Losing its magic touch

The credit crisis and recession have claimed GE's coveted credit rating. What does the future hold for America's venerable conglomerate?

Illustration by Brett Ryder

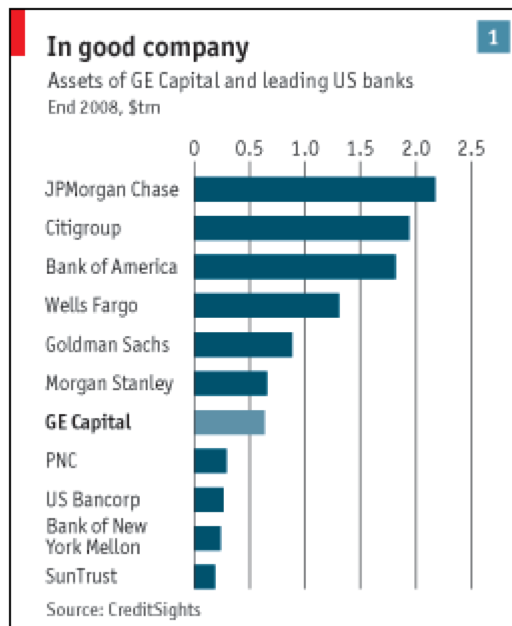
Among the many works that lionise General Electric (GE) as a model of management excellence is one entitled "If Harry Potter Ran General Electric", which claims to draw lessons for managers from J.K. Rowling's tales of the boy wizard. The book is unlikely to rival the original Harry in the bestsellers' chart. But its title might just appeal to shareholders of the American industrial giant, who have watched aghast as their company has fallen under a particularly nasty spell.

Since the turn of the year GE has slashed its dividend by two-thirds, lost a prized AAA credit rating on its long-term debt and seen its stock battered by speculation about the quality of some loans made by its huge financial-services division, GE Capital. Some analysts have portrayed this business as GE's very own chamber of horrors. On March 19th, after The Economist had gone to press, GE was due to reveal more details of the contents of GE Capital's asset portfolio in a bid to quell concerns about problems within.

These setbacks have been deeply painful for a 130-year-old company that has been a member of the Dow Jones Industrial Average since 1896. As well as underlining the importance of swift action to right GE Capital, they also raise big questions about the future of the conglomerate model that GE has long championed. And they have exposed mistakes by the company's senior managers.

How did GE get itself into a mess that has seen $269 billion wiped off its stockmarket value since the beginning of 2008? The main reason is that the strategy which helped GE gain its reputation for consistently producing bumper profits, year in and year out, has backfired. At its core was GE Capital. Founded in 1932 as General Electric Contracts Corporation to provide financing that supported the group's industrial businesses, the operation gradually expanded into other areas of lending unrelated to GE. Under Jack Welch, GE's chief executive from 1981 to 2001, GE Capital grew rapidly.

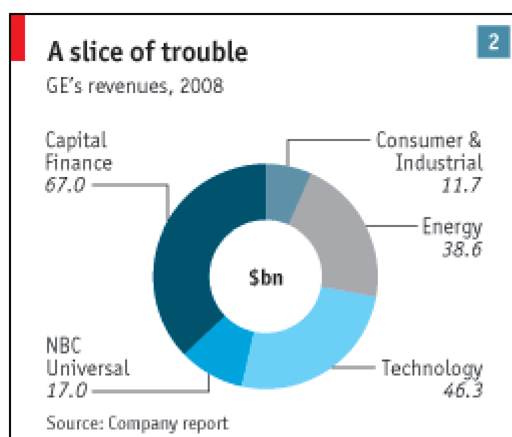
Although Mr Welch has recently argued that it is a "dumb idea" for managers to become obsessed with short-term profit goals, during his reign GE made Herculean efforts to hit its quarterly earnings targets. If GE's industrial businesses fell short of the mark, the company's finance arm would stage a last-minute sale of assets to close the gap. "GE used GE Capital like a cookie jar" into which it dipped when needed, says James Schrager, a professor at the University of Chicago's Booth School of Business.



