revenue per person at headquarters. In addition the CEO of conglomerate #2 repeatedly stressed the company's long-standing devotion to the principle of autonomy for the operating units.

Table 2

Conglomerate	Headquarters Employment	Revenue÷ HQ Employment
#1	50	$26,000
#2	22	$103,000
#3	60	$20,000
#4	37	$40,000
#5	31	$18,000
#6	46	$11,000
#7	28	$111,000

In all cases, the headquarters staffs in the conglomerates perform two functions: corporate level tax accounting and public reporting and disclosure. Most of the conglomerates also have a corporate controller who oversees reporting and control in the operating units. Remarkably, conglomerates 2 and 7 lack such a corporate officer. In these two companies, these functions are performed in the operating units. In addition, in some conglomerates there were a small number of professionals responsible for human resources, legal and environmental affairs, and insurance.

Those conglomerates that do not have corporate staffs for all overhead areas managed these functions in a variety of ways. Some duplicate these functions in each of the operating units. Others solve the staff function problem by building staff expertise at one of the operating units, and then lending or contracting out this expertise to other units. Thus, one conglomerate has a expert in environmental affairs that works for one division. This woman is experienced and knowledgeable, and a valuable resource for the entire company. She handles the environmental affairs for all of the operating units, serving as a consultant to other operating units, and charging for her time. Data processing is handled in the same way. Interestingly, none of the conglomerates that have group-level executives have any significant staffs at this level.

Organization Structure in the LBO Associations

The LBO associations are organized quite differently from the conglomerates. (See Figure 4.) They have a very flat hierarchy typical of professional partnerships. There are generally a small number of partners of the firm (the smallest firm has 3 partners, the largest has 7) and then a comparable number of associates. These members of the firm, along with a few supporting professionals (generally accountants and an office manager) make up all of the professional staffing. There are almost no "vertical" reporting relationships: none of the professionals in the firm report to any other single person. Rather, all of the non-partner professionals report to all of the partners as a group.

In addition, there is no organizational grouping of portfolio companies, and no equivalent of a group vice president. However, the partners and associates do specialize to some degree in what they do. This specialization allows them to take advantage of specific knowledge that they have developed. If an LBO association owns two or more units in the same industry, it is generally the case that the same partners and associates served on the boards of each of these units. This specialization was also evident in the acquisition process. Partners and associates develop expertise and reputations in an industry, and focus their efforts on industries in which they have done previous deals. This was not true in all the LBO associations we talked with, but it did occur in most cases. Furthermore, it was almost always the case that those partners and associates who worked on bringing in and structuring the deal would be the ones who would serve on the boards of directors of the companies after they had been bought out. Thus, while the LBO associations had no formal group structure, the functions of these group-level executives (evaluating acquisitions, oversight and accountability) were carried out by the partners and associates of the firms.

This point underscores a fundamental administrative difference between these organizational forms. Conglomerates, in the tradition of most corporations, are hierarchical in nature, and have one chief executive officer who heads the firm and is accountable to the board of directors. In most cases, it is unlikely that these CEOs could effectively monitor all of the firm's business units. Thus our conglomerates supplement the CEO with staff professionals and the group-level structure, splitting the evaluation and oversight task between "line" managers—group VPs accountable for the performance of particular units—and staff managers who give advice and set policies in certain areas. In contrast, the LBO associations lack this line-staff distinction. The partners and associates that bring in the deal also monitor and serve on the boards of these units, and are held accountable for the ultimate success of their own acquisitions.

Some LBO associations do have a kind of "staff" responsible for two functions: tax planning and advice for the firm and its partners, and a small group that works on investor relations and the periodic raising of the equity funds. These functions are analogous to the tax and investor relations staffs in the conglomerates. The main corporate staff function present in the conglomerates that was missing in the LBO associations was controllership: this large staff function in the conglomerates had no analog in the LBO associations. We return to this in Section VI, when we examine the systems that each type of organization used to control the units.

Governance

The legal and organizational structures of conglomerates and LBO associations are quite different. The conglomerates in our sample are all publicly traded corporations, with traditional management structures and controlling ownership (in most cases 100% ownership) of the operating units. The LBO associations, on the other hand, are all private partnerships. The partners and associates of the LBO associations serve as the general partners of the limited partnerships formed to make specific acquisitions. The equity in the operating units themselves is held by the limited partnerships (both the limited and the general partners), the operating company management, and sometimes (in the form of warrants and options) debtholders in the operating units.

While the legal structures of the LBO associations and conglomerates are different, both types of organizational forms are characterized by significant equity ownership by institutional investors, and powerful incentives for top management to worry about equity value. The partners in the LBO associations are not majority, or even very large, equity owners in the operating units: the partners and associates of the LBO firms typically own about 1% of the equity of the units.[13] However, the fact that the limited partnership agreements under which the funds are invested have limited lives forces the managers of the LBO associations to be highly concerned with the returns that their fund investors receive. When a particular fund reaches the end of its life, the LBO association must liquidate all of the investments that that fund has made and return the proceeds to the limited partners. In contrast, publicly traded companies are never *required* to repay their equity holders' invested capital. If the LBO association wants any equity to invest in future deals, it must go out and raise it again with a new fund. Thus, while LBO association partners are not large owners of the companies in which they invest, the future existence of the firm is tightly tied to the equity returns that they offer their fund investors.

The conglomerates in our sample all have significant amounts of management equity ownership and/or large institutional holders. Table 3 shows the ownership percentages by CEOs, management and board as a group, and other institutions for each of the conglomerates in our sample. These large management or blockholder stakes suggest one of two possible hypotheses about the conglomerates in our sample and why they survived the 1980s, when many similar firms were disassembled in the market for corporate control. One hypothesis is that the management ownership and large block holdings forced discipline on these conglomerates, causing them to run their companies efficiently and thus making them poor takeover targets. The second hypothesis is that the large blocks of stock in the hands of owners and institutions basically friendly to management

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13. In addition to this equity investment, the partners and associates of the firm (and often everyone else, including secretaries and receptionists) receive what is called a "carried interest" on any capital gains made from an investment. This carried interest rewards members of the firm with 20% of any increase in value of the operating units during the time that the LBO association owns the unit.[13] Thus, suppose that a company was bought with a $50 million equity investment. Most of this $50 million would have been provided by the fund investors who had committed to be part of the firm's equity fund. A small fraction of this equity (say $500,000) would have been put up by members of the firm. Suppose the entire equity stake is sold for $150 million in cash three years later. The members of the firm would receive 20% of the capital gain, or $20 million before any distributions were made to the equity investors.

made these firms takeover proof, allowing them to survive the 1980s even with poor performance.

