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Bigger is not always better

At university we learn that stock markets are efficient pricing mechanisms. That being the case, investors should appropriately value sprawling conglomerates on the basis of the sum of their individual businesses (often disparate). There should be little upside from splitting up or merging businesses.

In the real world, there are measurable benefits to merging businesses i.e. in pounds and pence on projected financial statements. These benefits, called "synergies", typically have to do with achieving economies of scale as bigger businesses. Synergies can come from many places and often include taking out duplicate costs such as head offices and research and development, using greater scale to negotiate lower input costs, exploitation of management's expertise in a similar business activity or even incremental revenue opportunities generated by cross-selling to each other's customer base. Whether it is in order to generate growth by gaining exposure to different markets or to expand profit margins, company executives have often been incentivised to create bigger and bigger companies.

However, there are also costs associated when companies become so large that they become unwieldy to manage. A sprawling conglomerate of disparate businesses where management cannot help but lack focus due to the unrelated activities taking place. These hidden costs are more difficult to quantify, but typically take the form of persistent underperformance of conglomerate divisions versus "pureplay" peers with more focused and accountable management teams. We know too, from many academic studies, that "spin-offs" are one of the few stock market anomalies which outperform over the long term. It is arguably for these reasons that, absent any projected synergies (or despite incremental costs), the stock market can place a higher valuation on the split businesses, than on the sum of the individual parts - unlocking the so-called "conglomerate discount". Whatever the reason, investors presently award higher multiples to focused businesses versus conglomerates.

United Technologies (UTX) announced last month that they are undergoing a portfolio review to be completed by the end of 2018. UTX is an industrial conglomerate spanning 4 divisions; Elevators (Otis), Air-Conditioning and Security (Carrier), Aircraft Engines (Pratt and Whitney) and Aerospace components. To us, and arguably the market, it is not clear what practical, on-going advantages combining these businesses creates. Certainly, there appears to be few cost or revenue synergies between Elevators and Jet Engines. This makes UTX a prime example of a business which might be worth more splitting up. Indeed, we think it would make the most sense in the near term for UTX to split into 3 parts, since Elevator companies trade at very high valuations relative to Air-Conditioning and Security. Although there will be costs involved, we believe these are immaterial and will be more than offset by the gains in valuation multiple in the near term. Longer term, the divisions should benefit from more focused management and there is potential to recoup some of the dis-synergy through more focused consolidation such as in the aerospace or building systems industries respectively, either through being the predator or as prey.

As shareholders, we are optimistic that the outcome of the review will be the splitting of the businesses, which in turn will help to realise the value of the individual pieces. Bigger is not always better.

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