The 1999 Annual Essay

The Real Meaning of the Merger Boom

by Peter F. Drucker

This essay by Peter F. Drucker, the "Father of Modern Management," is the first in a series of annual essays prepared for The Conference Board's Annual Report. Forthcoming Conference Board Annual Reports will present original essays by the world's leading economic and management authorities.

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Everybody knows that we are engulfed by the biggest merger boom in history and one that is totally unprecedented. But this simply is not true. There have been many earlier merger booms and some exceeded anything happening today, both in volume and in importance. But there is no "merger boom" today. There is a "merger and de-merger boom"—spin-offs, divestments, sell-offs, and businesses splitting themselves into several separate and independent companies. And these "de-mergers" equal in total dollar volume the mergers that dominate the front pages, and may even exceed them.

Today's mergers and acquisitions, and especially the ones that make the headlines, are qualitatively different from those of past merger waves. The majority of today's mergers are defensive; the majority of yesterday's were offensive.

The truly important developments in corporate and economic structure today are not the mergers and de-mergers. They are, largely unnoticed or at least unreported, new and different ways of corporate structure, corporate growth, and corporate strategy.

The biggest and most important merger boom in U.S. history was surely that of a century ago. Between 1885 and 1910 it created the great majority of the big businesses that then dominated the U.S. economy until 1960 or 1970: Rockefeller's Standard Oil and its progeny; General Motors; General Electric; AT&T; US Steel; US Rubber;

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International Harvester; and all the "Trusts" that so frightened our great-grandparents. This was equally true of the other developed countries of the time (i.e., of Europe), such as Germany's Siemens. Of the U.S. companies that meant "Big Business" in the first half of this century, and for 20 years beyond, only three—Ford, Sears Roebuck, and DuPont—were not the result of repeated mergers and acquisitions. Today, there are plenty of mergers and acquisitions in the new

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"Information Industries." But none of the companies that emerged as the dominant leaders in the "Information Revolution"—IBM and Xerox in its first phase, Intel and Microsoft in its second—were created by mergers and acquisitions or engaged in either.

Quite a few other "merger booms" occurred in both the United States and Europe during these past hundred years. Consolidation of many small companies created the larger electric utilities that existed in the United States at the end of the 1920s. In Europe, mergers created Unilever, the two German super-giants, IG Farben and the Steel Union (both dissolved after World War II by the victorious Allies), and IG Farben's counterpart in the United Kingdom, Imperial Chemical Industries. Mergers also reduced the number of major commercial banks in the United Kingdom from about 15 at the time of World War I to 5 in 1930, and, in Germany, from 12 in 1913 to 3 by 1933.

These merger booms did indeed result in increased economic concentration. But today's de-merger boom constantly reduces concentration. For every "mega-merger" or big acquisition there is at least one—and usually several—spin-offs, divestments, sell-offs to middle-sized or small companies, or the voluntary split-up of a big company into several new and independent businesses.

For example, on June 3, 1999, *The Wall Street Journal* reported one big merger and five de-mergers. The two largest steel companies in the United Kingdom and the Netherlands were merging to create the world's third-largest steel company with sales of $16 billion. But the same issue of *The Wall Street Journal* reported that Hewlett-Packard was spinning off its $8 billion business in test and measuring instruments, Procter & Gamble was selling its adult-incontinence business to a mid-sized company, and the Harris Co. was selling its entire semi-conductor business to a small company. It also reported that Japan's giant Hitachi was selling a very large division making semi-conductor masks to a mid-sized company, while Australia's giant Broken Hill Proprietary was selling its African platinum mine to a small company. These five de-mergers together probably equaled in sales volume the day's one mega-merger. And June 3, 1999 was by no means atypical; pretty much the same merger/de-merger story is being reported every day in the business press.

De-merging began in 1981, when Jack Welch, upon becoming General Electric's CEO, announced that GE would sell off whichever of its businesses could not become either number one or number two worldwide. Nothing like this had ever happened before. But for almost two decades now, de-merging rather than merging has been the development that has most thoroughly changed the world's—and especially the United States's—industrial landscape.