Table 3

Conglomerate	CEO	Managers and Directors	Other large Holders
1	3.20%	5.00%	11.20% [1]
2	0.28%	9.84%	7.78%
3	10.70%	23.10%	6.30%
4	1.64%	20.40%	0.00%
5	5.30%	19.70%	0.00%
6	3.00%	10.60%	20.40% [2]
7	2.80%	24.40% [3]	6.30%

(1) Owned by a family trust controlled by company management.

(2) ESOP owns 11.6%

(3) 21.8% of the fully diluted outstanding stock is controlled by managers of a recently bought company who now serve on the board.

In order to assess the power of each of the preceding hypotheses, we look at the long-term market performance of each of the conglomerates in our sample. Figure 5 shows the cumulative unexpected returns for these companies since 1970.[14] As is evident from this figure, these firms generally out-performed the market (adjusting for their systematic risk) during this period. Numerous biases could account for this finding: a survivorship bias, a bias in how we selected the firms to be in the sample, or a bias in which firms agreed to participate. We have attempted to control for the survivorship and participation

14. Cumulative unexpected returns are calculated as follows. A beta is calculated for each stock in each year, on the basis of the previous 60 months of data. This beta is used to calculate a monthly expected return for the security, using the capital asset pricing model. This expected monthly return is subtracted from the actual monthly return to generate an unexpected monthly return. These returns are then cumulated geometrically over the time period.

biases by constructing two portfolios of firms whose performance we can compare to that of our sample.

To assess the survivorship bias, we constructed a portfolio of 21 firms whose equity was listed on a major exchange over the same periods as our sample of conglomerates. To do so we randomly selected three firms that still traded in 1992, and that began trading in the same year as each of our conglomerate firms. As can be seen, the seven conglomerates in our sample outperform the portfolio of survivors substantially.[15] This suggests that the superior performance of our sample is due to more than a simple survivorship bias.

In order to assess the participation bias, we measured the performance of the 12 firms that we had identified as conglomerates with whom we would like to have spoken, but who refused to be part of our sample.[16] The performance of this portfolio is also shown in Figure 5. As can be seen, the "refused to participate" sample underperforms our sample, but also outperforms the market and the surviving firm portfolio. This suggests that there is a participation bias in our sample, but also that the sample selection criteria that we used selected unusually good performers.

Thus, the conglomerates in our sample seem to be successful as measured by market returns. This suggests that the fact that these conglomerates were not broken up by market forces in the 1980s was not a result of an ownership structure that made them takeover proof, but rather that they managed their portfolio of companies in a way that contributed value to the individual units.

Section VI: Control of the Operating Units

In this section, we describe how the two headquarters organizations control and direct the actions of the operating units. We examine how headquarters set the "rules of the game" for the unit managers: how they allocate decision rights to the managers of the units, how they measure performance, and how rewards and punishments are determined.

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15. It is interesting to note that the portfolio of survivors also outperforms the market slightly during this 20 year period. Thus, there is some survivorship bias.

16. There were 14 firms who refused to participate, but two of them did not have continuous trading data from 1972-1992. We excluded these two firms from this comparison portfolio. Inclusion of these two firms does not significantly change the results.

Conglomerates

While the conglomerates vary in their degree of decentralization, there are several common features in how they manage their operating units. They all use standard capital budgeting techniques, including limits on the size of capital expenditures that operating managers can make without approval from either the group-level executive or from headquarters. All but one of the conglomerates does all cash management centrally, with limited cash held by the units. In addition, all but one raised debt capital at the corporate level. The CEO of the one company that issued debt at the unit level acknowledged that he paid a price, in terms of a higher cost of capital, by doing this. But felt that it gave the units more autonomy.

All of the conglomerates measure the performance of the operating units and pay bonuses at least partially on the basis of accounting earnings. Several used a standard system (recommended by many compensation consulting firms) that evaluates managers on the basis of their ability to simultaneously generate revenue growth and return on investment. This system pays bonuses based on a formula that gives weight to both of these criteria, paying the highest bonuses for high growth and high returns.

The conglomerates varied in the degree to which they measured performance on the basis of cash flow versus accounting earnings. This is in sharp contrast with performance measurement in the LBO associations. One CEO expressed a concern with this difference:

> We manage for earnings. LBOs manage for cash. We should be managing for cash, but sometimes we find ourselves managing for earnings. I think Wall Street doesn't evaluate us on cash, but on EPS, but we better not take our eyes off cash.

Several of the conglomerates had very imaginative performance measurement and compensation systems. One was experimenting (in late 1992) with the Economic Value Added approach to performance evaluation.[17] Another had implemented a very "laissez faire" and highly leveraged compensation system. Under this system, a division manager was hired and given a base salary and a target level of profitability. The manager and his or her management team received 5% of all profits above the target as bonus. *This target*

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17. This approach combines a residual income approach to performance measurement with the absence of discretionary income targets, theoretically providing appropriate incentives for capital resource utilization and reducing gaming in the budgeting process. For more details, see Stewart (1991).

was not adjusted, as long as the manager stayed at the division. Thus, if a manager succeeded in increasing the profits of a division significantly, the management team got to keep 5% of all incremental profits. The predictable result of this was that some long-tenure division managers were making substantial sums as bonuses. The CEO of the conglomerate acknowledged this, but argued that the alternative, in which he ratcheted the target, would destroy incentives for the division managers. His argument was that the parent still got to keep 95% of the profits.

> Our guys are typically way overpaid relative to the market. Not in terms of base salaries, but the bonuses can get very big. But those are the rules. If we changed the rules, we wouldn't get the same results.

All of the conglomerates (with the exception of the firm that did not do central cash management) were able to retain fairly tight control over the actions and performance of the operating units through their control of cash and their central controllership function. As one conglomerate CEO stated:

> They [the units] have no cash. We know exactly what their cash needs are. We have a much more sophisticated cash management system, which serves as a real mechanism for control. No one can get seriously off track without bells and whistles going off.

LBO Associations

The most striking feature of how the LBO associations "control" their units, in comparison with the conglomerates, is the absence of any internal control systems that are common across the units. Each company is separately financed, and many of the constraints and incentives that serve as the rules of the game for the unit managers are put in place with the closing of the deal, in the form of debt covenants and management equity ownership. To a large degree, the two most important parts of a management control system—the budget and the bonus system—are "contracted out," in the sense that market forces are used (along with arms-length agreements with lenders) as the main components of the management control system.

