

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

Discussant - Retail Management

Adds taxes and capital procurement to reasons for conglomerates

Food 70's

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Being in business I find myself in a middle position between Mr. Stout and Mr. Nelson. It might help if I tell you a little about our company as a partial explanation of my own particular bias.

Checchi and Company is a consulting firm with a clientele principally among the larger American companies and the United States Government. We are also a management firm. We have the privilege of managing a number of commercial organizations including Greenbelt Consumer Services, the largest urban consumer cooperative in this country. Greenbelt runs a chain of 22 supermarkets, five furniture stores, nine gasoline stations and eight pharmacies. Checchi and Company also does investing on its own account. We have a large block of shares in a Philippine sugar mill, which is the third largest in the free world. We own a food wholesale company in the Virgin Islands. We are in mining, housing, farming, and other investments including some in food distribution and processing.

Unlike the majority of professional economists, I think that conglomerates are not wholly an evil thing. I think they, in common with most institutions, have a potential for good or evil. By and large, I think the impact of conglomerates to date has been on the plus rather than the minus side. I also think that we may have seen the beginning of a decline of conglomerate activity.

There have been three waves of mergers in American economic history. One was in the late 90's when the oil, steel, and other trusts were formed. The other was in the middle and late 20's. The third was in the middle and late 60's. This latter wave, as Dr. Houghton has pointed out, has tapered off considerably in recent months. Each wave was marked by an ebullient stock market. A dull or declining market does not lend itself readily to merger and acquisition adventures by conglomerates of anybody else.

Dr. Stout has indicated a number of reasons why conglomerates have grown. I would like to add a few more.

One are the tax laws. As most of you know, it is advantageous, particularly to the owner of a privately-held company, to sell out by exchanging shares with a large publicly-held company rather than by selling for cash. An exchange of shares is tax free. A transaction for cash is taxable. If I, as a food processor,

want to dispose of my family business -- sell for cash -- I would pay at least a 25 percent tax on the profit. If the business has been in the family a good many years, that tax can be quite substantial. If, on the other hand, I trade my shares to Ling or ITT, it's a tax free exchange. I must pay my tax when and if I sell the shares of the conglomerate, but I can pick the time when I pay the tax by picking the time when I sell the shares. I pay only on those shares that I actually sell and, if I set up a family foundation or make a gift to Ohio State, I can do it by using shares of the conglomerate and thereby beat the tax entirely. Hence, the tax laws encourage mergers including particularly the kind of mergers that conglomerates seek.

Another factor which encourages conglomerate growth is the high cost of capital. I'm not referring here just to the extraordinary high cost of capital during the past few months, but to a longer term trend. The prime rate today is about twice that of ten years ago, four times that of twenty years ago, and eight times that of thirty years ago. Returns on equity capital have also risen. Enterprise today is using relatively more capital for any given endeavor than ever before. Let's take the supermarket industry. In the small Maine town where I grew up there were, in my youth, four or five small stores. They were rented stores, a few counters in each, and an ice box. Now there is only one store, but it is large and represents a capital investment of 10 to 15 times the four or five small stores that it replaced. By and large, this increased need for capital has been applicable to all enterprise. Therefore, as the conglomerate is above all a capital mobilizer, the increasing demand for capital spurs conglomerate growth.

A powerful spur to conglomerate management to grow is the struggle to achieve a rising trend of per share earnings. Very few acquisitions are made that don't promise to increase per share earnings promptly of the acquiring company. An exception, partly based on the scarcity of capital, is the acquisition of asset-rich companies that may or may not have earnings. In such case, the acquiring company acquires a lot of useful assets which, it believes, it can in due course put to better use than they are now being employed.

At this stage, I think conglomerate growth has been more of a benefit than a detriment to the economy. I view with more alarm growth of a single company to a dominant position within an industry, because it can impose monopolistic pricing and restrictive practices. The conglomerate, coming as it does from the outside, typically taking over not the leading company in the industry but the sleepy company that usually is in the lower half of the industry in terms of performance, is a spur -- not a detriment -- to competition. If the top five hundred companies in the United States were each to decide to become a conglomerate and each tried to take an important position in a number of important industries, such as steel, aluminum, food distribution, etc., we would have a great deal more competition, not less.

I agree with Dr. Houghton that benefits don't always follow from conglomerate acquisition but, in general, the record is not bad. Fortune did a study a few months ago and I wish I had brought it with me so I could quote it precisely.

It indicated that it was not true that the per share growth in earnings of conglomerates was due previously to accounting changes or the adding in of low earnings multiple companies to high multiple companies. Fortune dissected the principle conglomerates and came to the conclusion that the per share earnings growth that had taken place was primarily internally generated. In other words, the conglomerates were running the companies they had acquired better than the companies had been run before.

Food businesses by and large sell at low earnings multiples which make them possible targets for acquisition by conglomerates. Some of the companies have assets that are not being well employed. We are now looking at a company which started out as a food wholesales, integrated backward into canneries and farm land, and is about to be acquired by a small conglomerate. There is little doubt that the conglomerate will immediately sell some of that land and employ the assets entirely differently. The return on the net worth of this particular food company is nil. The conglomerate will certainly not tolerate that for long. It will shoot for a return of perhaps twenty-five percent on net worth.

As Dr. Houghton said, profits are not necessarily a social benefit, particularly if the profits appear by accounting tricks. On the other hand, I think there is at least a rough correlation between high profits and social benefits. I think IBM is a more useful company to an economy, in spite of its very high return of capital or perhaps because of its very high return, than most of our textile firms. It's out front; it's pioneering; it makes money, and it spends money. The typical conglomerate manager will insist on a high return on capital. You cannot get a high return on capital by providing things to the market place that the market place doesn't want. I think that the pressure on any company that is taken over by a conglomerate will be to become more profitable and that is usually going to be by driving the company to supply something to the economy better or bigger than it was supplying before.

Are conglomerates likely to go more heavily into the food and distribution field, food processing, etc.? I don't think there's a high likelihood of this at this time. One, the stock market is wrong. Two, the food distribution field, the food processing field, etc., are not all that attractive. The return on capital, for example, is much higher from development and urban land than it is from holding farmland. Food distribution industries are also not that exciting for the typical conglomerate at this time, always excluding the particular exception. A chain of stores may be land-rich, where they own a lot of sites and are carrying those sites at cost. They will be picked up some time soon. Such a chain could be gobbled up, the sites sold and leased back to produce valuable liquidity, and could be interesting to a conglomerate for this reason. Mr. Houghton might say well that really doesn't do the country any good. I'd say he would be right except that probably the people who take over will be smarter than the people who now own or control the venture and they will do more with the assets -- both for themselves and for the country.