De-merging typically makes business both more focused and stronger, but in many cases, also smaller in size. For instance, since 1987, Imperial Chemical, the United Kingdom's chemical giant, has spun off or sold six big businesses (about half of its total) to concentrate on specialty chemicals. The net result of the restructuring may, therefore, well be substantial deconcentration in the overall economy. What is going on, in other words, is not a merger boom. It is massive restructuring.

One reason behind both today's mergers and de-mergers is the realization that economic diversification is increasingly a handicap in the world economy. Being in the world economy means operating in geographic diversification—and then to be successful, a business must focus economically and concentrate on a few areas which it truly knows and in which it has core strengths. This does not apply only to multinationals that operate in several countries. Every business is in the

world economy today, even if it does not make, buy, or sell outside a regional or national market. The world economy is where every business's competition comes from. Therefore, it is the world economy in which every business has to be able to compete.

Another reason is the steady shift from buying from suppliers to outsourcing major parts of the productive process. Automobile companies traditionally bought individual parts and accessories from separate suppliers—usually for one year only. Now, increasingly, they contract with one supplier to provide an entire part of the automobile (e.g., the entire front end or the dashboard with all its electronics) and for the entire life of a model. This then forces parts suppliers to merge. One example is the recent

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mega-merger of British American Lucas/Varity with TRW into the world's fourth-largest producer of automotive parts. The same development is happening in the aircraft industry and in appliance manufacturing. But this shift to outsourcing whole parts of the process also underlies a large number of de-mergers. It explains, for instance, why another very large parts manufacturer, Rockwell, liquidated itself, selling off individual divisions to other parts manufacturers.

Outsourcing—in which an organization contracts out to an independent company parts of its operations, such as maintenance, managing the company's computers and information systems, purchasing all but a few key supplies, hiring and training people, setting up and running the accounting system—is probably the fastest-growing of the structural de-mergers. No one knows how big outsourcing has become. But virtually no big company today—and not too many small ones—has not outsourced major operations which, only a few years ago, were done in-house. In nine large manufacturing companies I personally know and work with, up to 30 percent of all operating expenses are now fees to outsourcing contractors. These outsourcing contracts sharply decrease economic concentration. Yet there are no figures and no reports, even though the total of outsourcing contracts may well exceed the total of mergers and acquisitions.

Yesterday's mergers were offensive. They aimed at creating growth and wealth. The majority of today's mergers are defensive. They aim at preserving wealth, if not primarily at slowing down decline and shrinking. A majority of big mergers in the past 10 or 12 years have occurred in industries whose share of

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GDP or of the consumer's disposable income has not been growing for many years. This means they are highly vulnerable and on the verge of becoming declining industries. Even if their absolute sales still go up, they are losing ground. This is the case in the automobile industry, the steel industry, commercial banking, and investment banking. In its share of GDP, the pharmaceutical industry—another industry with numerous mega-mergers—is still growing. But its costs, and especially the all-important cost of creating a highly profitable breakthrough drug, are going up almost exponentially while its prices are coming under increasing governmental pressure from deeply troubled health services all over the world. Underlying the frantic mega-mergers in telecommunications is the fact that the traditional telephone business has become a mature business in developed countries where every household and every business now has at least one telephone. The telephone companies, therefore, whether the Baby Bells in the United States or the now privatizing national telephone monopolies in Europe and Japan, try frantically either to merge with one another or to buy their way into new and growing non-telephone telecommunications.

In fast-growing industries the key to rapid growth, especially in earnings, is a jump in market share. This is what the mega-mergers of the "Robber Barons" aimed at, as was fully understood by Rockefeller, Carnegie, J.P. Morgan, or by that least known of the "merger masters," William Durant, who built General Motors out of two dozen mergers between 1908 and 1920. Cutting costs is the way to stave off or at least slow decline in a shrinking or endangered industry. The easiest way to do this, at least temporarily, is to spread the overhead over a bigger base. And this is what so many of today's mega-mergers attempt to do. Whether this works, except for over a short period, remains to be seen. The stock market reaction would indicate that only de-mergers are seen as producing wealth and growth. When a company announces a de-merger, its stock usually goes up. This rarely occurs when a company announces a big acquisition or a mega-merger.