Each unit company in the LBO association is a totally separate legal and financial entity. There is no legal way for the LBO association to cross-subsidize one unit's losses with the profits from another, and the failure of one unit does not threaten the health of any other companies in the LBO association's portfolio. Any cash flows paid from the operating units to the limited partnership must be, by the covenants of the limited partnership agreement, distributed directly to the limited partners: they cannot be used by the general partner for any other purpose. Debt covenants typically specify how much the units can spend on capital expenditures, and typically constrain what the individual companies can do with excess cash flow: i.e. cash flow greater than that required to make interest payments and agreed-upon capital expenditures. Generally, excess cash must be paid out to debtholders. Acquisitions, issuance of new debt, or the retention of cash is generally prohibited by the covenants. All of these constraints are agreed to when the deal is consummated.

Management equity ownership in the portfolio companies is also an important part of the control system used by the LBO associations, but there is an important (and often overlooked) aspect to this equity ownership that makes it virtually irreproducible by the conglomerates. The equity owned by management in the LBO companies is generally illiquid. However, because of the requirement that the LBO association liquidate the limited partnership within a fairly short time period (10 years or less) there is a guarantee that the company will be valued, in a third-party transaction, at some point in the relatively near future. This guarantee of future liquidity, and of an objective and unbiased valuation event, is crucial to the incentives provided by management equity ownership. This liquidation event serves much the same function as the prospect of going public does to the managers of a start-up venture: even though the equity has no current market value, the future value of the equity serves as a key focus of management attention. Without the prospect of a third party, objective valuation event, management equity ownership would be much less effective.

Note that, because the conglomerates do not typically sell their units, they do not have the option of using this sort of incentive technique for their unit managers. Even if the conglomerates were to create publicly-traded divisional equity, if there was no guarantee of the outright sale of the division, the equity price would reflect the future dividend payments to the outside equity holders of divisional stock. Such a price might well not reflect the true economic value of the division.[18]

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18. The market value of a 25% stake in a division of a larger firm will equal the present discounted value of the expected dividend stream to the minority stakeholder. Since these dividend payments are largely at the discretion of the parent (minority shareholder rights notwithstanding) it is easily possible, indeed likely, that this present value will be different from 25% of the price that the division would fetch if sold to a third party.

The outsourcing of the budgeting system results from the heavy use of fairly short maturity debt financing. The financing of a typical LBO requires that the bought-out company make large cash payments, for interest and principal, over a five to seven year period. These required cash payments, along with the covenants that are attached to the debt, essentially determine an operating budget for the firm for several years. This operating budget is secured with external, legally binding contracts which makes it very difficult for the unit managers to renegotiate their obligations. If managers want to alter the covenants of their debt, they must induce debtholders to go along with any change. Such inducements often include cash payments from the company to the debtholders. If the company fails to meet debt covenants (technical default) or make required payments (default), debtholders have the legal right to place the company in bankruptcy. While most cases of default do not lead to declarations of bankruptcy, they do trigger renegotiation of debt and equity claims that often result in either an additional investment from existing equityholders, or a reduction in management's equity stake in the firm. Thus, the process of "doing the deal"— generating projections, structuring the balance sheet, securing financing—has an important consequence: it puts in place an operating budget with large rewards for success and strong sanctions for failure.

This description of the consequences of "the deal" casts a new light on the distinction between "operating managers," who know nothing about finance, and "financial types" who know nothing about operations. Even those we spoke to inside the LBO associations made this distinction.

> We are not operators. We do not get very involved in the operations of our portfolio companies. We are good at structuring financing, we have good relations with debt suppliers, we help with strategic planning, we may help to revamp the reporting systems. Our main value added, however, is in doing the deal.

Our contention from evaluating the structure and conduct of the LBO associations and their operating units is that this distinction minimizes the importance of "operations" in the success of LBO associations, and fails to account for a key aspect of how LBO associations create value. The LBO associations which are consistently successful in bidding for companies, winning those bids, and not having their portfolio companies default on their debt covenants, are those who know enough about the operations of the target companies that they can produce optimal "stretch" budgets: budgets that get managers to produce the most out of the operating assets, successfully pay the interest and principal payments, and still have a company at the end of this repayment period that another, independent buyer will want to pay a high price for. Without the skill to perform this function, an LBO association is sure to fail in the long run.

Section VI: When and Where Do Headquarters Create Value?

We have argued above that much of the value created by headquarters in the LBO associations comes from the structuring of the deal itself. The contracts put in place at that time establish important expectations and constraints. They also provide substantial incentives for the managers of the operating units. Headquarters' role from that point forward is essentially one of oversight: if things go as expected, this step is relatively straightforward. If significant problems develop, the partners play a stronger role, although this rarely means directly intervening in the operations or strategy of the business.[19] Instead, the partner may oversee the replacement of management, or assist the unit in its efforts to restructure its obligations. It is important to note that once it becomes clear to potential buyers that a deal's financing structure is not going to lead the operating company into serious financial distress, there is little role left for the LBO association partners to play.[20] They have added their value, and can generally utilize their human and financial resources better by selling the unit off and looking for a new deal.

This "front-loaded" value creation is not nearly as apparent the conglomerates, although they too may make some rapid changes in the operations and systems of the units that they acquire. Generally the plans that the conglomerates make for an acquired unit are far less concrete and more open-ended than those in the LBOs. Consequently, the budgets and control systems are less rigid.

The control systems used by the conglomerates are, in general, less strict, and provide both a smaller upside and a softer downside than the systems used by the LBO associations. The bonuses used by the conglomerates, while often generous by the standards of corporate compensation plans, do not come close to providing the

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19. This finding contrasts with that of Kester and Luehrman (1993), who show that at one LBO firm, Clayton, Dubilier and Rice, partners of the firm actually do get involved, to the extent of becoming managers of the units, when the situation warrants it. Kester and Luehrman argue that this is an "unusual attribute" of this firm.

20. The amount of time it takes for other potential buyers to recognize that the financial structure of a deal is sound varies from company to company. In some very successful deals, it becomes clear that the company will succeed almost immediately. In these cases the LBO firm can sell the company very quickly. In companies where the future success is more in doubt, the LBO associations tend to hold the units longer.

opportunity for real wealth that is possible through the ownership of highly levered equity in an LBO. Likewise, the costs to managers of failing to meet cash flow or profitability projections are substantially less at the conglomerates. In addition, the budgets and bonus plans are not locked in place with the closing of the deal, but are developed over the course of as much as a year after a unit is acquired. Furthermore, while the rules of the game facing the managers of LBO companies can be renegotiated only at substantial cost (in terms of both time in dealing with outside parties, and actual penalty payments for covenant violations), those in the conglomerate operating units can be altered with a phone call or meeting with top management. Such flexibility has a cost: it is precisely the strictness and lack of renegotiability that gives the LBO contracts their power. As Bennett Stewart (1991) has argued:

> Without involving external investors, it may be difficult for the parent to know the true . . . value of the unit. . . . Moreover, there is a risk that, without the threat of interventions by external creditors and without a clear mechanism to capitalize the value it creates, unit management will not take the plan as seriously as it should. No matter how realistic, war games are not war.