Jeffrey Immelt, Mr Welch's successor, sold some of GE's financial operations, including its poorly performing insurance businesses. But he continued to expand GE Capital, which built up large portfolios of property loans, credit-card debt and other assets in increasingly far-flung places, such as eastern Europe. If GE Capital were a bank, it would rank as one of the biggest in America (see chart 1). Its growth has made the division more and more important to its parent's overall revenues and performance (see chart 2). In 2007 GE Capital's profit made up 55% of the company's total.

GE's managers were delighted with this. But they failed to appreciate the risk of GE Capital's funding model, which left the business dangerously exposed to disruption in financial markets. With few retail deposits to speak of, the firm gorged on long-term debt and commercial paper to fund its lending. While the world was awash with credit, these cheap funds provided GE Capital with a licence to print money. But when the credit markets suddenly seized up, the strains soon began to show. In April 2008 GE shocked investors when it missed its first-quarter earnings target by a mile.

Since then, GE has been battling to shore up confidence in its financial arm. Among other things, GE Capital has tapped cheap funding lines backed by the American government and has greatly reduced its exposure to the short-term commercial-paper market. It has also secured more than 90% of the long-term debt that it needs for the year.



At the same time, GE has been building up cash, some of which has been deployed to prop up the finance business. Last October the firm raised $15 billion from a group of investors

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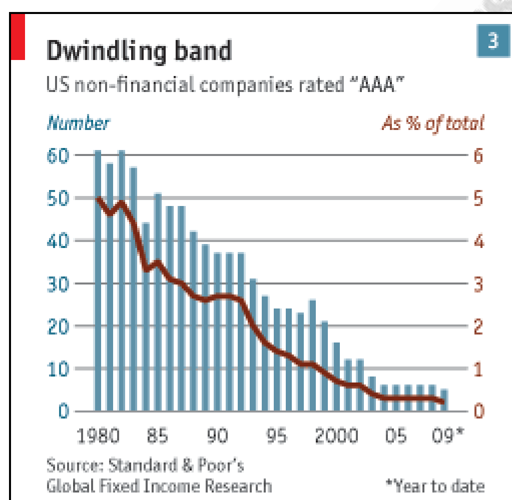
including Warren Buffett's Berkshire Hathaway. In February it said it would slash its quarterly dividend by 68% from the second half of 2009 in order to conserve $9 billion of cash on an annual basis. The dividend cut was a bitter blow for small investors who had come to view GE stock as tantamount to an annuity. It was the first time the firm had reduced its dividend since 1938.

Out of the club

Despite all this, GE failed to save its top-notch credit rating. On March 12th Standard & Poor's (S&P) stripped the parent company and GE Capital of their AAA long-term ratings, downgrading them to AA+. A mere five non-financial companies still have the agency's top rating (see chart 3). GE had been in the elite since 1956. Some expect its rating to slide further this year as the economy worsens. GE Capital clocked up $12.2 billion in 2007 and made $8.6 billion in 2008. Analysts, predicting write-downs, have been doubting whether it will make a profit of $5 billion in 2009, as its parent forecast earlier this year.

At this week's meeting GE was due to lay out for analysts the prospects for GE Capital's portfolio under two different economic scenarios. The company was expected to say that, under the less auspicious of these, GE Capital would only break even this year.



Given the unit's difficulties, it would be understandable if Mr Immelt wanted to jettison GE Capital as soon as it has been nursed back to health—which may take a while. But he insists he is committed to the business, which he says has strong franchises in areas such as aviation and energy finance, thanks to its close association with GE's industrial activities. The goal is to shrink the financial-services division so that it represents no more than 30% of GE's profit, to reduce its leverage and to develop a bigger deposit base, so that it is less reliant on wholesale funding.

There are two risks with this plan. The first is that investors will remain leery of GE's stock for as long as the company owns a sizeable business that is vulnerable to a systemic upset in the financial world. Shrinking it would lessen the threat to GE's cash-pumping industrial operations, but not remove it altogether.

