Peak Profits

Even before Covid-19, the golden age of corporate profitability was showing signs of topping out.

BAIN & COMPANY

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Executive summary

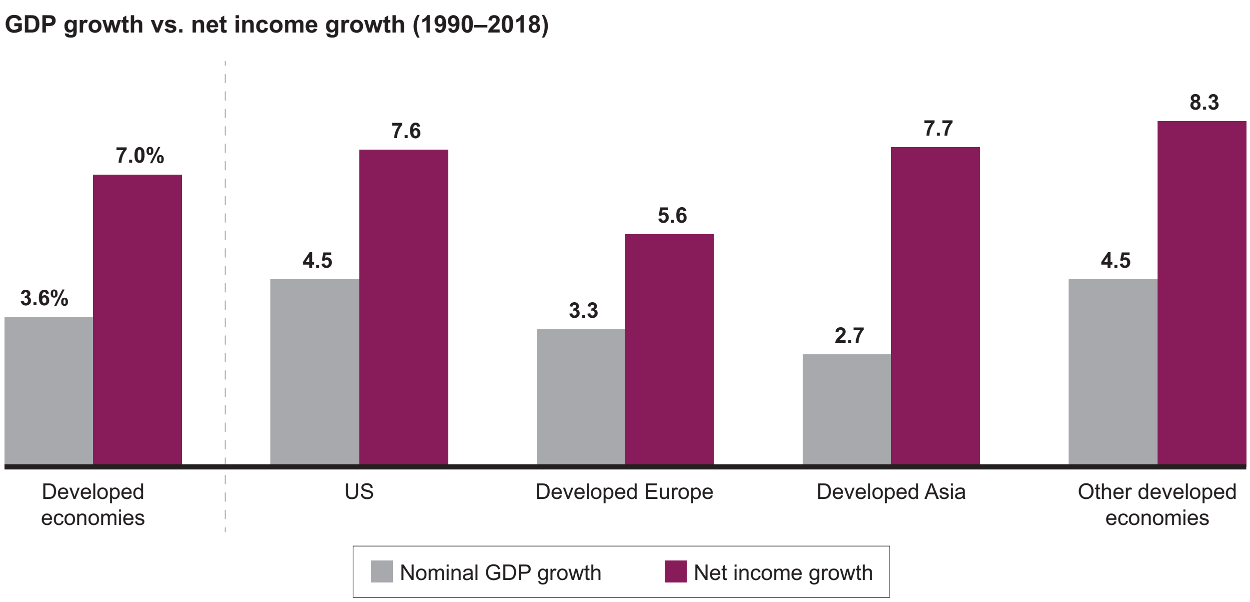
Corporate profits have been remarkably resilient in recent decades.

While GDP in the developed world has grown a robust 3.6% annually since 1990 (in nominal terms), corporate net income over the same period has grown almost twice as fast, or 7% per year *(see Figure 1)*. Companies in developed markets have churned out profits at a historic pace, despite massive economic dislocations like the bursting of the dot-com bubble in 2000 and the global financial crisis eight years later. Terrorism, immigration crises, Brexit, chronic geopolitical instability—none of it has managed to derail what has been a golden age of corporate profitability.

But can it continue?

Even before the Covid-19 crisis set off what is shaping up to be the worst economic shock since the Great Depression, corporate profits were showing signs of peaking. To understand why, and to explore what business leaders can expect when the economy returns to a steady state, Bain & Company teamed with Oxford Economics to study whether the forces that have contributed to this golden age of profitability will persist into the future. Based on that research, this report identifies several key factors that

Figure 1: Net income growth in developed economies has dwarfed GDP growth in recent decades



Notes: Public companies only; developed Europe includes Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Netherlands, Norway, Portugal, Spain, Sweden, Switzerland and UK; developed Asia includes Japan, Singapore, South Korea, Taiwan and Hong Kong; other developed economies includes Australia, New Zealand and Canada
Sources: Refinitiv; EIU; Bain analysis

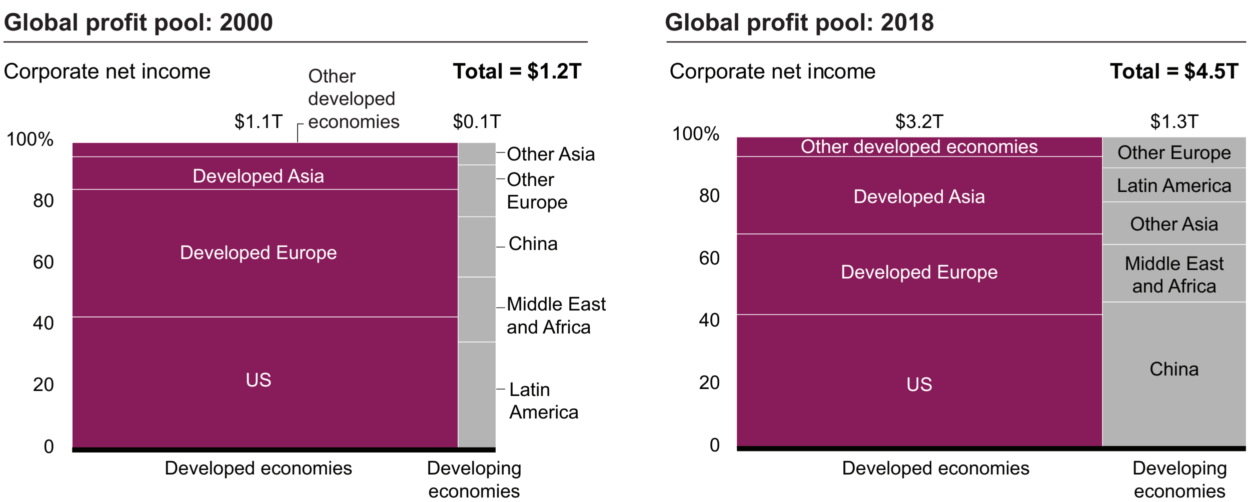
could dampen profit growth in the years ahead—factors that involve both market dynamics and a potential backlash from governments and societies. These forces predate Covid-19, but like other historic crises before it, the pandemic has the potential to accelerate currents of change that otherwise might have taken a decade or more to play out.

Bain and Oxford studied results from 13,000 listed companies in 26 developed economies spanning the US, Europe, Asia, Canada, Australia and New Zealand. We focused on developed-market public companies because of their outsize share of the global profit pool and comparable macroeconomic dynamics *(see Figure 2)*. While impressively rapid profit growth in the developing world (especially in China) has led to substantial share gains over the past 20 years, there's no question that companies in the developed world still dominate in terms of overall profits.