Despite the merit in Stewart's argument, the conglomerates' ability to renegotiate the rules of the game in a dynamic and flexible way reduces the costs of reacting to unforeseen problems and opportunities. The fact that the projections used by the conglomerate headquarters when making an acquisition are not locked in place in the form of externalized promises to make interest and principal payments, and that the conglomerates can use cash flow from a successful unit to fund shortfalls in another unit makes this organization more flexible. This flexibility makes strategic change easier: if a unit sees that there is an alternative strategy that would yield higher returns, but would cause the short-term budgets to be missed, the conglomerates can more easily change course and pursue such a strategy, without having to renegotiate a set of external contracts with debtholders. This argument suggests a hypothesis about the source of value creation in the conglomerates that is consistent with their strategy of buying and holding their unit companies: in these firms, the value added comes only over time, as unforeseen circumstances arise that call for judgment and a flexible response. The willingness to exploit operating synergies across some of their related businesses is also consistent with this view that value creation takes place over a longer period of time.

In the end, we are unable to definitively answer whether or not we believe that the *organizational form* represented by the conglomerates in our sample creates economic value relative to the LBO association. Certainly the results shown in Figure 5 suggest that *these firms* are economically efficient. Perhaps the prevalence of large block equity holders in these firms combine effective governance with the advantages of capital availability from public equity markets. Perhaps the synergy between units of homogeneous groups provide economic benefits unavailable to the LBO associations. And it is possible that the conglomerates can effectively use the flexibility in operations that their structure provides. Thus it may be that the inherent advantages of the organizational form are important, or perhaps our sample of firms represents the most successful of a breed: small to medium size, with clear intentions and careful implementation. In either case, the data do challenge the widely-held belief that conglomerates are a dinosaur of the past.

Looking Ahead

When beginning this work, it was our goal to compare two types of organizations at a given point in time, and to investigate whether they were competing organizational forms: firms serving similar economic ends through somewhat different means. We thus began the investigation with the intention of taking a "still" pictures of what each was doing, and how each type of organizational form was creating value.

Early in the project, however, it became clear that the competitive arena in which these firms operate was in substantial flux. In a clear example of Schumpeterian competition, an innovation (the leveraged buyout) had spawned a wave of "creative destruction." The innovation grew quickly, challenging and destroying old organizations. The rents from this activity encouraged others to enter the market and, in time, began to drive down "industry" rents.[21] This was possible because the resources and capabilities that were initially required to do a leveraged buyout were not unique to the early entrants, and the returns to this sort of innovative activity were very high. This influx of competition had profound implications for the players—both LBO associations and conglomerates. Most importantly, competition drove up the price of deals, making it increasingly difficult to find attractive investment opportunities.

In response to these changes, many of the firms in our sample were in a state of transition, and were attempting to position themselves for an increasingly competitive environment. In most cases, this involved a subtle upgrading of organizational skills and

21. This is consistent with the findings of Kaplan and Stein (1993).

capabilities; principally moving from more general to more specific skills. In the conglomerates this was seen in their efforts, in a few areas, to assemble sets of related businesses and to achieve synergies across them. The clear expectation in most of these firms was that, compared to the past, future earnings would depend more on creating value within existing businesses rather than through acquisition.

The LBOs were repositioning themselves in similar ways. Some movement toward specialization was clearly evident. One partner explained: "Unless we have experience in an industry, we cannot expect to be a competitive bidder. In industries that are new to us, we simply can not produce the kind of numbers we would need." At the same time firms were expanding the range of industries that they were prepared to specialize in, moving away from the traditional low technology, low growth industries in which most had concentrated. This often involved changing the capital structures of their deals, reducing leverage ratios in order to provide more flexibility for the operating units.

We saw several dramatic examples of this in our interviews. One LBO association was doing all of its acquisitions in two related industries: print and broadcast media. The partners in this firm were combining their financial expertise and deal structuring talents with substantial industry-specific knowledge to make a limited number of acquisitions in a tightly targeted niche. The chief constraint that this firm faced was finding management talent to run the companies. This drove them to "re-use" individual managers in more than one deal, encouraging them to expand their units with subsequent acquisitions. This generally involved financing the deals more flexibly in order to allow add-on acquisitions in the future.

Another large LBO association was moving in a similar direction, with an innovation that it labeled a "leveraged buildup." This arrangement strongly resembles the "group-level" structure of the conglomerates. In a leveraged buildup, a management team uses the LBO association's equity capital and its ability to secure debt financing to pursue acquisitions in a single industry. The LBO association partners closely monitor the acquisitions made by the management team, who in turn make the acquisitions and monitor the performance of the individual operating units. There are even some limited attempts to exploit synergies across the individual companies within the leveraged buildup groups. As of 1992, this LBO association had set up three of these leveraged buildups.

We also saw evidence of the conglomerates changing their internal systems in response to the new competitive environment. As mentioned, several were looking at innovative control and compensation systems for their unit managers, taking leads from the way that LBO associations structured their deals. Many were also considering increasing the amount of debt in their capital structures (at the corporate level), and many were involved in long-term stock buyback schemes.

This seeming convergence of the two organizational forms should not be surprising: it is unlikely that two forms whose economic function is very similar would continue to exist in competition. The long-term prospects for each, however, will depend on how they evolve to meet the changing demands of the environment. At this point it is too early to tell which organizational form is more likely to survive.

