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General Electric

Solving GE's big problem

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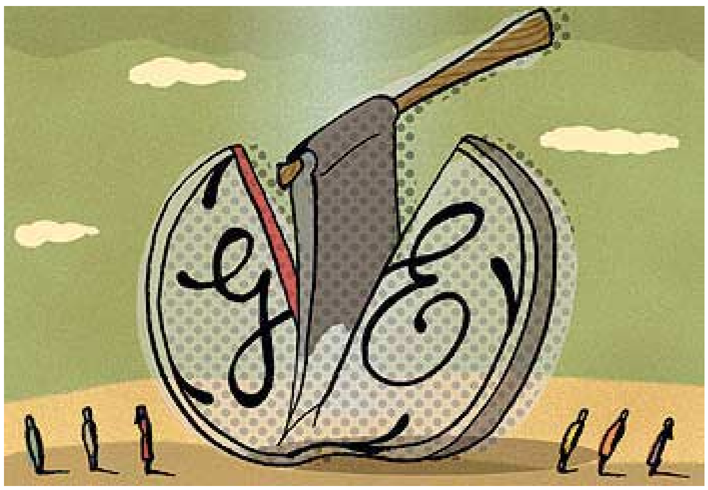

Should the world's biggest conglomerate break itself up?

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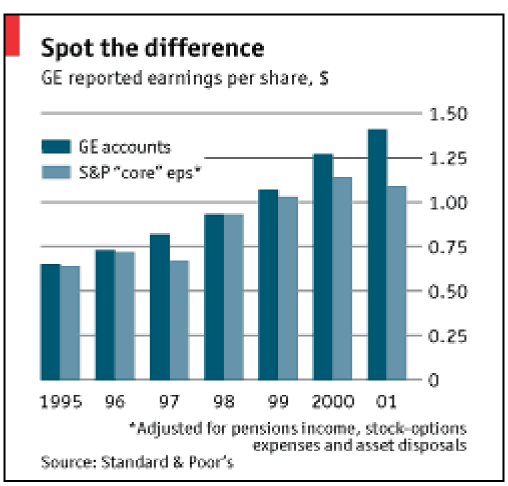
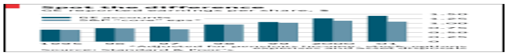
PERHAPS growth at General Electric (GE) is starting to slow. Shareholders have bet on it all year, driving down the share price of what is still the world's second most valuable firm to nearly 60% below its peak in August 2000. Wall Street's ever-bullish analysts have begun to agree: five of the 14 analysts tracked by First Call, a research firm, rate GE stock a “hold” (translation for non-Wall Streeters: “sell”). Now, even the firm's protests seem to be losing force. GE may at last be preparing itself for a refreshing burst of honesty.





There are many reasons to think that GE cannot increase its profits in the long term, as the firm's former boss Jack Welch promised in 2000, by 18% a year. It has more than 300,000 employees and its annual sales top $125 billion. Mr Welch was surely kidding: mature industrial giants do not grow like start-ups. Indeed, the firm that made itself famous during the 1990s by reporting nine straight years of double-digit growth in profits may have never actually achieved double-digit growth rates in the first place. After removing from the numbers "non-core" profits such as gains on pension-fund assets, Robert Friedman of Standard & Poor's, a ratings agency, finds that GE's core profits grew by only 9.2% a year during 1995-2001 (see chart).

GE dismisses S&P's work as just another take on "pro forma" earnings—a reference to the much-discredited profits game played by analysts and firms that has mostly inflated reported numbers. S&P's exercise is, of course, deflating. Like a lot of American firms, GE booked windfall profits from its pension funds in the 1990s: last year, pensions income earned GE more than $2 billion, or 15% of its total reported profits. Because the stockmarket is now less exuberant, however, GE will probably miss out on such profits in the future.

