



New Economy Conglomerates: Its Still About Creating Value

by Bob Gifford

New Economy conglomerates have a lot to teach, and to learn, from their Old Economy predecessors

Remember the good old days, back when these companies were considered leading edge, with sky-high valuations?. The media loved them, fueling the hype around their stock. They were held up as a new economic model for the future: a company built upon a diversified set of investments in some of the hottest technology companies.

Alas, those days are gone. Investors have learned that realizing these companies' value requires a great deal of time and hard work, and that the high growth they saw in the past is, for the most part, behind them. Their stock prices have retreated dramatically, probably never to return to their peaks.

Most likely, this scenario brings to mind the new breed of incubators, the companies variously termed American keiretsus or eco-nets, such as ICG, CMGI, Safeguard Scientific, or Divine Interventures. These new economy high-fliers made their marks by evolving from venture capitalists into incubators and beyond. They provide centralized finance, facilities, recruiting, administrative support, and management and strategic guidance. These companies maintain ownership in their investments long after the IPO that is the exit ramp for traditional VCs. They have moved from investors to operating companies, building a synergistic community out of their member companies. These are the New Economy conglomerates, a new breed of economic animal.

Or is it?

These opening sentences could just as well describe the traditional, old economy conglomerates. During the

1960's, conglomerates such as ITT, Allied Signal, Textron, and GE enjoyed the same over-the-top hype that their new economy counterparts enjoyed more recently. These companies were built through acquisitions of top engineering and technology firms in the aerospace, automotive, and industrial manufacturing industries. Their vision was, and still is, to create a diversified collection of subsidiaries to which the parent brings a structured management process, disciplined capital allocation, and shared activities and competencies to create superior shareholder value.

Since their glory days, conglomerates have lost their luster in the stock markets, but continue to survive, and even thrive, economically. While there are conglomerates that have seen a long decline, there is also GE, acknowledged as one of the best-run corporations in business today. Most of the aerospace industry and much of the industrial manufacturing and automotive industries rely on companies owned by conglomerates as their suppliers and manufacturers.

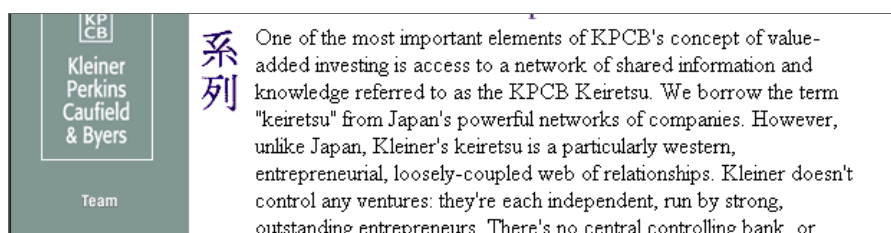
Given the similarities between the old and new economy conglomerates, what lessons they can teach each other? In what ways have these two diverse sets of companies arrived at the same factors for success, and what pitfalls have they both fallen into? While the new and old economy conglomerates share traits in common, there are important differences (see table on the following page). In what ways are these companies different and what lessons can each learn from the other?

Old Economy Conglomerates		New Economy Conglomerates
Bricks	↔	Clicks
Hierarchical	↔	Network
100% Ownership	↔	Minority Ownership
Business Acquisition	↔	Business Creation
Diversification	↔	Focus
Size	↔	Reach

Bricks vs Clicks

The Internet pure play can be at a serious disadvantage competing against the clicks and mortar combination of physical assets and online presence. Amazon, Webvan, and other web plays are demonstrating that often the website is the easy part. The hard part is executing well on the dirty, gritty operations required to source the right products, keep inventory under control, and get goods delivered to customers. These competencies aren't nearly as glamorous as those required to create a compelling website, but they are every bit as vital to the success of a clicks and mortar company, especially now that the markets are looking for earnings, not just revenue growth. These brick and mortar competencies not only keep customers happy, but keep costs under control as well.

