The changing face of global companies

Andy Budden | Capital Group | 19 August 2016

The global business landscape has undergone profound changes. Increasingly, the nature of companies driving rapid profit generation globally is shifting from heavy industrials to idea-driven firms. The evolving environment has challenged conventional investment approaches and mindsets. For example, investors have been forced to reconsider the traditional country-of-domicile approach and any excessive home bias they may have in their asset allocation. The strong home bias of many Australian investors, in particular, could mean missed opportunities over the long term.

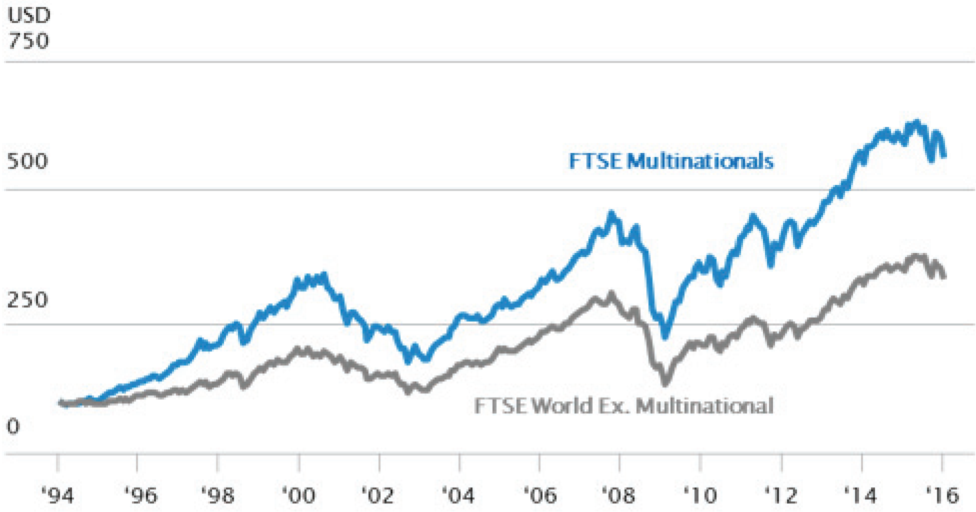
This paper examines the fundamental shifts in the make-up of global companies over the past two decades. The analysis sheds light on why global firms are different today and points to the emergence of a new breed of companies and investment opportunities.

GLOBAL COMPANIES ON THE RISE

The face of global business has been transformed over the past two decades. While companies such as Exxon Mobil, Coca-Cola and McDonald's are still giants, a host of new global companies is emerging rapidly. Many of these are idea companies – such as Google and Facebook – or firms with a unique solution to a global problem, such as diabetes or cancer. Often multinationals, these companies play a vital role in the global economy. They account for 80% of trade, 75% of private sector research and development (R&D), and 40% of productivity worldwide.[1]

The number of multinationals represented in the FTSE Multinational Index also reflects the rise of these companies. From 427 in 1994, there were 502 in 2003 and 722 in 2015.[2] From an investment perspective, they generated strong returns for the long-term investor. Figure 1 shows how multinationals fared relative to the broader market.

Figure 1: FTSE Multinationals Index versus FTSE World Ex Multinational Index (31 January 2016)



Source: Datastream. Total returns indexed to 100 as at 31 January 1994.

In addition, huge strides in technology, near-instantaneous communication and changing demographic patterns are creating paradigm shifts in the speed at which companies become global, how they do business and how they organise themselves. Some of the changes include:

