A GOOFY DEAL

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With the enormous planned merger between Disney and Capital Cities/ABC, vertical integration in the media business appears to be all the rage. Disney CEO Michael Eisner says that this merger holds so much potential for synergy that "1+1=4." His math may benefit from closer examination.

The Disney/ABC deal is only the latest in a series of vertical transactions in the information industry. This trend appears to ignore a painful lesson many companies have already learned: In a competitive market, vertical integration is a two-edged sword at best. With most such attempts, more can go wrong than right.

All of the ballyhooed synergies being talked about in this merger could as well be accomplished through nonexclusive strategic alliances between the companies. For example, if it indeed does make sense to package the Disney Channel and ESPN together to penetrate overseas markets, as analysts are suggesting, the same outcome could be achieved without a merger. Companies would remain free to seek appropriate alliances in various markets. Indeed, such alliances and partnerships will be necessary in order to launch and nurture new markets for existing forms of content as well as for new types of multimedia services.

The notion of a captive (i.e., in-house) customer of a captive supplier is a dangerous one because it often leads to uneconomic decisionmaking and can seriously hurt the competitiveness of the integrated company. It is also highly susceptible to politically tinged transfer-pricing considerations. Moreover, it has the almost immediate impact of inspiring counteralliances from rivals, negating many of its supposed benefits.

Beyond that, most vertical combinations are troublesome because they result in an "excluded market" that can often exceed the "included" market in size and profitability. In other words, they lead to the capture of a larger share of a smaller pie. The "second order" effect of such synergy-seeking efforts is seldom adequately considered by corporate strategists intent on the deal.

An early illustration of this was the ill-fated Allegis venture launched by then-Chairman Richard Ferris of United Airlines in 1987. Mr. Ferris's vision appeared, on the surface, highly plausible, even ingenious. He had acquired several small airlines, as well as Hertz, Westin Hotels and Hilton International, and wanted to combine those properties with United Airlines to create the ultimate "one-stop-shop" for business travelers. Holding it all together would be the "glue": United's Apollo reservation system. Mr. Ferris saw several operational efficiencies for the new company, including a shared information infrastructure and a common marketing platform under the Allegis umbrella.

However, there was a significant but less understood downside: While each of the three operating units (air, hotel, car rental) would likely capture a larger share of travelers using the other two, it also stood to lose most of the travelers not using the other units. In other words, by offering convenience and better value, Hertz might have captured 80% of United's customers coming in to Washington National; however, United might account for only 20% of the traffic through National. Before Allegis, Hertz (with, say, an overall 40% market share) captured about 40% of the customers using American, USAir, Delta and so on. After the merger, this number would be way down, since competing airlines would likely counter the United-Hertz combination by aligning with Avis, National and so on. The same logic applies to any combination of the three entities.

Allegis never got off the ground. Mr. Ferris failed to convince Wall Street analysts and then his own board of its benefits. The stock price fell, and less than four months after Allegis was formed, Mr. Ferris was forced out. The company sold off all nonairline assets to become United Airlines again. The lesson was not an entirely new one; even before the Allegis attempt, Pan Am, TWA and AMR had all failed in similar attempts to combine separate travel services under the same corporate umbrella.

Today, the combination of a predominantly content company (Disney) with a predominantly distribution and packaging company (ABC) raises many the same issues. Content is most valuable when it seeks and receives the widest possible distribution -- when it is readily accessible to every potential customer. By the same token, an information distribution/packaging company such as ABC functions best when it has unfettered access to all possible content sources at competitive prices and can assemble the best mix for its chosen market. Any reduction in this freedom is a steep price to pay for so-called synergies of forced joint action.

Indeed, to carry this argument to its logical conclusion, Capital Cities/ABC should separate its content and distribution entities and establish at least an arms-length relationship between them.