These day-to-day operational skills are the heart and soul of the Old Economy in general, and Old Economy conglomerates in particular. Why so? What's the proof point? They have succeeded based on their ability to



make the right capital investments in physical assets, and to build the operational infrastructure that provides reliable delivery of cost-effective, high quality products. The New Economy conglomerates have much to learn from the strengths of their Old Economy counterparts in this area.

Advantage: Old Economy Conglomerates

Action Item: New Economy Conglomerates need to pay as much attention to the traditional logistics, inventory management, and production scheduling as they have to website design, marketing, and customer service. These companies need to adopt operating practices that have proven themselves vital in asset intensive manufacturing industries, and to add a focus on ROIC, capital budgeting, and operational excellence to their existing focus on customer acquisition and satisfaction.

Hierarchical vs Network

Traditional conglomerates have been the quintessential hierarchical organization, with individual companies reporting up through division, segment, and corporate management layers. They have also generally reflected the command and control nature of hierarchical

organizations, where information flows up from the company and performance targets flow down from corporate. The corporate office allocates capital, with no ability on the part of individual companies to raise capital on their own. Business plans are approved by corporate, and once in place, are used to hold company managers accountable.

In contrast, New Economy conglomerates are structured as networks instead of hierarchies. Information flows horizontally among member companies instead of vertically. The incubator-cum-operating company is the enabler and facilitator of the network, not the controller and issuer of commands. Member companies are free to acquire capital on their own, not just from their conglomerate parent. While the conglomerate provides advice and guidance, the strategies and plans are the

responsibility of the member companies, as well as their execution.

The objective of the network is to identify new business opportunities that would not be uncovered, much less capitalized on, without this free-flowing communication among peers. Rapid growth of the conglomerate, as well as its ability to create new businesses, relies on the unanticipated innovation of its member companies resulting through their cooperation. Beyond new business opportunities, the horizontal relationships allow the scarcest resource in the New Economy, knowledge, to be shared far more effectively. As member companies face similar business issues, deal with the same economic and market uncertainties, and pursue similar strategies for value creation, sharing best practices and lessons learned with their peers provides an invaluable aid.

While it is tempting to view the New Economy network model as vastly superior to the traditional hierarchical model, there is a downside. Corporate-wide strategies, on occasion, require a business to subordinate their goals or change their plans to benefit the whole conglomerate. A network model is based on each component pursuing its own interest, even when it comes at the expense of the rest of the conglomerate. Optimizing the whole may mean having to over-ride the self-interest of one of the parts. This is most easily done in a hierarchical command and control organization.

Advantage: Draw

Action Item: Old Economy conglomerates should move from a sole emphasis on managing the hierarchical chain of command, to managing the network. They should create forums to allow managers at all levels in their businesses to build relationships and share knowledge across companies, and encourage movement of managers across businesses, instead of viewing it as “poaching” of talent.

Action Item: New Economy conglomerates need to create the ability to, at times, impose their will on member companies to optimize the success of the network at the expense of the individual company.

100% vs Minority Ownership

Traditional conglomerates have been built by acquiring full ownership of their subsidiaries. Less than 100% ownership interferes with the command and control nature of their hierarchical organization. Old Economy conglomerates have created value largely through

physical assets – the plant and machinery that creates physical goods – and optimizing the use of those assets requires full control through majority ownership.

In contrast, the New Economy conglomerates have been built largely through minority investments. Since they are structured as networks, control is not as important as enabling and facilitating information sharing and cooperation among member companies. Equity stakes are important factors in creating the trust between companies that is the prerequisite for information sharing and cooperation. But since cooperation is the objective instead of control, the equity stake does not need to be total.