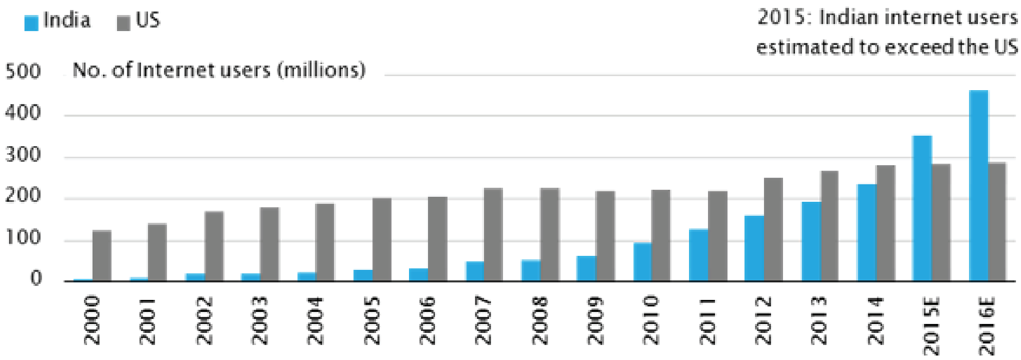
- A shift of innovation activities and R&D growth from developed to emerging markets – R&D centres are being established in places such as Bangalore and Sao Paulo;
- Bigger allocation of company marketing budgets to emerging markets compared to developed markets; and,
- A rise in the number of new global giants from Asia.

The next section of this paper discusses the central role that technology plays in driving change and how the new breed of global companies is creative, nimble and networked.

TECHNOLOGY IS A GAME CHANGER

Technology has accelerated product adoption and the pace is only quickening. It took four years for Apple's iPod to amass 50 million users. Facebook hit 50 million users in one year, while Twitter reached 50 million users in just nine months. The growth in Internet usage worldwide has stabilised at around 9% year-on-year[3] but digital penetration is still growing rapidly in some emerging markets. For example, there are now thought to be more Internet users in India than the US[4] (Figure 2) and the recently formed Association of Southeast Asian Nations Economic Community is expected to accelerate information flows.

Figure 2: Number of Internet users in the US and India (millions)



Source: Internet Live Stats. "Internet users" is defined as individuals who can access the internet at home via any device type and/or connection.

A major advantage for many technology companies is limited distribution costs, which translates to lower barriers to entry. Oftentimes, the distribution mechanism is a smartphone or tablet. An upshot of this is a change to the composition of the world's most valuable companies by market capitalisation over the past 20 years. Amazon, Google's parent Alphabet, Apple and Facebook were not listed among the top 20 companies in the MSCI All Country World Index (MSCI ACWI) in 1996 or 2006 (Figure 3). Until then, oil, mining and some consumer companies dominated the index.

Those companies are still a large part of the global investment landscape. But, increasingly, the more idea-driven companies in the technology and healthcare sectors are showing greater profit margins. According to McKinsey, profits are shifting from heavy industry to idea-intensive sectors that revolve around R&D, brands, software and algorithms. Sectors such as pharmaceuticals, media, finance and information technology have the highest margins. They are developing a winner-take-all dynamic, with a wide gap between the most profitable firms and everyone else.[5]

Figure 3: Top 10 largest companies in the MSCI ACWI (30 April 2016)

1996	2006	2016
General Electric	Exxon Mobil	Apple
Coca-Cola	General Electric	Alphabet
Exxon Mobil	Citigroup	Microsoft
Toyota	Microsoft	Exxon Mobil
Intel	Bank of America	Johnson & Johnson
Microsoft	BP	General Electric
Merck	HSBC Holdings	Facebook
Royal Dutch Petroleum	Procter & Gamble	Amazon
Philip Morris	Johnson & Johnson	Wells Fargo
Bank Tokyo-Mitsubishi	Toyota	AT & T

Not in the Top 10 in 1996 or 2006.

Source: RIMES. *Value of A and C shares, both of which are held in MSCI ACWI.

This has particular implications for Australian investors, many of whom exhibit a strong preference for domestic equities. It is true that Australian companies' high dividend yields can be appealing from an income standpoint, and that franking credits offer attractive tax benefits, but investors' home bias means they miss out on opportunities to invest in idea-driven companies, which are fast becoming global forces.

The new host of firms, meanwhile, will need to tread carefully as low barriers to entry have intensified competition. Because of lower upfront and distribution costs, companies are able to reach consumers faster and build user bases more rapidly. But consumers value the quality of the services the leading companies provide. High-quality experience has allowed Google to become the world's search engine and Facebook the sharing platform for 1.6 billion people. That is why technology companies are focused on quality and invest time and money in customer experience.