The second risk is that tomorrow's finance is going to look very different from today's. GE Capital flourished as a member of the "shadow banking" system of firms that offered myriad financial products without having to bear the regulatory burdens of banks. In future, firms that perform bank-like activities can expect much stricter oversight, whether or not they have a banking licence. That will impose greater costs on the business. And if GE Capital's credit rating continues to slip, raising its funding costs, it will find it much harder to turn a decent

profit. GE reckons that a shrunken finance operation can achieve a 15% return on investment. However, this may be wishful thinking.

Imagine, though, that Mr Immelt changed his mind and decided he would like to be rid of GE Capital. To say so now would be foolhardy, because this would trigger speculation about the unit's longevity as a stand-alone business, possibly unnerving its counterparties and sending more shockwaves through the financial system. There would also be huge legal, tax and other headaches to contend with—assuming Mr Immelt could find a buyer. But if GE's repair job were complete and the credit crunch a distant memory, there would be fewer hurdles to a sale.

Whatever the ultimate fate of GE Capital, a bigger question remains: does GE itself still make sense? The justification for a conglomerate is that in difficult times its broad selection of businesses should enable it to maintain profitability when its more specialised rivals struggle. GE's hybrid industrial-financial model was supposed to be a superior version of the type.

Yet by Mr Immelt's own admission, GE's reputation as a safe port in an economic storm has been "tarnished". Although the company made a profit of $18.1 billion in 2008, this was nearly 20% less than in 2007. This year is likely to see another sharp decline. Aside from the problems at GE Capital, several of GE's other businesses, such as media and health care, are having a torrid time. Nicholas Heymann of Sterne Agee, a stockbroking firm, reckons that GE's health-care business could see earnings drop by 25-30% this year as its customers suffer budget cuts.

Under the charismatic Mr Welch, the firm focused on cutting fat and boosting efficiency, and used the cash generated to go on a shopping spree, building leading positions in industries such as energy and transport. He also sold a number of ailing businesses. But by the time Mr Immelt became chief executive on September 7th 2001, just four days before the terrorist attacks on New York and Washington, it was clear that GE needed to change direction. For one thing, its rivals had aped many of the efficiency-boosting management tools that had once given GE an edge. For another, the rise of deep-pocketed private-equity firms had created stiff competition in buying top-notch assets.

Mr Immelt, recognising that the world has changed, has placed more emphasis on organic growth since taking office. He has built up the company's marketing expertise, whereas in Mr Welch's GE engineers and spreadsheet jockeys were the masters. And he has focused on innovation. Since 2001 GE has invested $330m to expand its research facilities around the world. It spent $4.3 billion on R&D in 2008, up from $2.3 billion in 2002.

In a bold initiative, "Ecomagination", GE is aiming to dominate the market for clean technologies such as wind and solar power. By lifting its investment in clean-tech R&D to $1.5 billion a year by 2010, the company hopes to produce more ideas like its hybrid diesel-electric locomotive, which stores the energy dissipated during braking in batteries that can be called on to power the engine later. Such ideas have boosted organic growth in GE's industrial businesses to 8% in 2008 from 4% in 2001.

Illustration by Brett Ryder

The firm has also dumped a number of its underperforming operations and made acquisitions in promising areas such as Hispanic media and clean technology. Altogether, GE has snapped up about $101 billion of assets since 2001 and disposed of $53 billion of businesses. Now looks like the time to pick up more high-quality targets on the cheap. Given the problems with GE Capital, however, the company is likely to think twice before splashing out. Mr Immelt and his lieutenants have repeatedly stressed in recent weeks that their number one priority is to keep the company "safe and secure".

Here lies the rub. One tenet of the conglomerate model is that a judicious mix of businesses should offer insurance against the worst ravages of a recession, leaving enough capital free at the corporate centre to support expansion when rival firms are pulling in their horns. Yet GE Capital's problems are so great that the priority now for its parent seems to be to hoard as much cash as it can.

