The Conglomerate Dilemma: Reshaping General Electric

General Electric Company (GE:NYSE) – market cap as of 17/11/2017: $157.92bn

Introduction and past events

General Electric (GE) is an American multinational conglomerate corporation incorporated in New York and headquartered in Boston. As of 2016, the company operates through the following segments: Aviation, Current, Digital, Energy Connections, Global Research, Healthcare, Lighting, Oil and Gas, Power, Renewable Energy, Transportation, and Capital which cater to the needs of Financial services, Medical devices, Life Sciences, Pharmaceutical, Automotive, Software Development and Engineering industries. In 2017, GE ranked among the Fortune 500 as the thirteenth-largest firm in the US by gross revenue.

As a huge conglomerate with over 125 years of history, GE went through numerous acquisitions and divestments. However, since 2010, GE has greatly downsized its operations in GE Capital and sold multiple portfolio businesses. In 2011, GE Capital sold its $2bn Mexican assets to Santander for $162m and exited the business in Mexico. In August 2015, GE Capital agreed to sell its Healthcare Financial Services business to Capital One for $9bn. Also in August 2015, GE Capital agreed to sell GE Capital Bank's on-line deposit platform to Goldman Sachs. Terms of the transaction were not disclosed, but the sale includes $8bn of on-line deposits and another $8bn of brokered certificates of deposit. In September 2015, GE Capital agreed to sell its transportation-finance unit to Canada's Bank of Montreal. The unit sold has $8.7bn of assets, 600 employees and 15 offices in the US and Canada. According to the CEO Jeffrey Immelt, the divestments and transformation of the company were aimed to reestablished GE as a technology company. GE radically changed its portfolio by focusing on core industrial businesses and divesting slower-growth, low-tech, and nonindustrial practices. In 2015 alone, GE Capital divestitures totaled $157bn, and they included most of its real estate and loan portfolios. "All these transformations dovetailed to a certain extent. They were intended to focus us on creating value for customers by making our core businesses leaner, faster, more technical, and more global, and putting them on the cutting edge of the digital age" said the CEO. The company anticipated its high-value industrials to generate more than 90% of total earnings by 2018 following the divestitures. GE Capital's verticals are now aligned to drive growth in GE's core industrial businesses – GE Capital Aviation Services (GECAS), Energy Financial Services (EFS) and GE Industrial Finance, which will include the Healthcare Equipment Finance business, Working Capital Solutions (WCS), and other financing activities to develop lending and leasing products for the GE Store. One financing center that serves the entire GE system, GE Treasury, and several specialty insurance platforms, are also a part of the "new" GE Capital.

Industry Overview

GE has traditionally operated in many industries, each with different market structures and contexts, some of them which are not strictly related to its historical core operations, such as its industrial lighting, its locomotive, and its energy businesses. The latter has recently undergone the merger with Baker Hughes which closed earlier this year and has been under-performing since then. Another example of this dynamic would be the Alstom acquisition, closed in late 2015, after which demand has proved sub-par for the market.

John Flannery, GE's new chief executive, has announced that the company will focus on its three core industries, namely power, healthcare, and aviation. For the first of the three, the outlook is not very bright: the demand for electricity has been lower than what would be expected given the realized growth of the economy. The US' Energy Information Department (EIA) has reported that the growth rate for electricity demand since 2002 has been more than one percentage point lower than it was for the past decades. The same dynamic is at play in the EU, where end-use electricity consumption declined in 22 out of 28 countries according to Eurostat. Further, the replacement of old equipment and the economic shift towards industries with a lower energy consumption profile drags down the possibility of revenue growth in the segment. GE, whose power business accounted for c. 24% of its total revenues last year, has suffered competitive pressures to lower its cost structure in order to face this new reality and fend off competition from renewables.