We found that, over the past several decades, six waves of change have powered the steady rise in corporate profitability:

- **Labor's waning bargaining power**, due to a decline in unionization and simultaneous expansion of the labor supply
- **Financial liberalization**, which drove up the profitability and economic share of financial services

Figure 2: While developing economies, led by China, are gaining ground, the developed world still controls the largest share of the global profit pool



	Developed economies (2000)	Developing economies (2000)	Developed economies (2018)	Developing economies (2018)
Share of net income	92%	8%	72%	28%
Share of GDP	64%	36%	57%	43%

Notes: Public companies only; developed Europe includes Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Netherlands, Norway, Portugal, Spain, Sweden, Switzerland and UK; developed Asia includes Japan, Singapore, South Korea, Taiwan and Hong Kong; other developed economies includes Australia, New Zealand and Canada; Latin America includes Argentina, Brazil, Chile, Colombia, Mexico and Peru; Middle East and Africa includes Turkey, Saudi Arabia, Nigeria, UAE, Israel, South Africa and Egypt; other Europe includes Russia, Poland, Romania and Czech Republic; other Asia includes India, Indonesia, Thailand, Philippines, Malaysia, Bangladesh, Vietnam and Pakistan
Sources: Refinitiv; Bain analysis

- **Globalization**, which allowed firms to access lower-cost supply chains and new export markets
- **A commodity super-cycle**, driven by surging industrialization in China and India
- **The rise of major Internet platforms** (in the US especially), which powered extraordinary profitability for a small cohort of firms through network effects and asset-light growth
- **Automation**, which fueled the displacement of labor with capital in an expanding range of sectors

In parallel, the cost of capital has fallen precipitously, affording companies a meaningful boost in economic profit.

A widening performance gap

These six waves have been particularly strong in the United States, pushing returns for US companies to historic heights. Yet, while *average* profitability has been steadily rising, *median* profitability has actually fallen. The difference owes to a significant divergence in outcomes between the large incumbents of the US market and a very long tail of midsize competitors. The bulk of the increase in the profit pool in recent decades has been captured by large firms. Smaller competitors, in fact, have seen return on equity fall. While large firms (greater than $25 billion in revenue) had an average ROE in the 1980s that was 1.3 times greater than that of small firms (less than $1 billion in revenue), the ratio expanded to 4.2x in the 2010s. The spread in technology widened even further, to 10x.

One reason for the performance gap between large and small firms is that technological change has increased the benefits of scale. Increasing economies of scale have coincided with a surge in mergers and acquisitions, which has pushed up concentration rates in most subsectors of the economy. As a result, 1% of listed companies in the US now account for 41% of corporate profits, up from 33% in the 1980s.

This growing scale advantage has made it harder for smaller rivals to unseat established incumbents, leaving them stuck with middling profitability. In that context, it is not surprising that midsize firms have increasingly relied on leverage to boost returns in recent years, driving their debt ratios to historic levels. That has left them especially vulnerable to the Covid-19 downturn.

Gathering headwinds

As powerful as these macro trends have been, we see two emerging mechanisms that could exert downward pressure on corporate profitability and perhaps force a reversion to the historical mean.

The first is the market itself. Favorable market trends typically ebb and flow. As we enter this new decade, the tide of globalization has begun to recede. Recent trade wars had already pushed companies to rethink their commitment to offshore supply chains. Then the coronavirus pandemic exposed how risky those stretched, low-cost supply lines really are. A move toward reshoring to better manage risk will likely pressure margins.

At the same time, labor market changes will exert upward pressure on costs for many companies. Over the past several decades, three megatrends have assured a steady supply of labor that has had a dampening effect on wages: the aging of the baby boom generation, more women entering the workforce and the rise of offshoring. More recently, each of those trends has either tapped out or reversed. While the Covid-19 unemployment shock will offset this shift in the short term, finding talent with the right skills for the right job is getting harder in many areas of the economy.

On the upside, it's likely that an acceleration in automation and the continued growth of Internet platforms will support high profitability levels. But those benefits will mostly flow to the biggest and fastest companies. The rest will continue to suffer from their lack of scale in a market that just got tougher. Indeed, the Covid-19 shock could prove devastating for midsize companies with too much leverage. Some may be acquired or disappear entirely, but others may find themselves joining the growing cohort of zombie firms—struggling companies that survive on evergreen loans only because banks are unwilling to cut them off and book the hit to capital.

On balance, these factors alone might not be enough to slow the corporate profit juggernaut. But there is a wild card that could dramatically reshape corporate return profiles as we emerge from this pandemic: an expansion in the role of the state.

Surging corporate profitability, isolated as it's been among large firms, has coincided with a number of troubling social indicators. Rising income inequality (before and after taxes and transfers) and stagnant upward mobility have fueled increasing discontent with the status quo. The Covid-19 crisis and the global financial crisis before it have also shed light on the increasing fragility of today's economy. On one end of the spectrum are smaller firms struggling (and taking on more financial risk) to keep up. At the other end are the large, interrelated, "too big to fail" firms that have increasingly required government support, raising populist ire on a global scale.

Since the Industrial Revolution, the relationship between business and society has fluctuated through cycles of rising and falling freedom for the firm. Even before the Covid-19 crisis, firms had begun to face growing demands from society to adopt a wider view of corporate purpose beyond the short-term maximization of shareholder wealth. In response to the pandemic, the role of the state has dramatically expanded, as governments have actively intervened in the operations of the market and stepped in as the investor of last resort.

As society grapples with challenges ranging from global warming to the regulation of data to the human costs of automation, a more interventionist government may become the new norm. The toll on corporate profitability through regulation, taxation and other interventions could be significant.

Profit pressures globally

While this overview has focused on the US, as it is by far the largest contributor to the global profit pool, other developed economies are likely to face their own flavors of earnings pressure.

- **In developed Europe**, the recent trajectory of corporate profits has been largely tied to the promises and perils of the European project. Following the adoption of a single currency, returns soared in the early 2000s as capital (and leverage) flooded into the periphery countries, particularly Portugal, Ireland, Italy, Greece and Spain. The financial crash and subsequent sovereign debt crises led to a downward step change in profits as Europe struggled to regain its economic footing. While stronger protections for labor and a more expansive welfare state than in the US have dampened the rise in inequality, Europe has increasingly struggled to achieve international competitiveness (particularly on the periphery) and has badly lagged the US and China in terms of scaling large technology companies and Internet platforms. These weak spots have blunted both profitability and real income growth, contributing to surging populism, and Covid-19 will only magnify the challenges. Without reform, corporate profits in Europe will come under immense strain in the coming decades.

- **In developed Asia**, the pattern of corporate profitability for Japan has been distinctly different from that of the Asian Tigers—South Korea, Singapore, Hong Kong and Taiwan. For Japan, a sluggish macro economy following the financial crisis in 1990 dragged down corporate profitability and growth, causing the erstwhile economic powerhouse to miss the golden age of profits enjoyed in the West. The Asian Tigers, by contrast, have ridden a combination of high growth and (relatively) stable returns to immense shareholder value creation and a broad-based improvement in living standards. For these economies, the main issue is a reliance on global trade flows for a major portion of GDP. That may leave them particularly exposed in a deglobalizing world, at a time when their economic growth has begun to decelerate.