Cheaper and instant communications have also allowed global tastes to converge. Enterprise software solutions, cloud computing and digitisation of manufacturing platforms are enabling firms to innovate new products and solutions in multiple locations, with faster speed to market. Multinationals are progressively establishing more R&D centres in emerging markets to be closer to consumers. Nestlé has development facilities in Gurgaon, India, Beijing and Shanghai in China, as well as Singapore. General Electric, Philips and Cisco have also set up R&D centres in Bangalore, India.

By building powerful digital platforms and networks, the biggest technology and tech-enabled giants have reached never-before-seen scale in users, customers, revenue and profits. These platforms can drive marginal costs to almost zero, enabling technology and tech-enabled firms to make rapid moves into new sectors.[6] In addition, the need to tailor many of these products can be minimal. A BMW 7 Series, for instance, is the same 7 Series in Moscow or New York. Similarly, a consumer who purchases an iPhone 6 in Shanghai or Sao Paulo is buying the same product.

That convergence in demand is allowing for greater economies of scale in many ways. Nissan and Renault is a case in point - they share the same platform for their new car model. Put another way, globalisation is happening not just across consumption, but also production.

Almost by definition then, companies that become global are among the best. Many of these are multinational leaders in their respective industries, with strong balance sheets. Having navigated through different market cycles, many are also better equipped to deal with economic and financial shocks than their smaller domestic counterparts. A study by the Harvard Business Review found that being part of a larger multinational network, on average, was associated with superior economic performance during crises.[7]

Next, this paper examines some of the major drivers of long-term sustainability and highlight why a deeper knowledge of emerging markets is key to success on many fronts.

THE IMPORTANCE OF DEEP GLOBAL DISTRIBUTION NETWORKS

The dynamics that drive companies to become global leaders can vary by industry. One of the most effective defenses companies can build are distribution networks. It has been a hallmark of the longest surviving global companies. One example is Coca-Cola, which counts its fleet of trucks and relationships with retailers and bottlers worldwide among its distribution assets.

In much the same way, brewing companies have become global powerhouses through a series of acquisitions or joint ventures that extend their control of global distribution networks. The latest significant merger involves Anheuser-Busch InBev and SABMiller, which sell roughly 30% of the world's beer, including brands like Budweiser and Stella Artois.

The economies of scale to branding and marketing when companies have the distribution networks can be significant. One of the biggest competitive advantages of global companies is the capability to create global brands and put massive marketing budgets behind them.

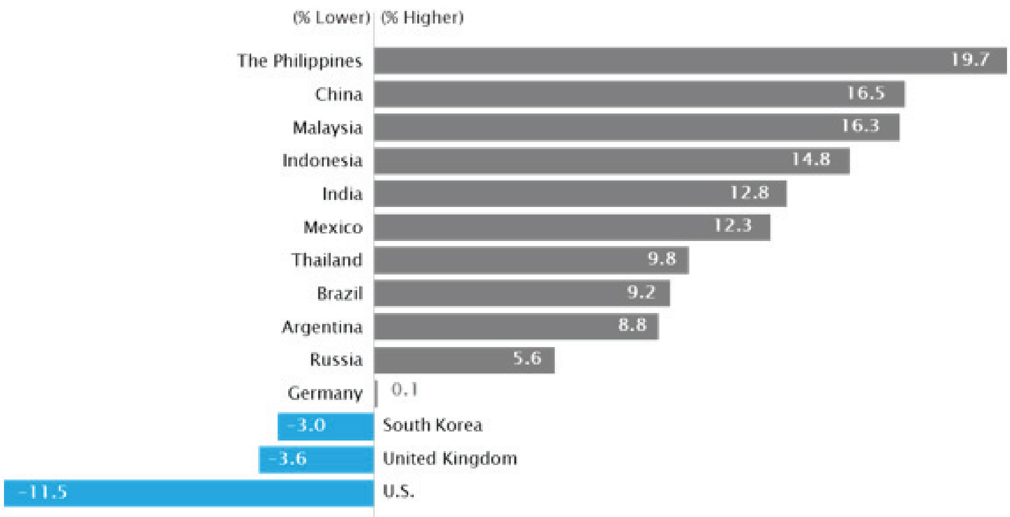
It is no surprise then that large pharmaceutical companies are following in the steps of consumer companies. Drugmakers are concentrating on treating certain diseases such as cancer or Alzheimer's as the practice of medicine has become more and more specialised.

