

# The age of the supercompanies?

MIKE GALLAGHER, CFA, CAIA

HEAD OF DISTRIBUTION, INTERMEDE INVESTMENT PARTNERS

American corporations are enjoying a golden age of profitability. Intermede examines the sources of their current relative dominance and the potential risks faced by some of the technology businesses that currently sit at the top of the pile.

A MARCH 2016 article in The Economist argued that the process through which the level of corporate profitability typically mean-reverts appeared to be broken in the United States.<sup>1</sup>

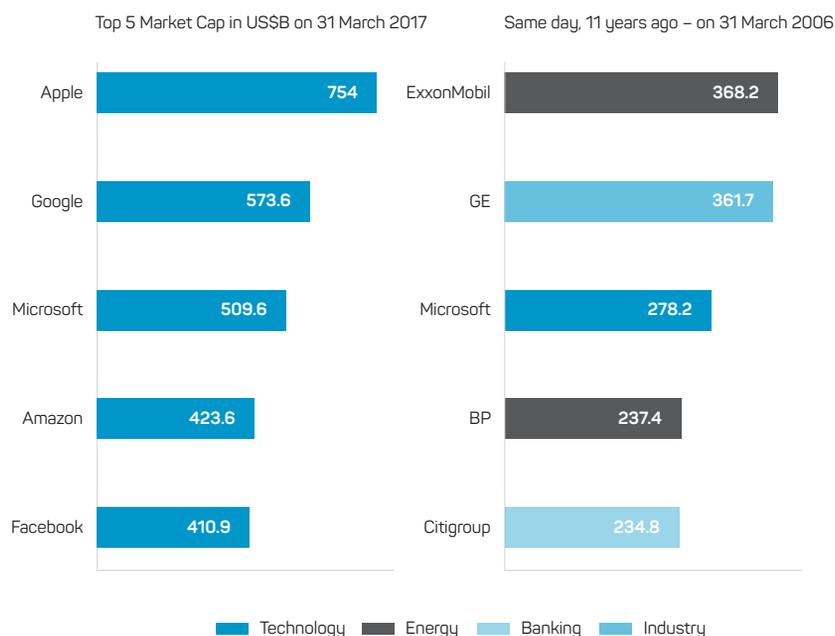
High profits typically attract new entrants to a sector, after which increased competition dilutes these supernormal returns. Discouraged investor capital then heads for the exits, planting the seed for the cycle to begin again.

An observation from consulting firm McKinsey supports the view that US firms have bucked this trend in recent years: "An American firm that was very profitable (one with post tax returns on capital of 15-25%) in 2003, stood an 83% chance of still being very profitable in 2013 ... In the previous decade, the odds were about 50%".

The proposed causes of this sustained corporate dominance included increased consolidation (the number of listed firms in the US has halved in the last 20 years), as well as an increased level of concentration within industries.

An outcome of the above shifts (to which we would add as additional causes, the decreased bargaining power of labour, and a declining corporate tax burden) has been a leap in profitability. Cash flow return on investments for US companies has gone from an average

CHART 1: Supercompany dominance in recent years



\*Berkshire Hathaway has been excluded from the rankings since it's mainly a stock portfolio company

Source: 'The profound implications of five increasingly dominant tech companies', medium.com, accessed 26 September 2017.

of approximately 5.5% (1976-1996) to closer to 9% (1997-2016).<sup>2</sup>

Clearly then, this has been a good period for US corporations. At the forefront of this trend have been the small set of mega cap technology businesses ("supercompanies") that have risen to dominance in recent years, as reflected in Chart 1.

## AS INVESTORS, HOW SHOULD WE VIEW THIS TREND?

A period of peak optimism with respect to the operating prospects of a business can coincide with a heightened level of investment risk, if this positive sentiment leads the market to place an excessive valuation on the future earnings stream

of the company. It is therefore important to seek correctives when times are good. One arguably reliable behavioral guardrail can be found by reviewing the mixed history of technology investing.