So does this mean that GE should be broken up? Assuming the company can revive GE Capital, there might be a case for hanging on to that business even if its margins are squeezed. By refocusing on its original mission, a stripped-down finance unit could help drive sales at GE's industrial operations by providing finance for large infrastructure projects and other activities. But investors would need cast-iron reassurance that the business would be kept out of the freewheeling activities in which it has come a cropper.

The case for keeping the rest of GE together, at least for the time being, is based on three arguments. For a start, the company's leaders deserve more time to show that their R&D investments can pay off as the economy recovers. Next, in a world in which governments will become bigger customers for GE's wares, thanks partly to huge fiscal stimulus packages, the company's expertise in dealing with public authorities should benefit all of its divisions. Given GE's strength in areas such as clean technology, energy and transport, it stands to benefit from at least some of the public money that will be up for grabs.

The third argument in favour of keeping GE's industrial side intact is that it has learnt how to sell its disparate wares to foreign governments in compelling combinations rather than one by one. Last year, for example, GE signed a wide-ranging partnership with Mubadala, the commercial-investment arm of Abu Dhabi, which included a joint venture in commercial finance, some renewable energy projects and a new GE training centre. The company also struck deals in China, connected to the Beijing Olympic games, that generated $2 billion of revenue. At a time of rising protectionist sentiment, GE's ability to assemble such packages could ease its path into new markets.

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In his annual report to GE's shareholders, which was published last month, Mr Immelt argued that so long as the company could get itself through the recession, it would benefit as global capitalism was "reset" in some of the ways outlined above. To weather the cycle, GE's management plans to keep cutting billions of dollars from its costs, to generate more revenue from its growing business that services turbines, jet engines and other GE gear, and to keep investing in the development of its employees' capabilities, on which it spends $1 billion a year.

Fallen heroes

GE prides itself on being a breeding ground for exceptionally talented managers. That is likely to remain true. Its industrial businesses are basically well run, even though recession will be a drag on their results. Yet the company's halo has slipped because of the debacle at its finance arm. Given the precarious nature of GE Capital's funding structure, GE should have been alert to the risk of a complete dislocation in financial markets. But it failed to consider such a possibility. The firm says it now plans to give a greater voice to contrarian types within its ranks, who can play devil's advocate in planning meetings.

GE was not the only blue-chip company to be caught out by the speed with which credit markets shut down. But it made matters worse by being slow to reveal details of GE Capital's loan portfolio. Instead it tried to persuade investors that the business could ride out the storm, without giving them enough information on the contents of the finance arm's black box of assets. This sparked wild speculation about the state of GE Capital's balance-sheet, undermining GE's share price (see chart 4). "As financial services became more volatile, we should have given more transparency and less guidance," admits Mr Immelt.

The chief executive has paid personally for GE's poor performance. At his own suggestion he is going without a bonus for last year (though he was paid a salary of $3.3m). For 2007 he scooped $5.8m. Mr Immelt has also given up a special, three-year, long-term incentive payment that would have been worth $11.7m.

Some critics claim that GE's boss has dented his credibility by making several optimistic predictions that have been quickly proved wrong. For instance, barely a couple of weeks before the company revealed that it had missed its earnings in the first quarter of 2008, Mr Immelt declared that he expected GE to hit its target. In September he denied that the company needed a fresh capital injection. But soon afterwards it announced that it had raised $15 billion from Mr Buffett and others.

Mr Immelt argues that he had to reverse course swiftly in the autumn because financial markets suddenly took a turn for the worse. “What you don’t want to be is a consistent but dumb guy,” he says. He has a point: had GE not moved fast to build up its finances then it would certainly be in a far worse predicament now. Nevertheless the suspicion lingers that GE’s boss has a habit of promising too much. The best way for him to rebuild confidence in his leadership will be to demonstrate that GE can bounce back quickly from its woes. It will require a prodigious feat of managerial wizardry to pull that off.

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