Great content, just like great products, will readily find distribution. If a product cannot earn distribution the old-fashioned way (by providing real value to a sizable segment of the market), buying distribution is certainly not the answer. Some years go, unable to find a retailer willing to stock his computers, Jack Tramiel, chairman of Atari Corp., decided to buy Federated Group Inc., a struggling electronics retail chain. The reason other retailers were reluctant to carry Atari's machines was that most customers regarded the company as just a video-game manufacturer. With its purchase, Atari triumphantly gave its computer line extensive and prime shelf space within Federated stores. Not surprisingly, both Atari and Federated soon faltered.

Though neither Disney or ABC are struggling (to say the least) the downside remains the same, while the upside is even more dubious. It is difficult to conceive that Disney today has problems obtaining distribution for its content, just as ABC has little trouble acquiring content for its distribution system. With the merger, less-than-optimal decisions on content sourcing and distribution channel selection will become increasingly likely in the future.

Some analysts have suggested that the lessons of United and Atari don't apply to the information industry. But they clearly do, as the cases of Matsushita and Sony show.

Matsushita entered the movie business by purchasing MCA, seeking synergies between entertainment content and its own devices business. While the studio did well under its hands-off ownership, Matsushita failed to realize synergies in hardware sales, even with the studio producing hits such as "Jurassic Park." The company recently sold out to Seagram.

For its part, Sony Pictures has endured a string of box-office flops, forcing a huge $2.7 billion write-down in 1994 from its 1989 acquisition of Columbia Pictures. Sony's move arose in part from the failure of its Digital Audio Tape format, which languished because few companies put out music on the new format. By convincing itself that an in-house source of content would enable it to jump-start a market for new types of electronic devices, Sony made a colossal miscalculation. The company may well be forced to exit the content business and retreat to what it does extraordinarily well: design and manufacture world-class electronic products.

An even closer analog to the Disney/ABC deal are two recent initiatives by several of the Baby Bells. In August 1994, Disney signed a deal with Ameritech, BellSouth, and Southwestern Bell to develop content for the phone companies' planned interactive networks. A few days later, Creative Artists Agency brokered a deal with Bell Atlantic, Nynex and Pacific Telesis with similar objectives.

While these deals are relatively small, they still defy logic. Bell Atlantic CEO Ray Smith used to joke about nobody wanting to see a movie made by a phone company. Yet, that is precisely where these ventures appear to be headed. Potential problems abound: First, the broadband networks that these services are aimed at are likely to roll out very slowly and will scarcely cover a fraction of the market that might be interested in such fare. Second, the networks would be forced (or at least obliged) to carry the internally developed content, even though it may not be of acceptable quality.

But even if the content is of high quality, it will not achieve the market coverage it needs to generate adequate revenues if it is restricted to the Bell networks. It would thus have to be sold to others to make the entity viable in a business sense -- making it no longer unique to the Bells.

Consider what John Malone, CEO of cable operator TCI, had to say about the Baby Bell agreements in the April 10 issue of Business Week: "I'm not sure what it gets them. I mean, I may be smoking pot or something, but I thought I had a 15-year contract for all of Disney's movies. They say they want guaranteed access to programming, but that's like saying you need to own a share of stock in a dairy to get milk. Money buys programming. Anyone with good programming is going to want to distribute it as broadly as possible. They're not going to say: `I'm only going to sell my product to Ray Smith's subscribers.' This is brain damage."

A case can be made for combinations between content providers and delivery services, but only under one condition: to jump start the flow of content for newer types of networks. America Online is doing this today by providing seed funding for a select group of providers of new information services. Over the years, Mr. Malone himself has invested in content companies such as TBS, the Discovery Channel and the like, primarily to ensure an adequate supply of content for the then-nascent cable industry. But TV isn't a new medium, and it doesn't take Disney's direct involvement to ensure a plentiful supply of programming.

Maybe Michael Eisner should have talked to John Malone before placing his $19 billion bet on Cap Cities/ABC. This may not be a Mickey Mouse deal, but there's a good chance that, in retrospect, Mr. Eisner's decision will be seen as Goofy.

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