## WHY DO THINGS GO WRONG?

In a widely-circulated recent client memo,<sup>3</sup> Oaktree's Howard Marks listed the risks that can deflate techno-optimism: an unforeseen change in environment; the emergence of a hidden flaw in a young business model; excellence in concept being undercut by weakening execution; or (perhaps most commonly) extreme overpricing of decent fundamentals subsequently resulting in destruction of investor wealth.



Our favourite encapsulation of irrational valuation dynamics came from Scott McNealy, the ex-Chairman of Sun Microsystems, from a 2002 interview reflecting on the way in which the market priced his company at the dotcom peak:

“Two years ago we were selling at 10 times revenues when we were at \$64. At 10 times revenues, to give you a 10-year payback, I have to pay you 100% of revenues for 10 straight years in dividends. That assumes I can get that by my shareholders. That assumes I have zero cost of goods sold, which is very hard for a computer company. That assumes zero expenses, which is really hard with 39,000 employees. That assumes I pay no taxes, which is also very hard. And that assumes you pay no taxes on your dividends, which is kind of illegal. And that assumes that with zero R&D for the next 10 years,

I can maintain the current revenue run rate. Now, having done that, would any of you like to buy my stock at \$64? Do you realise how ridiculous those basic assumptions are?”<sup>4</sup>

Thankfully, valuations for today’s tech companies are somewhat more reasonable. Chart 2 shows the extent to which current technology market capitalisation is supported by profits this time around:

### SO WHERE ARE THE DANGERS FOR THIS SET OF SUPERCOMPANIES?

Given the near-duopoly position of current portfolio holdings Facebook and Google in the online advertising market (it was widely reported in May 2017 that the two companies are currently capturing almost 100% of the growth in online advertising spend<sup>5</sup>) one area we are carefully considering is the potential

“An American firm that was very profitable (one with post tax returns on capital of 15-25%) in 2003, stood an 83% chance of still being very profitable in 2013... In the previous decade, the odds were about 50%”.

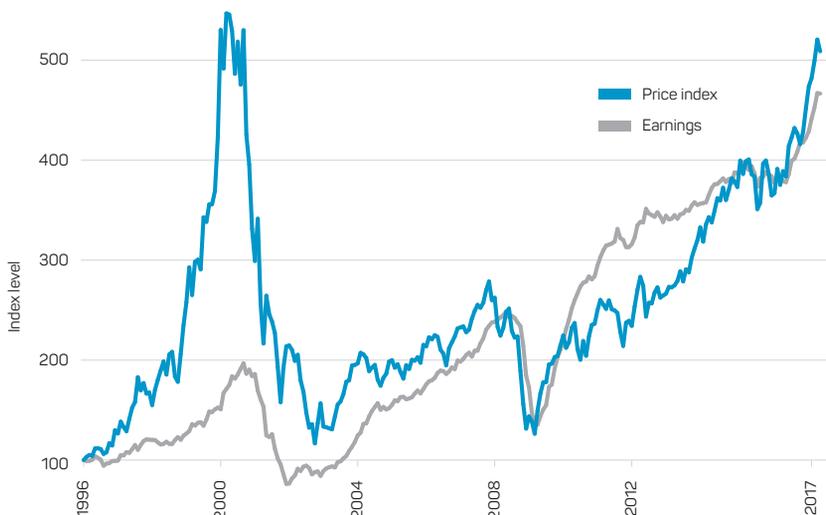
risk of antitrust action. The recent €2.4 billion fine imposed on Google by the EU Competition Commission<sup>6</sup> for exploiting its dominance in search is a salient reminder of the need for vigilance.

But, it is also important we do not let our inner pessimist blind us to the extraordinary (and still-strengthening) competitive positions held by these businesses. In October 2012, when Facebook hit 1 billion users, 55% used the service daily. When Mark Zuckerberg announced in June 2017 that the 2 billion milestone had been reached, the fraction of daily users had increased, remarkably, to 66%.<sup>7</sup> The next most popular service on the web, YouTube, with 1.5 billion regular users, is owned by Google.<sup>8</sup> The continued strong growth in earnings and cash flows being generated by both businesses speaks eloquently of their extraordinary ability to monetise human attention.