Increasingly, big pharmaceutical companies, instead of investing in their own R&D capacity, are using their cash hoards to acquire smaller firms, where new drugs are being researched. In the process, they strengthen their grip over their distribution network. Mergers-and-acquisitions activity in the healthcare sector was robust in 2015, with US$724 billion in announced deals.[8]

DEEPER KNOWLEDGE OF EMERGING MARKETS IS ESSENTIAL

Developing economies are becoming a formidable force. No longer just satellite markets, they are central drivers of growth for many global companies. The global consumer base has increased to roughly 3 billion people in 2016 from 1 billion in 1980. Emerging market consumers have fuelled demand, with younger consumers in some countries earning more than their parents (Figure 4). This increased spending power will reshape demand and influence purchasing patterns in those regions.

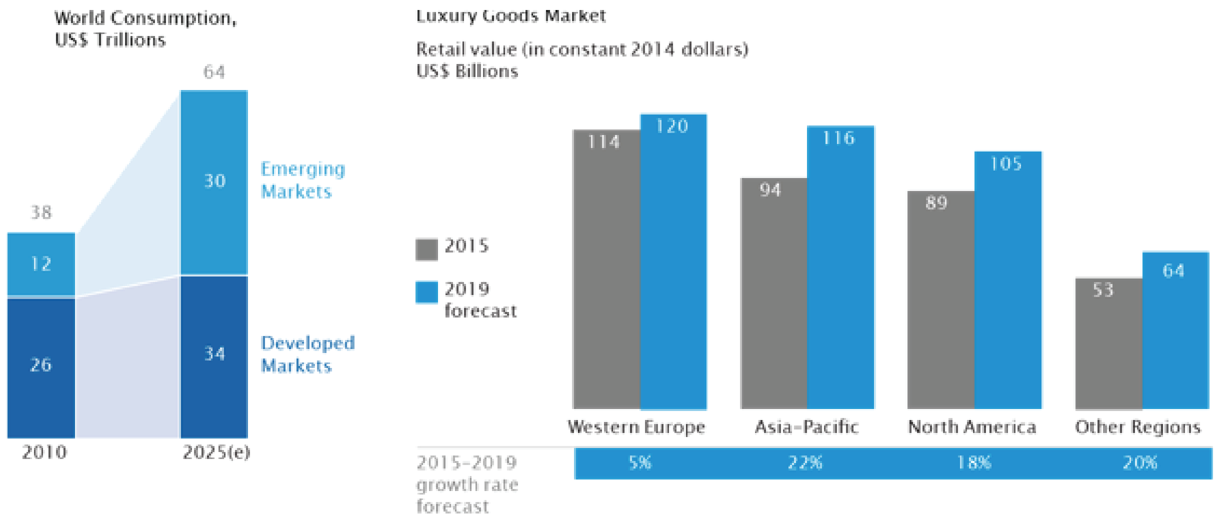
Figure 4: 2015 average gross income of 25- to 29-year-old versus national average



Source: Euromonitor International 2016

Emerging market consumption is estimated to reach US$30 trillion in 10 years, roughly half of all global spending, with strong growth forecast particularly for luxury goods in Asia-Pacific (Figure 5).

Figure 5: World consumption and the luxury goods market



Sources: Statista, McKinsey & Company.[9]

Traditional measures such as GDP growth or per capita GDP are no longer reliable indicators of a company's expansion prospects. In the past, as an economy grew, consumers' needs and desires tended to grow in line with per capita gross domestic product. Today, however, whether the aggregate per capita GDP is $5,000 or $30,000, aspirations and needs can grow independently. If a global company has a product or solution that is ubiquitous, it will appeal to consumers in many different markets. A company's ability to deploy that product in a number of markets is therefore crucial.