The real news, however, is that neither mergers nor de-mergers—that is, changes in ownership and control—are still the main way to create growth and wealth. Almost unnoticed by the public, and almost totally ignored by the business press and financial analysts, is that the real boom has been in alliances of all kinds, such as partnerships, a big business buying a minority stake in a small one, cooperative agreements in research or in marketing, joint ventures, and, often, "handshake agreements" with few formal and legally binding contracts behind them. It is the way, for instance, in which the pharmaceutical industry has, in the main, moved into new technologies such as genetics. In the past, a big, established company would have moved into such a new area by starting its own development or, more often, by acquiring a company in the new area.

Now the way is typically an agreement that does not give the big company control, such as the numerous agreements that pharmaceutical companies all over the world have made with the science departments of U.S. universities.

Equally typical of the new ways of growth and expansion, but unimaginable at any earlier age, is the recent (June 1999) seven-year pact—worth $8 billion—between IBM and Taiwan's Acer. Under the agreement, each firm will supply crucial PC parts to the other. Yet, Acer is not only a major supplier to IBM (actually manufacturing IBM's low-priced PCs, which are then sold under the IBM label). Its own PCs, for which IBM will now make key components, are also serious competitors on the world market to IBM's own products.

Many more of these alliances defy any traditional definition, whether financial or legal. What, for instance, is the alliance concluded late in 1995 between Intel and Sony—an alliance reportedly entered into without even a signed contract? Intel will design a new PC exclusively for Sony and will manufacture its main electronic parts. Sony will assemble and market the PC

in the U.S. market, in head-on competition with Intel's major customers. There is no financial investment by Intel in Sony or by Sony in Intel. And each firm pays its own costs. What Sony gets is access to Intel's design capacity. What Intel gets is a guaranteed and exclusive customer for its new microchips. This surely fits neither the traditional joint venture nor the traditional "know-how" agreement. What is it then, legally or financially? There seem to be quite a few similar agreements around—in medical appliances, for instance. And outsourcing is also, economically, an alliance or a partnership.

These new relationships do not need to be reported to the SEC or to any governmental body. They do not publish any figures. They do not,

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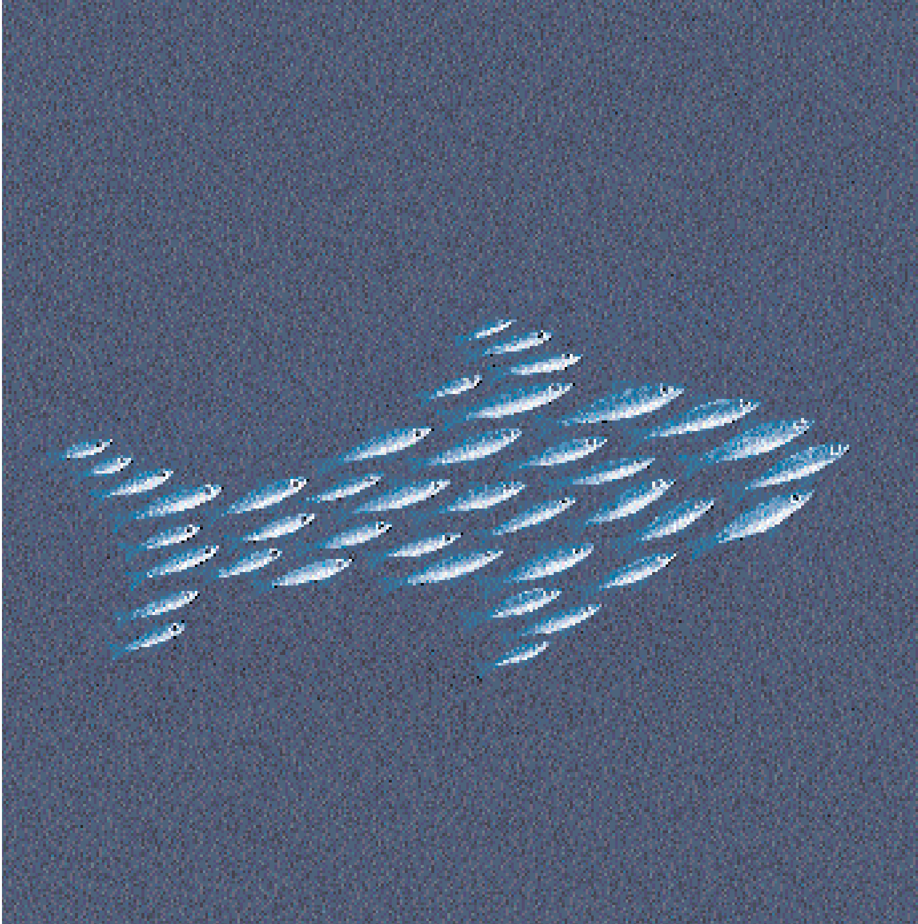
as a rule, involve substantial investment and they need not even be disclosed as a footnote in the auditor's report. To be sure, they usually require some sort of a contract. Legally, this contract looks no different from any other contract for supplies, or for services. Economically, however, it is a partnership meant to be long-lived and entailing working together. The number of such alliances is surely very large—much larger than the number of mergers and acquisitions. One U.S. company—Corning Glass—is said to have more than 1,000 such alliances and partnerships. So has one Japanese company, Toshiba. And the number is growing fast. One mid-sized high-engineering firm had 16 such alliances in 1990. By the middle of 1999, the number had grown to 185—not counting outsourcing deals in five or six areas.