- **In Australia, New Zealand and Canada**, profits are heavily concentrated in the resources sector and have closely followed global resource prices over recent decades. Profitability surged through the early 2000s on the back of the commodity super-cycle but has since reverted to historic levels as the cycle ran its course. Higher unit labor costs fueled by demand from the resources sector have reduced the ability of these markets to compete in other tradable sectors. As the most recent super-cycle continues to dissipate, a resurgence in corporate profitability in the coming decades will be more challenging.

The new imperatives

Throughout history, crises have often served as catalysts for change. We expect the Covid-19 pandemic will be no different. The crisis will likely accelerate trends that were already in place, making it harder for global companies to generate the level of profit growth they have enjoyed over the past 40 years.

Peak profits, moreover, coincides with a historic shift in business eras—from the era of shareholder primacy to what we call the era of scale insurgency. For business leaders, winning in this new era will require:

- **Sharpening your competitive edge.** While macro tailwinds have pushed up aggregate profitability in recent decades, our modeling suggests that nearly 60% of the variance in firm-level profitability still comes down to factors specific to a given company or sector. In other words, much is still directly within the control of business leaders, and their strategic choices matter immensely. As profit pools shrink, competition for customers will intensify. To survive, firms will need to deliver the benefits of both scale and intimacy.

- **Rediscovering business building.** In an environment of heightened competition for profits, creating value will require firms to rediscover the lost art of business building. This will be especially important if governments raise barriers to M&A. In low-interest-rate environments, intrinsic value is far more sensitive to growth than to margins, meaning the stakes are especially high.
- **Resilience.** To offset margin pressure, many firms will be tempted to trade greater efficiency for lower resilience. In a more turbulent world, this will prove to be a false economy. Instead, firms should look beyond this year's earnings and consider the implications their strategic, operational and financial choices will have across the business cycle. Doing this well will require a candid dialogue with investors, who have not borne the full cost of firms' lack of resilience over the past two business cycles.
- **Elevating citizenship and sustainability.** Demands for business to take on a greater civic role will only get louder in coming years, as the recent groundswell around racial and social justice has shown. The ability to navigate an increasingly complex web of societal expectations will come to be seen as a moral imperative as well as a significant source of competitive advantage. The new era will require firms to proactively identify and meaningfully address the issues their employees and customers care about—or risk losing both.

Part 1 of this report offers a detailed exploration of the evolution of corporate profitability in the US since the 1980s and the outlook for the next one to two business cycles. Part 2 compares the US experience to other developed economies, clarifying what is similar and what is distinctive across regions. Part 3 provides a more thorough exploration of how firms can prepare now for a world in which profits are harder to come by.

1. The United States

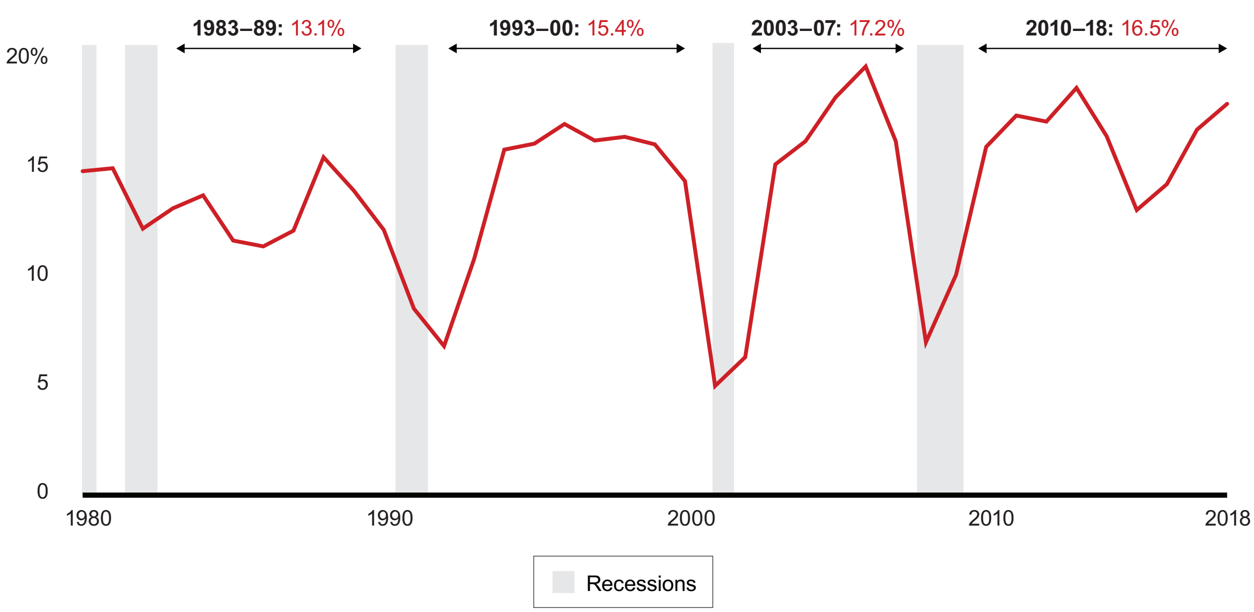
We began our research with the US economy because it is by far the single largest contributor to the global profit pool. The US accounts for 30% of global profits, and its return on equity is materially higher than that of other developed economies.

ROE in the US has been on a steady upward march since the 1980s *(see Figure 3)*. The line isn't a straight one, however, because movements in profit are highly volatile—far more so than movements in GDP. The business cycle has a heavy impact on returns, and these cycles occur in irregular patterns, with peaks and troughs of differing durations. To isolate this effect and examine the long-term trend in profitability, we defined four windows across the last four business cycles during which ROE wasn't skewed by recession and recovery. Across these cycles, US ROE has risen by 3.4 percentage points, from 13.1% to 16.5%.

At the same time, declining interest rates have reduced the cost of equity by nearly 5 percentage points, from 13.4% to 8.5%, since 1980 *(see Figure 4)*. In recent years, yields on US Treasuries have continued to fall while equity yields have stabilized, implying a widening of the equity risk premium. As a result, the cost of equity has hovered just above 8% since 2000, despite the continued decline in the cost of debt. All together, the result is an economic profit spread of roughly 8% for US equity.