To thrive, global companies must understand consumers in emerging economies and how to develop and market brands in those countries. Nestlé and Unilever, two of the most successful global consumer product companies, have some brands that are global – including Nestlé's Nespresso and Unilever's Knorr – while others are made to serve just local markets. They also use global and local supply chains.

In addition, multinationals have found success developing products in emerging markets. Unilever's Pureit water purifier was developed in India before being sold in Brazil, Mexico, Indonesia and Nigeria. Unilever also created a Knorr-branded bouillon jelly in China that became popular around the world. In short, the old mindset of increasing R&D in the US and Europe and exporting those products has become irrelevant. Equally, these developments suggest that investment opportunities in emerging markets are evolving and have expanded beyond the traditional segments such as resources companies.

EMERGING MARKETS SPAWN GLOBAL FIRMS

In just the past decade, global companies have changed in scope and competitive dynamics shift as rapid advancements in technology and growth in emerging markets have challenged the old ways of doing business. Cincinnati-based Procter & Gamble (P&G) - home to Tide detergent, Pampers diapers and Gillette shaving products - struggled with price points and a more-centralised operation than its rivals. Faced with sluggish sales growth, P&G divested brands around the world to boost profitability.

Not identifying regional trends can be costly. Nokia, which once dominated India's mobile phone market, saw its market share decline after local upstarts rolled out phones featuring two SIM cards. In other words, companies have to be multinational in their thinking and approach at all levels from the board, to senior and middle management, and to the field.

Some companies in emerging markets are becoming big players on the global stage. Tencent, China's biggest social networking and online gaming company, is one of the world's most valuable Internet businesses. It recently began expanding overseas and generates 7% of its annual revenue outside of China. Huawei Technologies, another Chinese company, has grown to become the world's largest telecom equipment maker and the third-largest maker of smartphones behind Apple and Samsung.

According to Boston Consulting Group, the number of companies with more than US$1 billion in annual revenue increased six fold from 2003 to 2013, to more than 1,000 in Asia, and almost doubled in Latin America, Africa and the Middle East, to more than 700.

CONCLUSION

This new era for global business has changed how companies structure themselves and how they approach consumers. Technology is accelerating product adoption and has made it easier for companies to go global. Some of the most successful companies today are idea-intensive digital enablers. They use software and algorithms to become global forces, managing products with extensive runways for growth, while their deep distribution networks act as an effective barrier against competition.

At the same time, GDP growth and consumer needs are no longer closely tied. Emerging markets are also exerting greater influence. They are driving growth globally and becoming innovation hubs for global companies. Many multinationals have established R&D facilities there, using domestic skills to fine tune global and local products and ideas. Increasingly, companies in developing economies have the tools to become fierce global competitors.

In summary, these paradigm shifts are challenging traditional business models across industries. The new breed of companies that has emerged - creative, nimble and networked - offer a powerful opportunity set for investors. More critically, investors in very concentrated home markets, such as Australia, need to consider diversifying their domestic exposures to access this wider and deeper set of long-term opportunities.

ENDNOTES

1. Dobbs, Richards; Koller, Tim; Ramaswamy, Sree; Woetsel, Jonathan; Manyika, James; Krishnan, Rohit; Andreula, Nicolo. "Playing To Win: The New Global Competition for Corporate Profits." McKinsey & Company. September 2015. http://www.mckinsey.com/business-functions/strategy-and-corporate-finance/our-insights/the-new-global-competition-for-corporate-profits.

2. Datastream, Capital Group.

3. Internet Trends 2016: Code Conference. Klein Perkins Caufield & Byers.

4. ibid.

5. McKinsey & Company, Op Cit.

6. ibid.

7. Alfaroy, Laura; Chenz Maggie. "Surviving the Global Financial Crisis: Foreign Direct Investment and Establishment Performance." *Harvard Business Review*. June 2010.

8. Dealogic.

9. Adapted from "Winning the $30 Trillion Decathlon: Going for Gold in Emerging Markets." McKinsey & Company. November 2012.

DISCLAIMER

Andy Budden is an investment director with Capital Group.