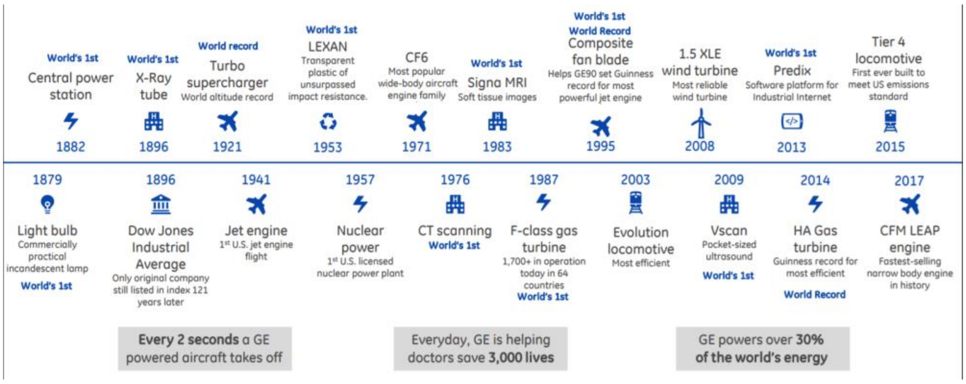
In the healthcare industry, the last year US presidential election results have shifted the landscape. GE expects a slower healthcare market if the Affordable Care Act (ACA, or Obamacare) in the US is repealed, as announced by the Trump administration. However, the demographics trend taking place in the advanced economies nudges the market towards rising demand. Further, companies in the sector haven't been able to implement more cost and operational improvements and they will need to adapt to the new challenges brought forward by innovation driven by the application of big data analytics.

As the aviation industry is concerned, GE can allow for more optimism in its decision to double down in its three core businesses. Oliver Wyman, the consultancy, estimates that over the next ten years c. 60% of the worldwide aircraft fleet will be replace by new-generation models. The bulk of the fleet growth will come from emerging markets, whereas Europe and North America will present a small but still positive growth rate. This context is already reflected in GE Aviation's performance, whose operating income rose 12% YoY in Q3 FY17. The company reports that worldwide revenue passenger kilometers jumped c. 8% YTD and that air freight volumes in the period going from the beginning of the year to August 2017 were 11% higher than in the same period of the previous year.

Company Overview – through the 'restructuring lenses'

General Electric is a 125 years old American Conglomerate; as complexity of the Company has grown through the years, and significant changes have occurred, the starting point is to look at the most recent state of the businesses portfolios. As of 13-nov-2017 investors update, the GE umbrella is comprehensive of:

- Power
- Renewable Energy
- Oil & Gas
- Aviation
- Healthcare
- Transportation
- Lighting

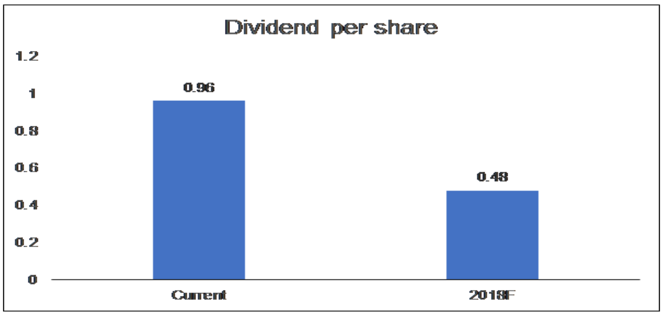


As of 2017E, out of expected $125bn revenues, 75% to 80% come from segments in which GE holds the leadership in the market; more specifically: the firm is the leader in aviation, power, healthcare and transportation, has a full stream within the oil & gas business thanks to the acquisition of Baker Hughes. The overall recipe for value creation is summarized by GE in 6 pillars: leading franchises, valuable and productive assets, strong human capital, global reach and leadership with technology, also through significant investments for the future. The overall value proposition is therefore based on investments to drive growth, relying on a strong technological and reputational backbone.

According to GE this proposition can be further refined and the process would pivot around the focus on GE strengths and cuts to the portfolio where deemed value accretive. In detail, GE sees its major strengths in its customer base, technology and asset quality, expertise and global reach; this 'internally generated' strengths are amplified by a tonic end market which allows for high margins and growth, well suited for satisfactory ROIC and stability.