Even growth of 9% a year may be hard to repeat on any consistent basis. The global economy is no longer as buoyant as it was in the late 1990s. This will hit profits at GE's cyclical businesses, such as plastics. GE profited handsomely from a bubble in America's energy markets, into which it sells power turbines. In 1995-2001, profits in GE's power business grew by 37% a year, to over $5 billion last year—nearly 40% of total profits. The energy industry is now in a mess, as is the airline industry, another important GE customer.

As GE Capital has grown, its prized triple-A credit rating has come under pressure

Things ought to be brighter for GE's financial businesses, collectively called GE Capital, which have in the past thrived in recession by acquiring cheap assets. However, as GE Capital has grown (from under 30% of the conglomerate's profits in 1991 to 40% in 2001), its prized triple-A credit rating has come under pressure. The rating agencies say that they like the way GE manages its financial businesses. But they make it clear that GE can no longer allow GE Capital to grow faster than the overall company without sacrificing the triple-A badge. (Only nine firms still have that deep-blue-chip rating.) No matter how well run, financial firms are riskier than industrial ones, so the mix at GE must be kept right, say the agencies. As usual, the agencies seem to be behind the game: the credit markets already charge GE more than the average for a triple-A borrower.

Until now, guarantees from the industrial half to the financial half have let GE understate the true amount of capital tied up in its financial businesses. But the agencies are becoming stricter here too. Further financial-business growth, they say, will need to be built on the explicit foundation of extra shareholder funds on GE Capital's balance sheet. Arguably, this derating has been under way for some time, as the markets bet that GE will either allow GE Capital to grow unchecked, further tainting the quality of its earnings, or leave the finance businesses hobbled by slow growth on the industrial side.

GE seems to have two big ideas about what to do next. The first is to "reshuffle the portfolio". Mr Welch would never have countenanced the sale of GE's historic lighting business. But his successor, Jeffrey Immelt, cannot afford sentiment. At a recent presentation to shareholders, lighting (which Mr Immelt merged, earlier this year, with GE's appliances business) ominously appeared under a column headed "re-position for value". Also in this column were two financial businesses, Employers Reinsurance Corporation and GE Equity, both of which have given Mr Immelt headaches lately. Mr Immelt also said that he wants to buy new industrial businesses.

Mr Immelt's second idea is to begin managing GE Capital in the same way that Mr Welch managed GE's industrial arm, and thereby earned the nickname "neutron Jack": by wringing out costs. At GE Capital, profits grew at the same rate as revenues during the 1990s, as it focused on growth through acquisitions. On the industrial side of the business, profits grew twice as fast as sales. In July, Mr Immelt said that he would reorganise GE Capital's 26 financial businesses into four big units, which seemed to presage bloodletting. Denis Nayden, the man who orchestrated GE Capital's acquisitions strategy, has been pushed to one side. Insiders say that Mr Immelt is now busy installing experienced industrial cost-cutters into GE's financial businesses. In Stamford, Connecticut, GE Capital's home town, company wives are preparing for pain.

Wield the axe, Jeff

GE has long been the exception that proved the conglomerate rule: the firm really was worth more than the sum of its parts. Now, GE's shares no longer trade at a premium to the market. Some board members have even begun to talk privately about a "conglomerate discount".

GE's industrial and financial halves used to help each other. GE Capital got the benefit of a triple-A rating; GE's industrial units got a captive finance company. But now, GE Capital has far outgrown its old captive-finance role. And increasingly, investors want to peer through GE's results to the health of GE Capital's balance sheet. Like it or not, the markets act as if the triple-A rating has already gone. The costs of sticking together, meanwhile, are mounting. GE's industrial businesses are clearly set for a miserable few years. However the firm configures itself, shareholders and creditors will punish any outperformance of the finance businesses over the anaemic industrial side. The jet engines and power plants have become a millstone around GE Capital's neck.

This points to a simple conclusion: break up the company and set GE Capital free. The markets are not demanding it, but it may be only a matter of time. Mr Immelt should seize the initiative, not wait to be forced into action. "Control your destiny", goes the title of one adoring book on GE management, "or someone else will."