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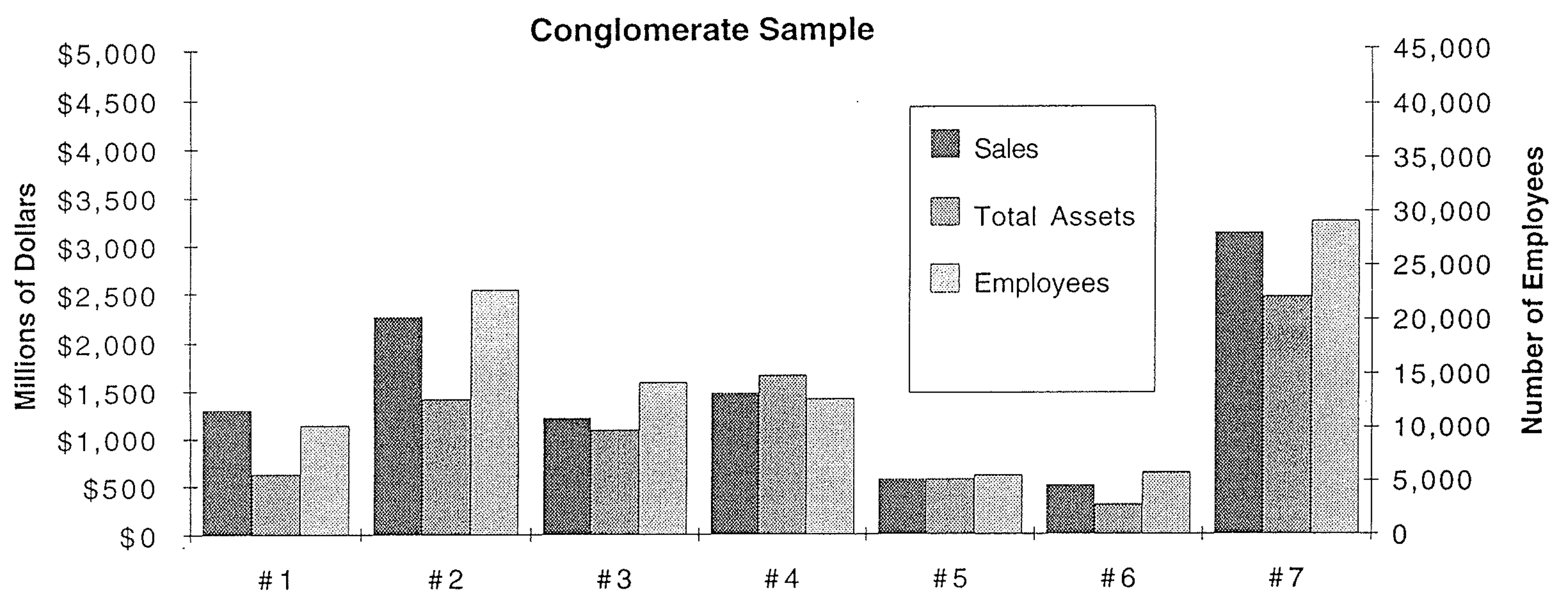
Figure 1: Size Distribution of Conglomerate and LBO Association Sample