For what concerns cuts to the portfolio and, generally speaking, disciplined investments, GE has declared to improve the investment policy; the goal is to focus on profitable investments, yielding a stronger cash position. Capex shall be more balanced, stabilizing at 1x reinvestment rate, and R&D shall be c. 4% of revenues per year. This stronger discipline will improve the cash and cash generation profiles, and further assurance will come from the cut in dividends ($0.48 per share) and a target 2.5x leverage (calculated as Net Debt / EBITDA).

As it may be a significant of a concern for investors, it is worth delving further deeper into the dividend policy.



Clearly, the DPS is set to diminish by 50% (drop in dividend yield from approximately 4.7% to an expected 2.3%), bringing the overall outflow from $8.4b to $4.2b, but what is interesting is that the ratio dividend/FCF will drop from above 100% to a healthier 60% to 70%. The alignment of the dividend payment with the FCF is reasonable and welcome as no firm shall systematically pay out more than the cash it generates: this attitude would cast distress on the investment policy and induce higher leverage; moreover, as per Modigliani-Miller, this financing decision would have no whatsoever positive impact on the value of the firm (EV) and, therefore, on shareholders' net wealth (as a quick check: through debt issue, the firm will record an increase in financial debt and cash which yields a net 0 effect on the Net Debt and, therefore, on the Equity Value assuming a plain vanilla EV-to-Equity bridge; the argument still holds even if we include minorities, associates and pensions. After the dividend distribution, cash will drop by the amount of the dividend and so will do the equity; this cancels out the 'increase' in net debt and is neutral to the value of the firm).

Going forward in 2018, GE expects adjusted EPS from $1.00 to $1.07, driven by organic revenue (3% at most), margins on industrial earnings of 40bps and industrial profit in the range of 2% to 7%. Given the decision to cut dividends and discipline capex and R&D investments, it is worth having a glance at the 2018E Industrial FCF: the flow shall settle around $6bn to $7bn, mainly driven by higher continued net income, working capital and capex discipline. Overall, 2018 is deemed by the management as a 'reset and stabilize year' in order to set GE on the right path for future growth.

One last fundamental variable in the path towards sanity and cash flow generation is the control of the costs profile of GE: total cost out in 2018 is forecasted to settle around $2bn, springing from simplification of the power business, focus on digitalization, synergies and integration with Baker Hughes and additional savings across all segments.

GE restructuring and rationale

The dividend cut, along an already announced $20bn asset disposal, are clear signals of the turmoil GE is going through; as reported in the investors update, GE is set on a path to become smaller and simpler, greatly focused on earnings and cash flows improvement. The basic rational of the proposed cuts is to be found in cash savings and greater cash flow generation potential, also driven by a disciplined investment policy (see GE description).

Dividend cuts are never pleasant: it is less distributed cash to shareholders and it clearly signals to the market that the company is out-of-balance from a financial standpoint when the cut is executed purposely to save cash.

This plan to revive GE cash position, follows a first attempt in 2015, pivoting around the sale of financial services operations. This time, the proposed $20bn asset sale is mainly addressing the remaining assets in the lighting division (a long-time jewel of the crown of a business created by Thomas Edison) and the assets of the century-old locomotive business.

If aircraft engines and medical equipment divisions are performing well, then power and oil divisions are somewhat lagging behind, due to an overhaul of the industry equilibria. This crisis stretches also towards another big player in the industry: Siemens. The two have suffered from declining production costs in solar and wind power, making them cheaper sources compared to old-fashioned fossil fuel; GE (Siemens alike) has been forced to cut down costs and reshape their approach to business. The relevance of this strategic fit can be easily assessed through a quick look at the 2016 revenue breakdown for GE: 23.7% of revenues comes from the power segment and such significant swings are likely to have repercussions which will not leave the business and management indifferent.