The driving force behind this shift to partnerships and alliances is not money. Big established companies would have little difficulty raising the money needed for either their own development or outright acquisitions. The reason is a change in the conceptual model. In the past it was universally believed that one management model would serve every kind of business. No one expressed this belief more strongly than Harold Geneen, who built a giant company out of acquisitions in the 1960s and 1970s. He acquired 350 companies in the most diverse industries. He was convinced that he could manage all of them and make them all grow by imposing on them the same financial controls and methods. His ITT was the darling of the stock market as long as Geneen ran it. But it began to collapse almost immediately when Geneen retired in 1977.

Today, increasingly, we have come to accept that while principles of management are universal, their application and execution are profoundly influenced, perhaps determined, by the different technology, the different markets,



the different cultures of an individual operation, and, above all, by a company's theory of its business. We are applying this new paradigm even where there is ownership control.

For example, in early summer 1999, the Swiss pharmaceutical giant Roche (formerly Hoffman LaRoche) acquired 100 percent ownership of a mid-sized U.S. genetics company, Genentech. Only 20 years earlier, when Roche had been on an acquisition binge and bought dozens of companies—cosmetic companies, companies producing flavors and essences, and so on—it announced that these acquisitions would become successful by being made into "Roche companies," that is, by having them run and managed in the proven and superior Roche way. Few, if any, of these acquisitions have lived up to these expectations—and by now they have all been de-merged. But Genentech, while wholly owned, will be run as an independent company and in its own totally different way. To underscore this, Roche is selling 19 percent of Genentech on the stock market.

The foundation for the best-known earlier alliances, the joint ventures between U.S. and Japanese companies in the 1960s and 1970s, was still control—which may explain why so few of them survived as a joint venture even though the great majority were eminently successful as a business. The foundation of the new relationship is mutual trust.

The present merger boom is a surface phenomenon—the waves on the ocean's surface rather than its currents. But currents make the climate rather than waves. The real structural changes, in other words, are the alliances and partnerships. They are creating a "different climate." They create a different economy and require different management. They threaten to make obsolete traditional concepts of "bigness" such as the *Fortune* 500—still based, as they are, on control by ownership. These changes make the economy more flexible and more adaptable. But they also make it far less transparent and may make it more volatile. They surely require that executives acquire new skills, if not a different mindset.

They change, for instance, what we mean by "leadership." For in these new alliances, partnerships, and co-existences, nobody commands. Nobody "reports." No one is "the boss." But no one is "the subordinate" either. The same executive who is the "senior" today may, in the same alliance or partnership, be the "junior" tomorrow. Yet, these partnerships and alliances are also not "teams"—every member works independently and with its own goals, objectives, and tasks. Making these new structures perform and work is a good deal more difficult than making the traditional command structure based on ownership and control work. But where they do work, they produce superior performance and superior results.

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