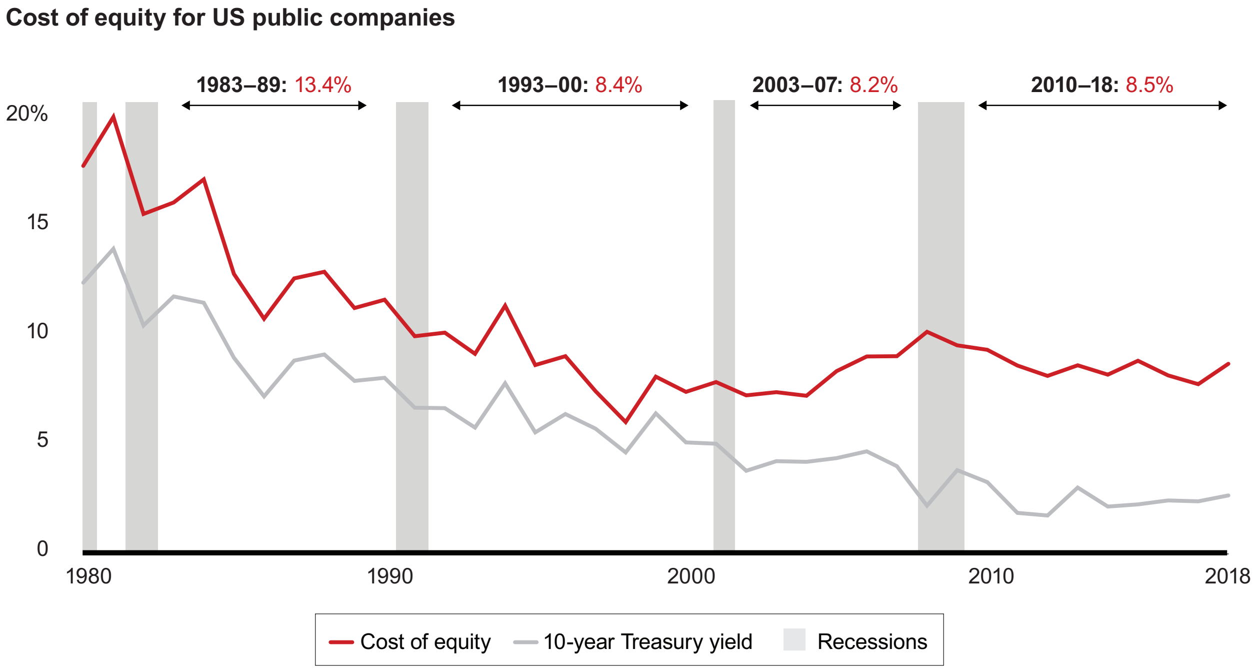
Figure 3: Despite recessions, US companies are much more profitable than in the 1980s

Return on equity for US public companies



Sources: Refinitiv; Bain analysis

Figure 4: Falling interest rates have driven down the cost of equity



Sources: Refinitiv; Bain analysis

Over this same time period, the composition of the profit pool (and the US economy more generally) has changed significantly *(see Figure 5)*. In the 1980s, the industrial and natural resources sectors dominated the profit pool. Today, the leaders are financial services and technology, which have raised their share from a combined 16% in 1980 to 45% in 2018.

The data shows that industry-level ROE (and, for nonfinancial industries, return on invested capital) has evolved significantly across the last four business cycles *(see Figure 6)*. After accounting for the mix shift over time, as well as patterns of rising (and falling) profitability across industries, we can begin to unravel the forces that have driven the rise in aggregate returns in the US.

The six waves of change

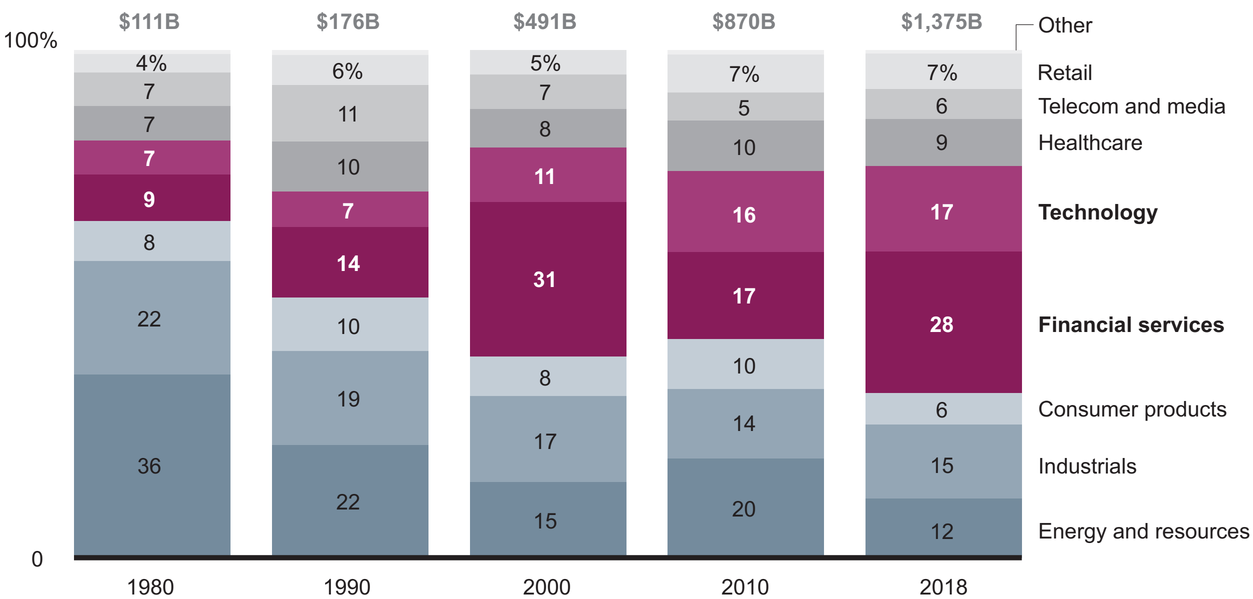
To isolate the biggest factors behind the upward trend in profitability, we worked with Oxford Economics to model the relative impact of a wide array of factors at the industry level. We combined these findings with input from our global team of partners and experts to sharpen our conclusions for each industry.

We found that six coinciding waves of change had the most impact.

Labor's waning bargaining power. From the 1960s onward, the total labor supply in the US surged upward as the baby boom generation entered the workforce and female participation began to rise.

Figure 5: Financial services and technology have taken over from resources and industrials as the largest profit generators in the US