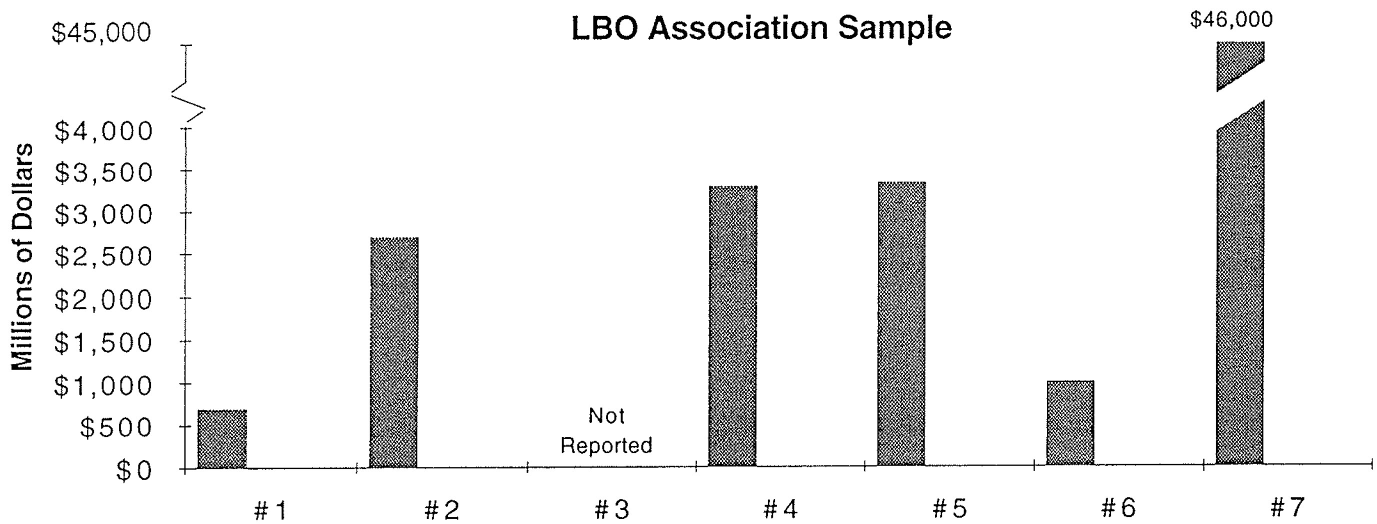


Figure 2: Number of Acquisitions and Divestitures by Conglomerates

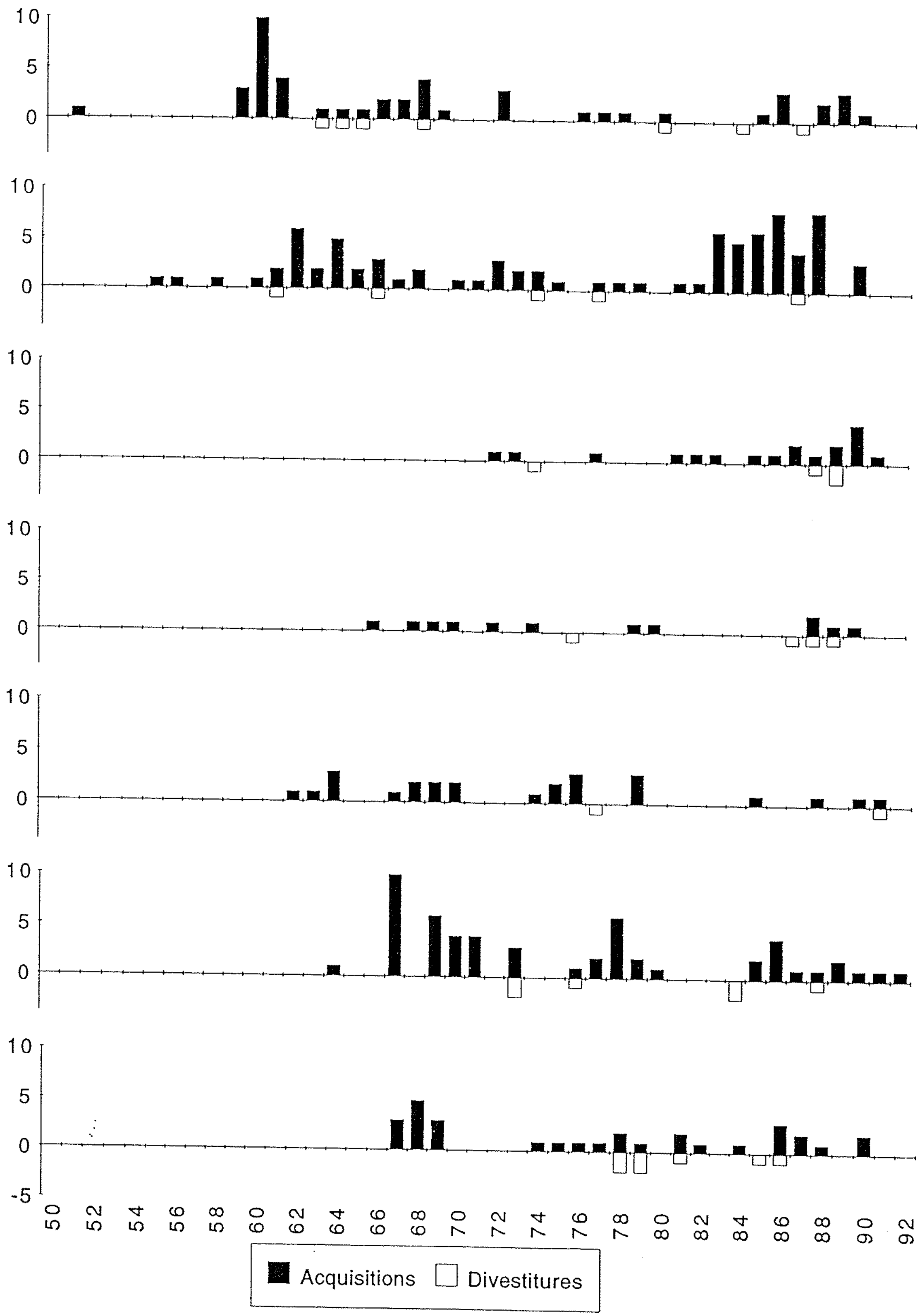


Figure 3: Acquisitions and Divestitures by LBO Associations

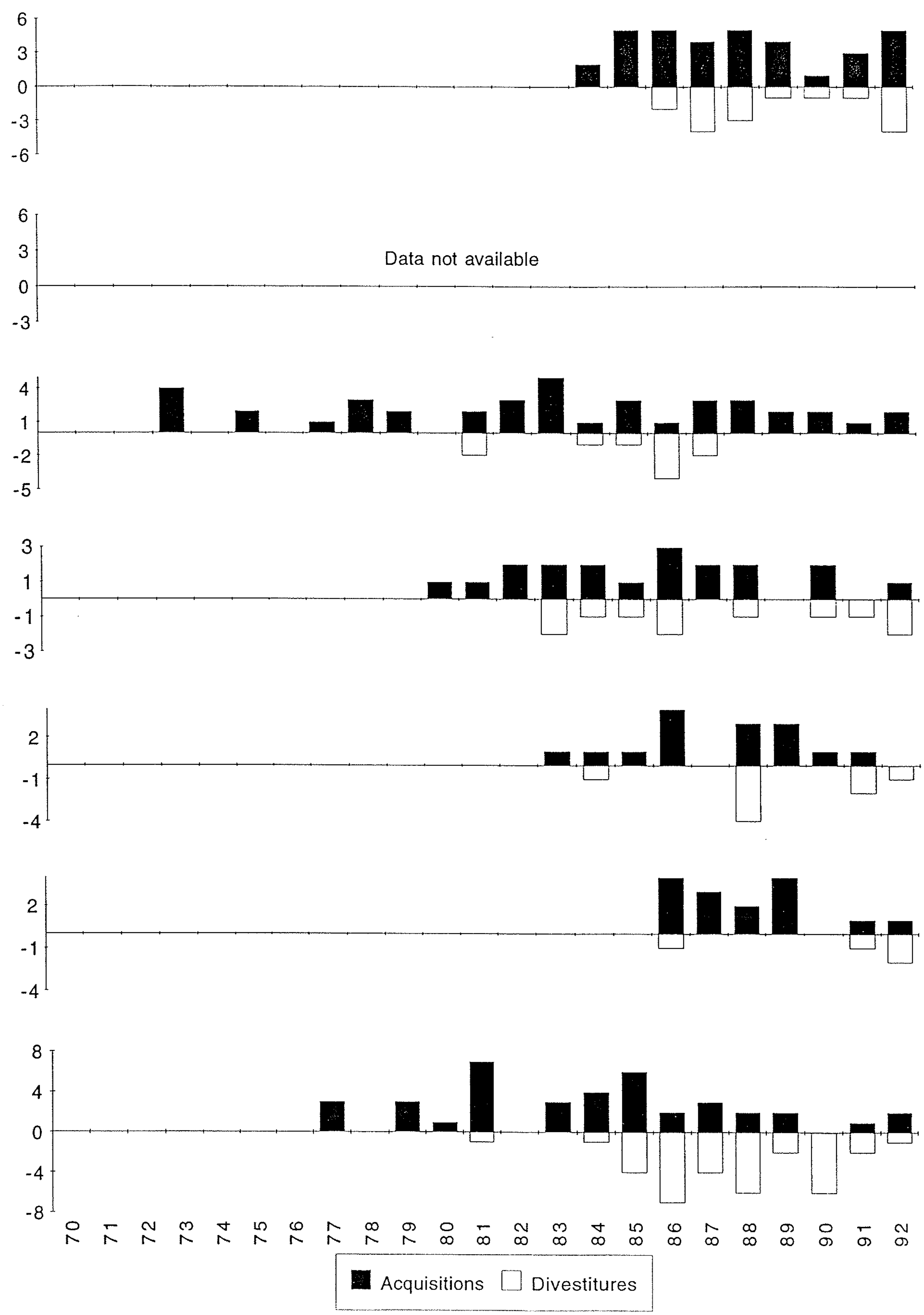


Figure 4: Organization Chart for LBO Association