For now at least, we believe, it appears to be the age of the supercompanies. **B**

### CHART 2: Tech renaissance

World technology stocks price and earnings, 1996–2017



Sources: BlackRock Investment Institute, with data from MSCI and Thomson Reuters, July 2017. Notes: the price index is based on the MSCI All-Country World Technology Index. Earnings are represented by the aggregate 12-month forward earnings estimate. Both series are rebased to 100 at the start of 1996.

For more information, visit [intermede.co.uk](http://intermede.co.uk)

1. ‘Too much of a good thing’, The Economist, 26 March 2017. 2. US Industrial firms weighted by net assets, Credit Suisse, MSCI. 3. ‘There they go again... again’, Marks H, Oaktree Capital Management, L.P, 26 July 2017. 4. ‘Scott McNealy on the bubble’, Scott McNealy, Nyquist Capital, accessed 26 September 2017. 5. ‘How Google and Facebook have taken over the digital ad industry’, Ingram M, Fortune, 5 January 2017. 6. European Commission – Press release, Brussels, 27 June 2017. 7. ‘Two billion people coming together on Facebook’, Facebook newsroom, 27 June 2017. 8. ‘YouTube has 1.5 billion logged-in monthly users watching a ton of mobile video’, techcrunch.com, 22 June 2017.



INTERMEDE  
INVESTMENT PARTNERS

## **Important Information**

This document has been produced by Intermede Investment Partners Limited (“Intermede”), a limited company registered in England and Wales (Reg. No. 8827481), having its registered office at Third Floor North, 75-76 Wells Street, London W1T 3QH, United Kingdom. Intermede is authorised and regulated by the UK Financial Conduct Authority with firm reference number: 624278.

This document is directed only at persons in the United Kingdom who are professional clients within the meaning of Directive 2004/39/EC.

**This document is distributed in, and directed at recipients in, the United Kingdom only. The distribution of this document into any other jurisdictions may be restricted and accordingly any persons in such jurisdictions into whose possession this document comes are required to inform themselves about and to observe such restrictions. Persons who do not have professional experience in matters relating to investments should not rely on this document.**

This document has been provided for information purposes only and has not been provided as either a solicitation or recommendation with respect to the purchase or sale of any securities or an offer to provide investment services. The information contained in this document does not constitute an offer to purchase securities to any person in the United States or to any U.S. Person as such term is defined under the United States Securities Act of 1933, as amended.

The information provided is believed to be accurate at the time of compilation and is provided by Intermede in good faith. However, Intermede does not make any representation as to the quality, accuracy, reliability, timeliness or completeness of the material. Except in so far as liability under any statute cannot be excluded, Intermede, its directors, employees, representatives and consultants do not accept any liability (whether arising in contract, tort, negligence or otherwise) for any error or omission in the material or for any loss of damage (whether direct, indirect or consequential) suffered by you, the recipient of the information or any other person.

The information contained in this document is not intended to be and should not be taken as investment, tax, legal or any other type of advice. It does not take into account the objectives, financial, tax or legal situation or needs of any investor or purport to be comprehensive and should not be relied upon as such. You must obtain professional or specialist advice before taking, or refraining from, any action on the basis of the content on this document.

**This document is not intended for and is not to be distributed to retail investors.**

Past performance is not a reliable indicator of future performance. Values may fall as well as rise and you may not get back the amount you invested. Income from investments may fluctuate.

This information is issued and approved by Intermede, a member of the NAB Group. An investment with Intermede is not a deposit or liability of, and is not guaranteed by, the NAB Group. All information is to be treated as confidential and may not be reproduced or redistributed in whole or in part in any manner without the prior written consent of Intermede. This document is not intended for public use or distribution.

Copyright © 2017 Intermede and/or its affiliates. All rights reserved. A128765-0417C