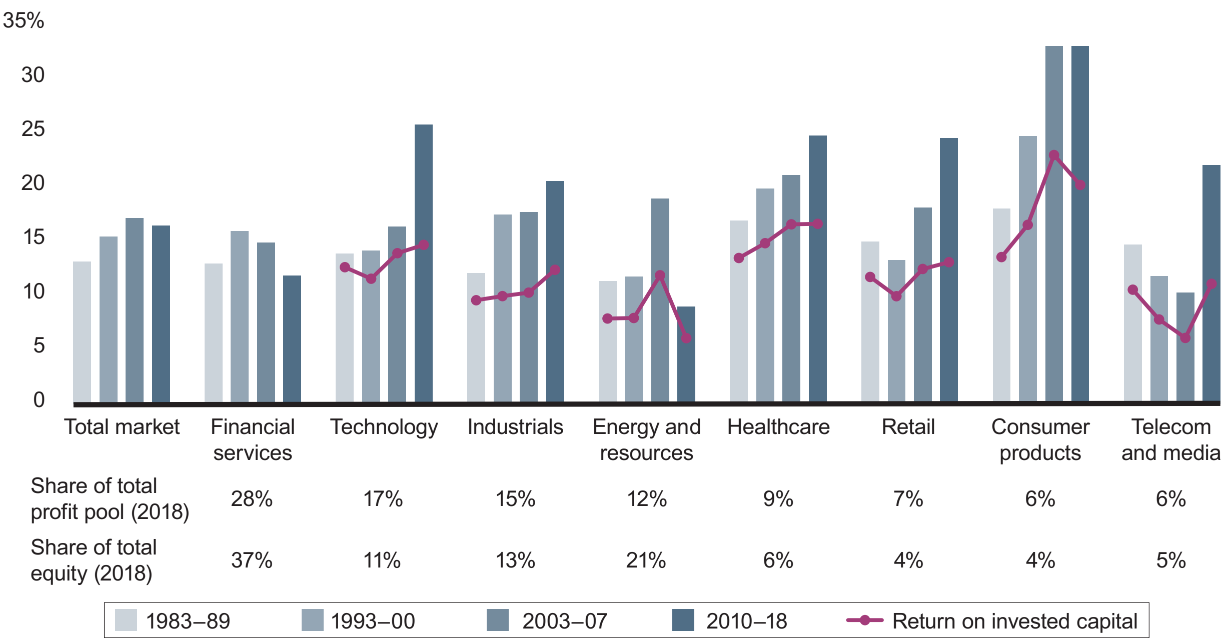
US net income by industry (public companies)



Sources: Refinitiv; Bain analysis

Figure 6: Profitability trends have varied by industry, but most have seen strong growth

Return on equity for US public companies, by industry



Sources: Refinitiv; Bain analysis

At the same time, union membership declined and other forms of institutional protection for labor weakened *(see Figure 7)*. In labor-intensive industries, especially industrials and consumer products, the resulting drop in bargaining power was a major contributor to rising profits through the 1980s and 1990s. (Our full *Labor 2030* report is available at *bain.com/insights* under Macro Trends.)

Financial liberalization. The 1980s ushered in a new wave of financial liberalization in the US, ending the regulatory regime that had defined the nation's financial sector since the Great Depression *(see Figure 8)*. Congress unwound restrictions that prevented retail banks from combining with investment banks and insurance companies. Interest rate ceilings went away, and limitations on interstate branching eased.

At the same time, the volume of capital available for investment ballooned, as the working-age population hit their peak saving years and companies shifted en masse from defined-benefit pension plans to 401(k) and other defined-contribution plans. Advances in computing, meanwhile, enabled a step change in the speed and sophistication of financing activities. The result was a dramatic increase in both the profitability and growth of financial services in the US, significantly expanding the industry's share of the total profit pool and bolstering aggregate profitability in the economy as a whole.

What happened next is well-trodden ground. The financial collapse in 2008 not only sent the US economy into a tailspin but also ushered in new regulations and capital requirements for financial services firms. While some of these regulations have eased in recent years, profitability in financial services today has fallen well below its precrisis levels. The experience of the financial services industry over the last decade may serve as a bellwether for what is to come in other sectors (as we discuss later in this report).

Globalization. The 1990s and 2000s saw the collapse of the Soviet Union, the integration of China and India into the global trading system, and—more broadly—a period of relative geopolitical stability favorable to the expansion of global commerce. Advances in communications infrastructure and the emergence of the Internet collided with these geopolitical shifts to help push trade's share of GDP to new heights *(see Figure 9)*.

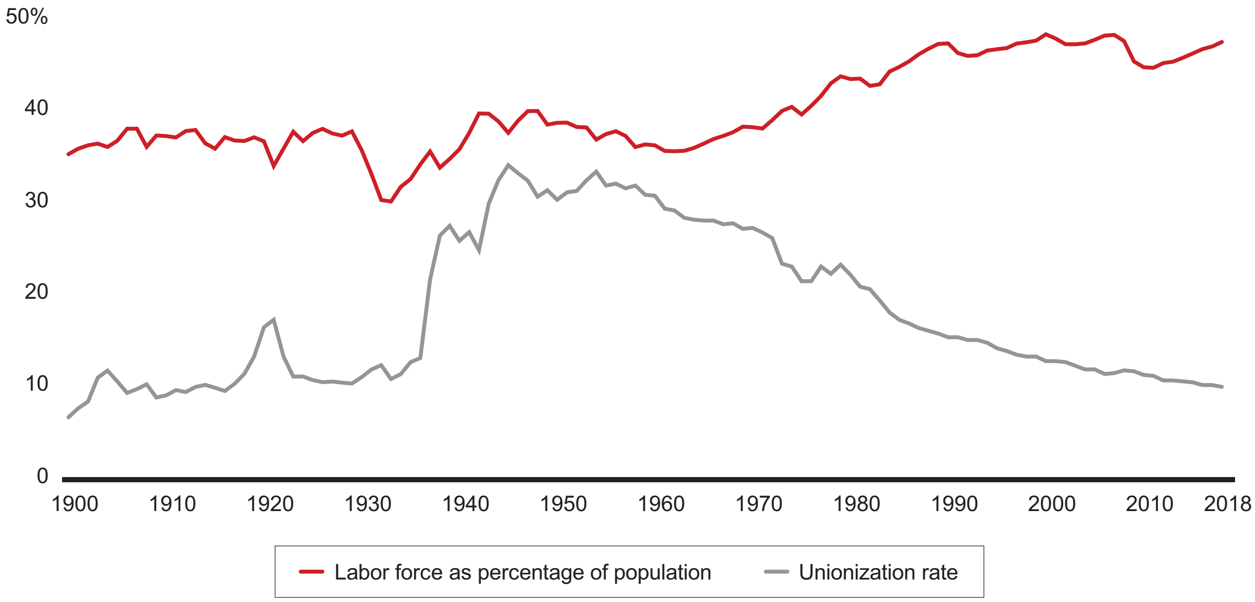
The effects of globalization on corporate profitability are multiple and complex. Access to lower-cost supply chains improves margins, while loosened trade barriers open up profitable new export markets and unlock greater economies of scale. At the same time, globalization has introduced new competitors to the US economy, dampening the profitability of domestic firms.

Statistically, we find that the positive effects on profitability outweigh the negatives. This has been particularly true for the industrial, technology and consumer products sectors, which now rely heavily on intermediate imports from markets with lower labor costs.

Commodity super-cycle. For the resources industry and other sectors linked to the commodity cycle, trends in global commodity prices are critical to profitability levels. Those prices tend to move in multidecade cycles (known as super-cycles) resulting from the time lag between new demand and the creation of new supply.

