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Is It Time to Break Up?

In a growing economy, focused businesses can produce higher total shareholder returns than diversified companies.

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Breaking up is hard to do — except when it boosts your share price. Companies such as Motorola, Sara Lee, Fortune Brands, and Expedia have recently reaped S&P 500-beating boosts by splitting themselves into pieces. Indeed, the plethora of spin-offs and "starbursts" during the past six months has many executives and directors wondering whether breaking up makes sense for their firms. Even companies like Cisco Systems are now pondering whether to undo the years of acquisitions that transformed them into diversified giants.

The trend is a good thing, says Gregory Milano, chief executive of Fortuna Advisors, a strategic advisory firm. That's because Fortuna has found that market pessimism about the ability of conglomerates to deliver robust returns — expressed as the so-called diversification discount, when a company is valued at less than the sum of its parts — has a basis in reality.

Milano and his colleagues recently compared focused companies (those with one SIC code) with diversified companies (those with business units in several SIC codes) on the basis of five-year periods of total shareholder return (TSR), which combines share-price appreciation and dividends paid. They found that during the past decade, focused companies tended to outperform diversified ones. For the five years ending in 2003 and 2004, the difference was dramatic, says Milano.

On the other hand, the shares of conglomerates held up better than those of focused companies during times of uncertainty, as in the financial crisis; they earned a sort of "diversification premium," says Milano. "Because the cash flows of differing businesses are not perfectly in sync, they kind of offset each other," he says.

Still, "as we come out of a crisis and head toward growth, if diversified companies are ever going to think about splitting up, this is a good time to do it," says Milano. The chances of a company finding a buyer for a split-off unit rise significantly, and, assuming a premium, that pushes up the seller's share price. Buyers can purchase only the assets they want, not "a bunch of assets they don't want that they might have to then sell."

Milano views the diversification discount not as a market phenomenon but as a performance problem. Conglomerates, he says, tend to fund their individual businesses not when opportunities are good, but when money is available: "When there is a lot of cash, everybody gets more capital; when's there's not much, every unit gets less." Over time that leads to lower TSR, he says.

Cross-subsidies — where management forces one division to buy from another, even though the seller may not offer the best price and value — also dent results, says Milano.

Conglomerates aren't all bad, of course. One advantage: a diversified business can afford to invest in a good long-term idea and wait years for it to pay off — patience that venture-capital and private-equity firms can rarely afford, says Milano.

Private equity, however, is actually a business model that conglomerates ought to emulate in trying to manage diverse businesses effectively, notes Milano. Financial sponsors keep diverse businesses separate and expose them to market factors — they obtain their own financing and have to form bank relationships. And if they don't perform, they don't get capital.

"One of the beauties of the external market is the ability to unfund bad ideas," says Milano. "Corporates are not as good at that internally."