Advantages of minority ownership include greater

- Liquidity, since member companies can be divested much more easily when a public market already exists for its equity.
- Access to capital, since capital can be raised by the member or from the conglomerate, depending on cost.
- Speed, since minority investments allow the conglomerate’s network to grow larger, faster, with the same amount of capital.
- Performance measurement, since the market values member firms’ performance, including future growth as well as current earnings, not corporate staff based upon adherence to budgeted targets.

The brick-and-mortar [conglomerates] will die no matter what...the reality is that you have to take your best employees and best businesses and spin them off and just own 40 percent of everything that’s left. Do that and you survive.

-Flip Filipowski,
CEO, Divine InterVentures

Of course, minority investments sacrifice the control that is occasionally required within the conglomerate, as mentioned above. Sub-optimizing the market value of one business to maximize the value of the conglomerate

as a whole can only be done when the conglomerate is the majority, if not sole shareholder of the subsidiary. External shareholders will not stand idly by while their investments are squandered to the benefit of the conglomerate.

Advantage: New Economy conglomerates

Action Item: Old Economy conglomerates need to be open to minority investments to gain access to new competencies and create alliances, even though minority investments can't be folded into your traditional operating model. Define your objective in acquiring a target company, and consider whether your objective can be met just as well by a minority investment, with less capital.

Action Item: New Economy conglomerates need to be prepared to acquire majority or complete ownership of a member company when that company is to play a key value-creating role for the conglomerate at the expense of its own market value.

Business Acquisition vs Business Creation

In the mature manufacturing economy, creating new businesses was a slow proposition. Ten years from inception to IPO was not an unrealistic expectation. Growth through acquiring established businesses was a much faster approach when compared to the long and uncertain path of growth through business creation. Besides which, the stock market did not reward business creation to the extent it rewarded the operation of mature businesses. The heavy reliance on P/E ratios and earnings per share reflected the importance of current period earnings to the stock market.

However, these factors no longer hold true. In spite of the recent market correction, successful start-ups are able to move from inception to IPO in two years instead of ten. Capital requirements for start-ups are large and growing, and are spent in months instead of years. And, the price-to-sales multiple has now taken over as the most meaningful metric to the stock market, with companies going to IPO before reaching profitability.

The New Economy conglomerates are enabling business creation and growth by providing incubator services to

start-ups, as well as capital. However, the most important assets they provide are the competencies necessary to move from start-up to maturity. The New Economy conglomerates are providing advice and guidance, and are also helping to recruit members of the start-up management team. The larger the network, the greater the conglomerate has the ability to source the right executive at the right time.

The irony is that the Old Economy conglomerates have the equally critical industry-specific operational competencies, as well as physical and financial assets required to start up a clicks and mortar B2B e-business. Old Economy conglomerates should now have a natural edge in this arena, but have not moved quickly to capitalize on their advantages. However, as Old Economy conglomerates mobilize, they should be an even match for the New Economy conglomerates.

Advantage: Draw

Action Item: Old Economy conglomerates should learn to use the competencies and the energy of its employees to incubate new businesses instead of acquiring existing ones. If new business incubation is not a core competency they wish to develop, they should look to partner with VC firms and incubators to provide the knowledge necessary to succeed, as well as additional capital.

Action Item: New Economy conglomerates should partner with, and perhaps invest in, Old Economy companies in their target industries to acquire the deep industry and operational expertise necessary to succeed in B2B plays.

Diversification vs Focus

The Internet is dramatically reducing the coordination and transaction costs for purchases between companies. There is no longer a cost advantage to maintaining large parts of

the value chain under a single corporate roof. Businesses can't survive through mediocrity in some aspects of their value chain just because they excel in another. Instead, businesses

need to focus on their core competency – the one segment of the value chain in which they excel – and rely on partners to provide their complementary competencies as suppliers, assemblers, distributors or outsourcers.