Figure 7: Labor's bargaining power has dropped sharply since the 1960s as unionization rates fell and the labor force grew

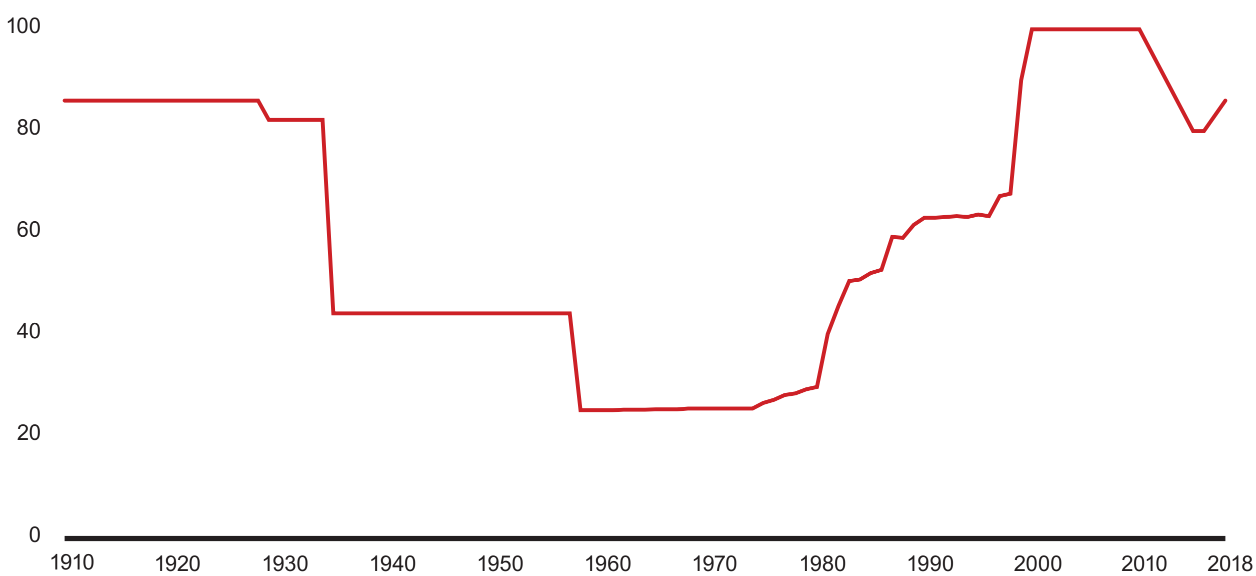
US labor force size and unionization rate



Sources: OECD; Johannes Gutenberg University Mainz; US Bureau of Labor Statistics; US Census Bureau

Figure 8: A wave of deregulation prior to the global financial crisis fueled growth in financial services

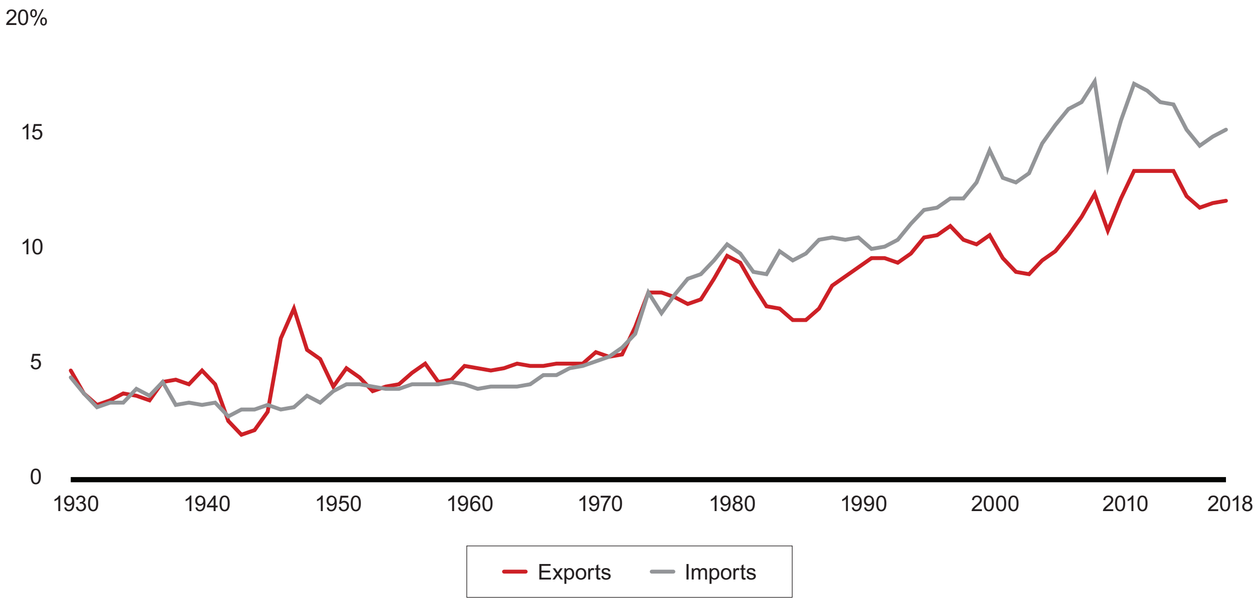
Financial deregulation index (US)



Source: Philippon and Reshef (2009), extended and reindexed to 100

Figure 9: As globalization accelerated during the 1990s and 2000s, trade became a much bigger part of the economy

Imports and exports as percentage of US GDP



Sources: Federal Reserve Economic Data; US Bureau of Economic Analysis

The rapid growth of Japan in the second half of the 20th century, combined with the 1970s OPEC oil crisis, triggered an upswing in commodity prices that peaked at the beginning of our window of analysis *(see Figure 10)*. The subsequent downswing in the price of agricultural commodities contributed to rising profitability of consumer products companies through the 1980s and early 1990s.

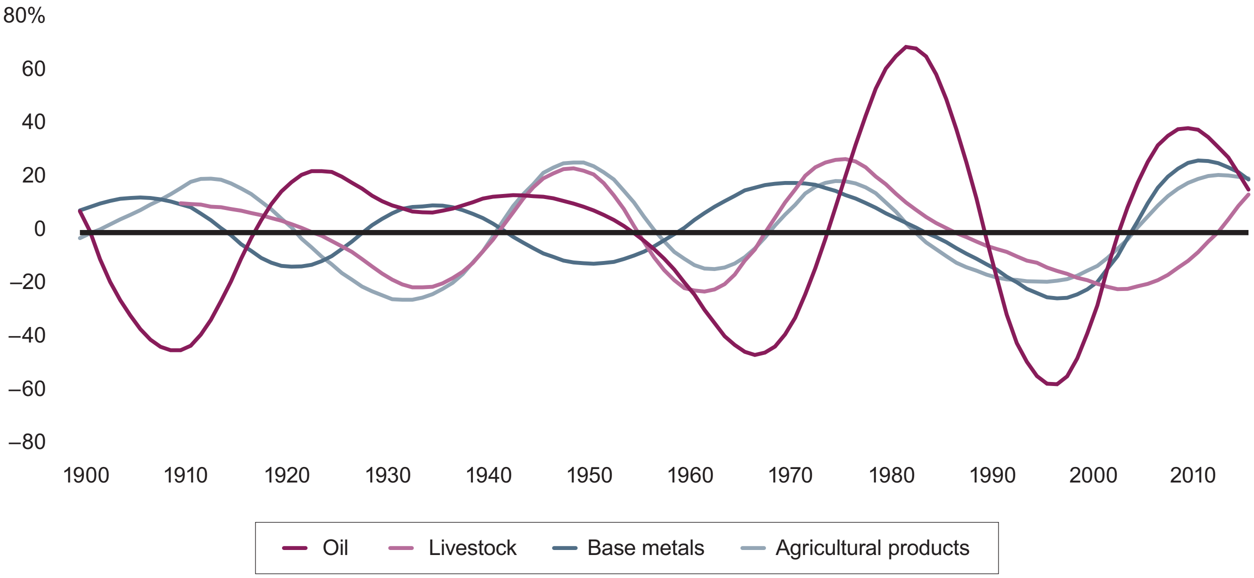
Then, in the 1990s and 2000s, the rapid industrialization of China triggered a new synchronized upswing in commodity prices, with an especially sharp rise in oil prices. The result was a surge in profits for the resources industry (more than offsetting the drag in sectors such as airlines).