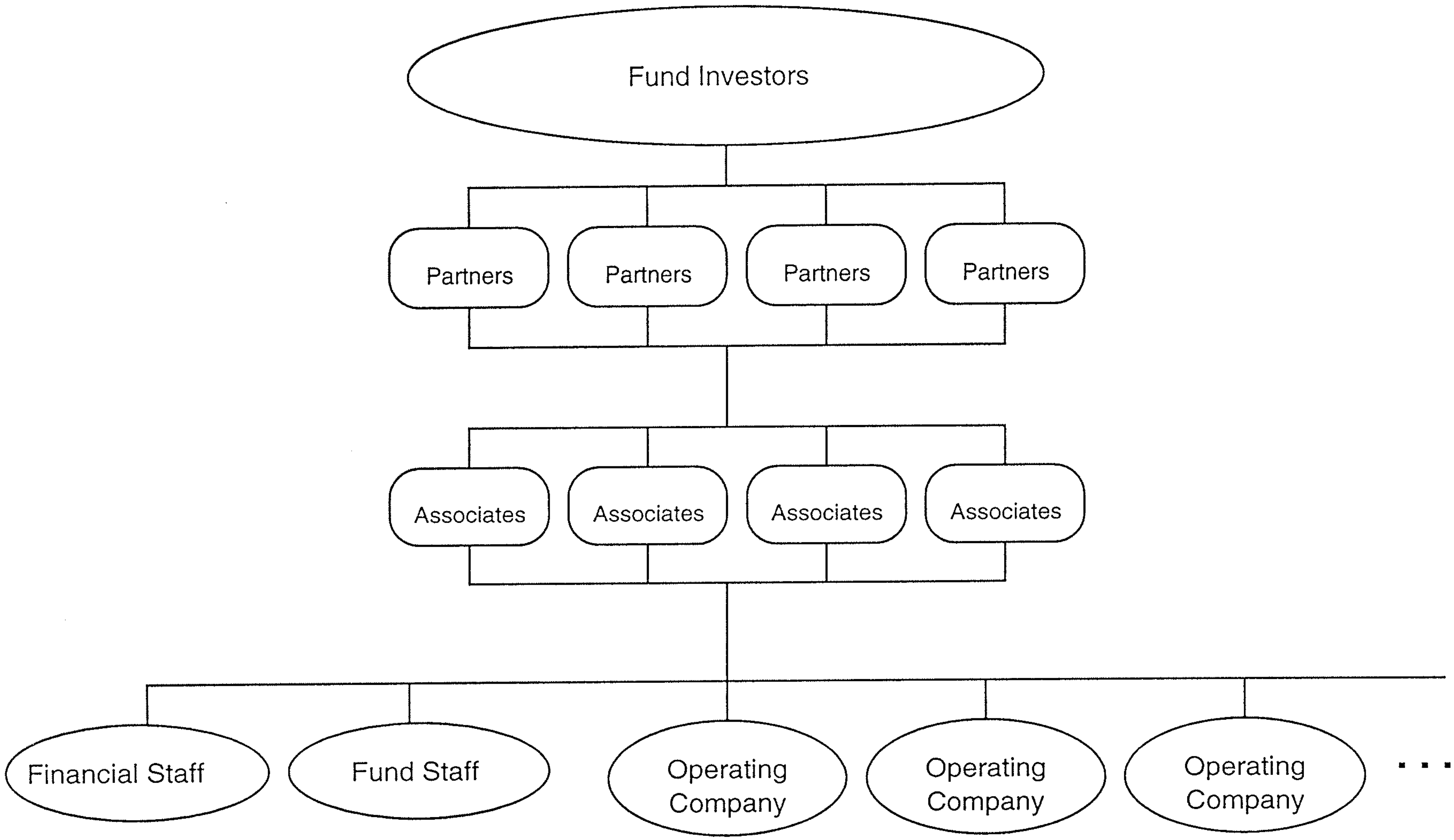


Figure 4 continued: Organization Chart for Conglomerate

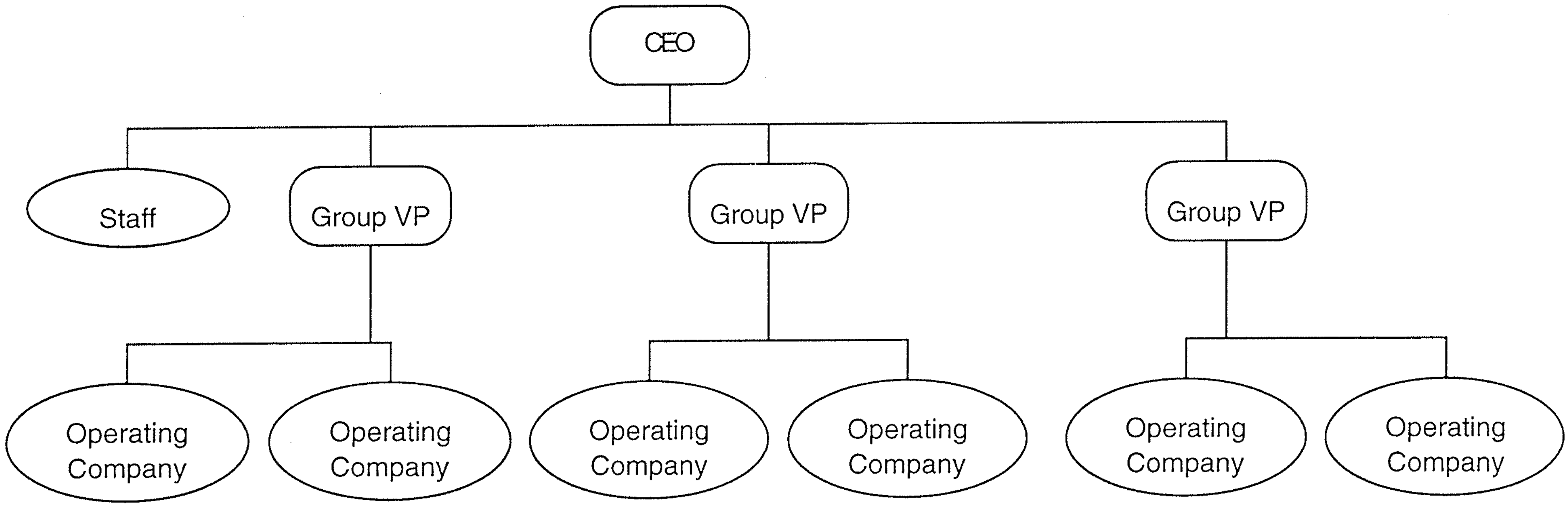
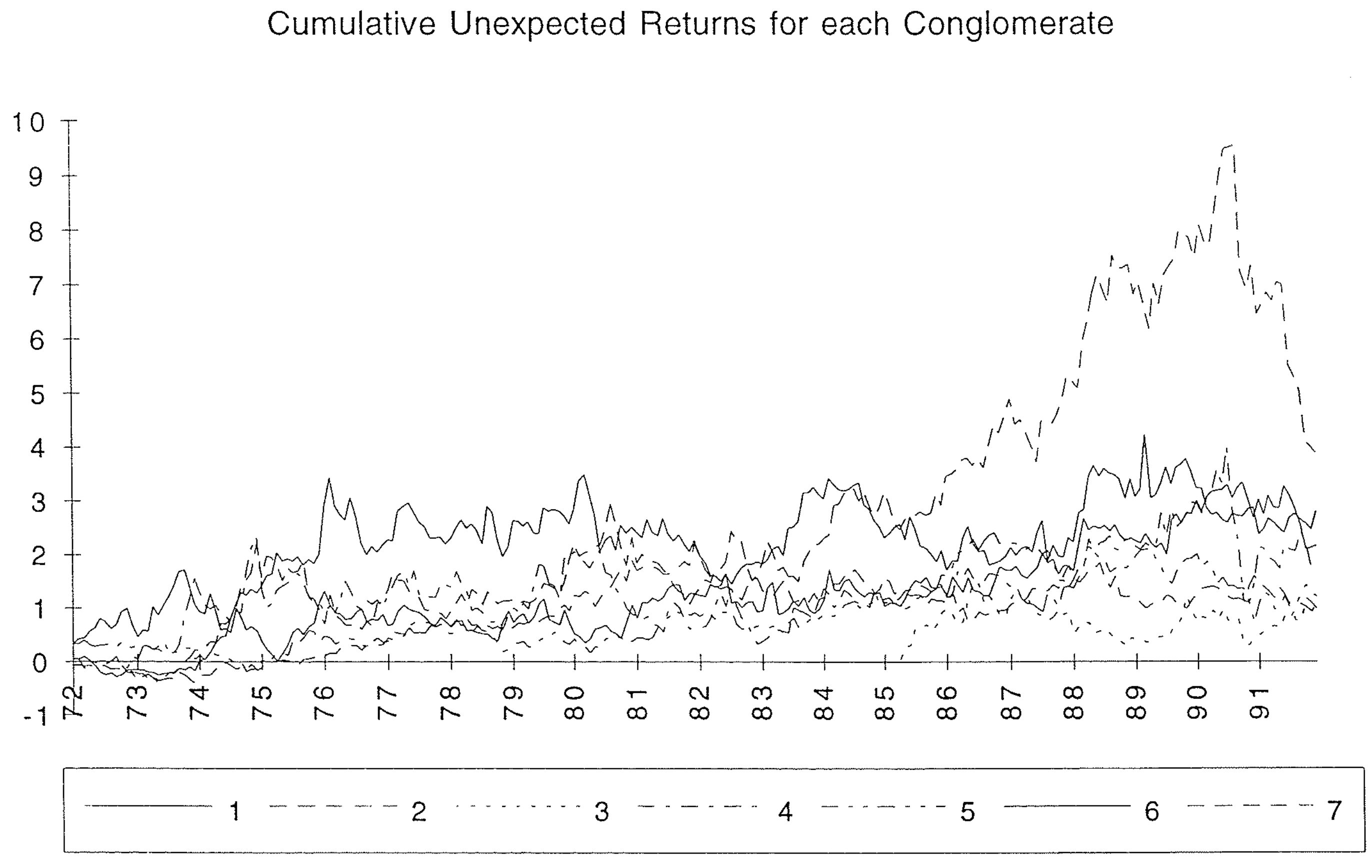
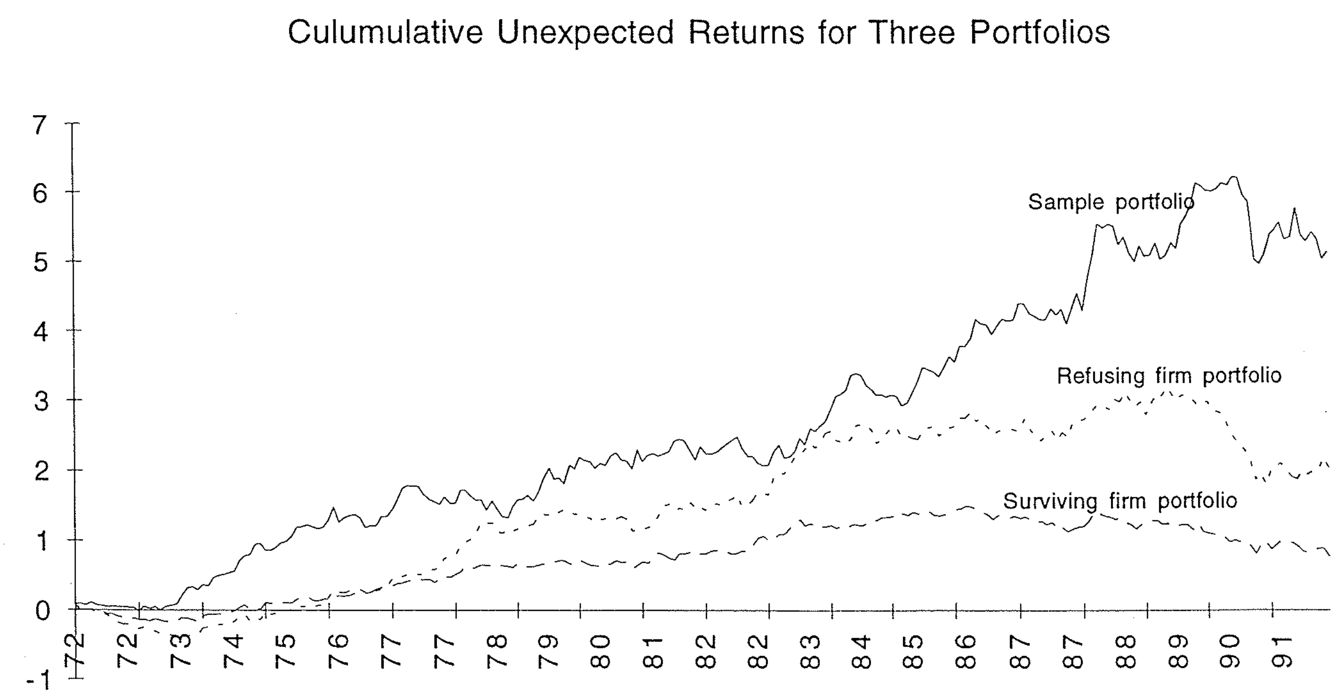


Figure 5: Market Adjusted Conglomerate Returns





The three portfolios in bottom graph are: 1) the 7 conglomerates in the sample, 2) the 12 of the 14 firms who met the criteria for inclusion in the study (two did not have continuous trading data), but who refused to be part of the sample, and 3) a portfolio of firms which started trading in the same year as our sample, and survived to 1992.