mission	idealab!'s mission is to develop individual ideas into highly focused and successful Internet businesses. idealab! leaders believe that to succeed in the dynamic Internet market, companies must achieve a rapid speed of execution by tapping the services, support and knowledge of individuals and organizations that have extensive experience in starting Internet companies. idealab! combines the best elements of a small and nimble company with the financial strength and wisdom of a much larger organization -- sharing these benefits with its operating companies.
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The New Economy conglomerate facilitates this focus on core competencies. The incubator's role of providing outsourced resource management services, such as facilities, HR, accounting, or IT, continues in the New Economy conglomerate. These shared activities help reduce costs, but that is a secondary benefit. The primary purpose is to enable member companies to focus on accelerating their time-to-market through focus. New Economy businesses can't afford to spend any bandwidth on issues not directly related to commercializing their core product. The advantages of being first-to-market put speed at a premium, and speed requires focus.

Most of the Old Economy conglomerates took a step in this direction in the 80's and 90's with shared services organizations. However, to complete this process, these shared services organizations must be forced to compete for the business internally against external providers, while being encouraged to pursue external customers as well.

Advantage: New Economy conglomerates

Action Item: Old Economy conglomerates should focus on core competencies, and outsource supporting and non-core activities to sister companies or outside providers. They need to utilize the internet to link their businesses with the growing number of service and outsourcing providers, allowing them to provide better and cheaper services.

Size vs. Reach

In the past, sheer size has seemed to become a goal in itself. But, when an Internet pure-play like Yahoo exceeds GM in market value with a fraction of the revenues, size itself is clearly not the source of value. For the New Economy conglomerate, the goal is not size, but reach.

Reach represents the breadth of options and future opportunities available to a business. In periods of high uncertainty, a currently unknown technology, or business model, or sales channel can emerge as a dominant factor within a matter of just a few months. Forecasting winners and losers, and positioning today to be able to capitalize on the winners, isn't practical. Instead, the New Economy conglomerate looks to create a portfolio of opportunities covering as many potential winners as possible. While most will not pay off, the chances that the conglomerate will be positioned to take advantage of those that do pay off are high. Similar to venture capitalists, New Economy conglomerates want to cover as many bases as possible so

they will not be left out of the "new new thing", whatever that may turn out to be.

"I think the word keiretsu is just a sound bite with great PR value."

*- Anonymous venture capitalist
(as quoted by Red Herring)*

The advantage of having access to the next emerging technology, business model, or market is not only to gain high returns from the investment itself. The conglomerate creates value by combining disparate competencies together to create new business opportunities and new businesses. The potential for new business opportunities increases as the number of potential alliances and combinations increases. Metcalfe's Law, which states that the value of the network increases exponentially with the number of connections, also applies to the New Economy conglomerate. The likelihood that the conglomerate will be able to combine the latest wireless technology with the most compelling content providers with the most loyal customer base depends upon the size of the conglomerate's network of businesses.

The New Economy conglomerate creates value in the same ways that conglomerates have created value in the past: by sharing activities, sharing competencies, achieving scale. But the New Economy conglomerates create value in a new way as well. The horizontal network of relationships, built through flexible and dynamic minority investments in focused companies, is able to generate new business creation opportunities. And the number of opportunities for business creation depends upon the conglomerate's reach: the number and quality of connections it is able to make among technologies, customer relationships, supplier relationships, and distribution channels.

While Old Economy conglomerates certainly have the advantage in terms of current revenues, and even more so in terms of earnings, they do not have the reach to position themselves well for the future.

Advantage: New Economy conglomerates

Action Item: Old Economy conglomerates need to look for investments, partners, and new businesses that will expand their reach and position them to not only maintain their size today, but to participate in growth opportunities for the future as well.

In short, traditional conglomerates should hold fast to those strategies that continue to create value in their industries, but move rapidly to adopt new strategies and new approaches to value creation in the dynamic, uncertain, and rapid New Economy industries. Likewise, New Economy conglomerates need to respect the knowledge and abilities of the conglomerates that have preceded them, learn from their mistakes, and adopt the business practices that have led them to survive and thrive for the past forty years.

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