This upswing began peaking around 2010, with the subsequent downswing triggering a large drop in profitability for the resources sector. The emergence of higher-cost US shale during the preceding boom magnified the effects of the falloff, since much of the new US capacity couldn't produce profitably at lower prices.

The rise of the Internet platforms. In the late 1990s, growing Internet penetration collided with a frothy financial sector to create the infamous dot-com bubble. To feed booming demand for Internet access, telecommunications providers invested heavily in their networks, driving penetration rates ever higher.

Figure 10: The most recent commodity super-cycle began peaking around 2010, triggering a sharp drop in resource-company profits

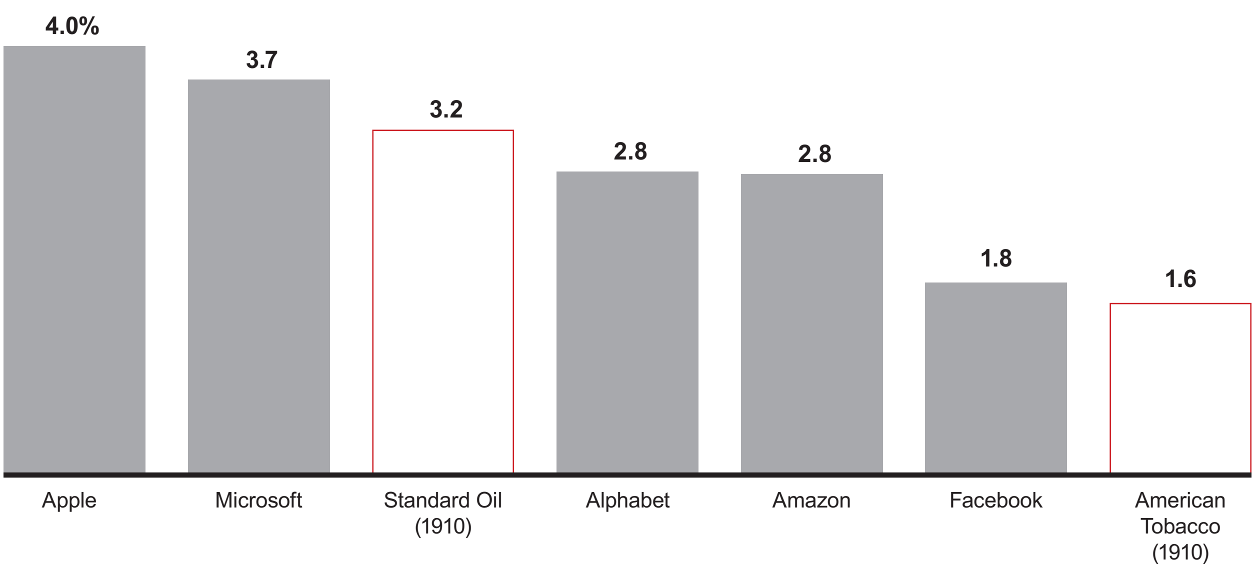
Price cycles across major commodity groups



Note: Price cycles represent the percentage deviation from the long-term trend
Source: Bank of Canada

Figure 11: Internet platforms now rival legendary titans like Standard Oil in terms of size and economic influence

Market capitalization as percentage of total US market cap



Note: Market capitalization as of December 31, 2019, for Apple, Microsoft, Alphabet, Amazon and Facebook
Sources: Federal Reserve (Wilshire 5000); UCLA historical GDP data; S&P Capital IQ; Bain analysis

While the 2001 crash left many investors burned, the frenzy of innovation and investment laid the groundwork for a new breed of firm that would help push US profitability to new heights: the Internet platform. Today, Google, Apple, Facebook, Amazon and Microsoft together account for approximately 10% of total net income in the US and around 15% of total market capitalization. With an average ROE of about 30%, these companies are roughly twice as profitable as the rest of the market.

Their growth owes to network effects made possible by the proliferation of high-speed Internet access. In sectors like retail, the platforms have been forces of creative destruction, dragging down the profitability of incumbents that struggle to keep pace. This pattern may well continue as these companies (or new ones) expand into new economic domains. Financial services and healthcare are likely candidates for change.

That said, the runaway success of the Internet platforms has also attracted the kind of increased scrutiny that hearkens back to the antitrust debates of the early 20th century. Indeed, the share of total market capitalization captured by today's tech giants rivals that of some of history's most powerful industrial titans *(see Figure 11)*. Covid-19 has actually accelerated the business momentum of the Internet platforms by spurring so much additional online activity. But it has also brought even more scrutiny and questions about whether these businesses have become too powerful.

Automation. In recent decades, advances in computing power have opened up new opportunities for firms to substitute capital for labor through the automation of routine tasks. The introduction of industrial robots has already had a significant impact on blue-collar jobs and has helped boost profitability for the industrials sector during the most recent business cycle.

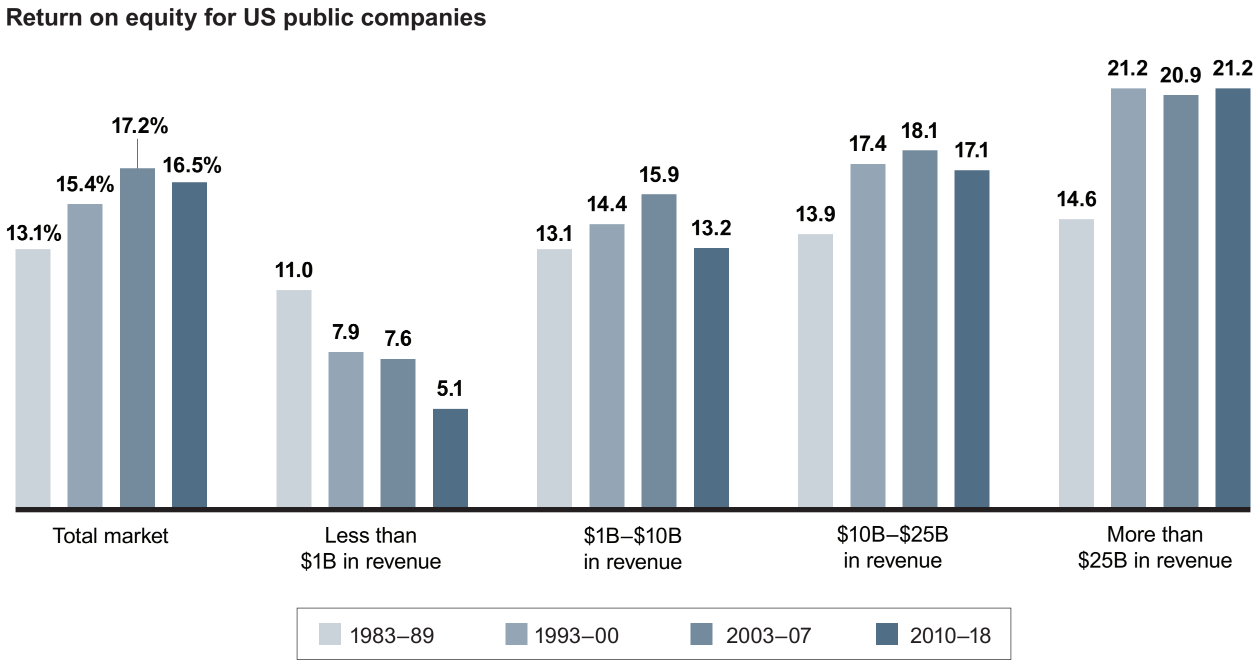
Knowledge work is the next frontier. Over the next business cycle, we expect significant investment in back-office technologies such as robotic process automation, as companies look to automate as many manual processes as they can. (Bain's *Labor 2030* report breaks this trend down in detail.)

Winners take all

Together, these six waves have driven up the overall return on equity in the US economy to historic heights. But the bounty hasn't been distributed evenly. While *average* profitability has been steadily rising, *median* profitability has actually fallen. The reason: There's been a significant divergence in profitability between large incumbents and the long tail of midsize competitors *(Figure 12)*.

Scale advantage has been one of the iron laws of business strategy for decades. As firms grow, they are able to spread fixed costs across a larger customer base, exercise greater bargaining power over suppliers and, in some cases, exert pricing power over the market. Since the 1980s, larger firms have been widening their advantage. As the US has shifted to a knowledge economy, intangible assets such as intellectual property and software have become increasingly critical for success. The "high fixed cost, low marginal cost" dynamic of intangibles favors large firms over smaller rivals.

Figure 12: The golden age of profitability has favored large companies over smaller ones



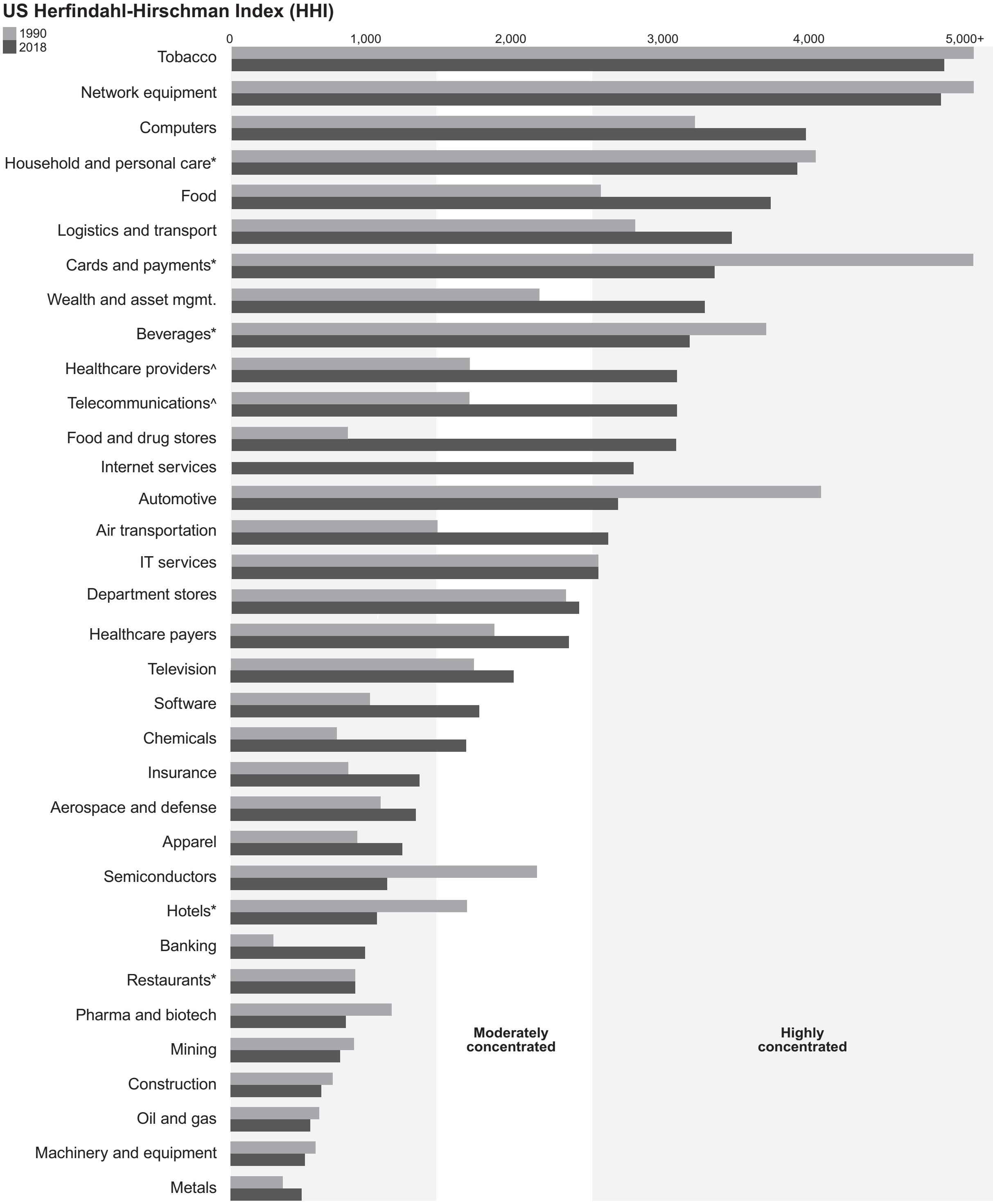
Sources: Refinitiv; Bain analysis

A wave of consolidation since the middle of the 20th century has also reinforced the growing economic clout of larger firms. Financial liberalization and the shift in regulatory attitudes toward antitrust that began in the 1970s led to a boom in M&A. This has resulted in a significant increase in concentration in many (though not all) subsectors of the economy.

To measure this trend, we used the domestic Herfindahl-Hirschman Index (HHI) to estimate concentration over time across the largest subsectors of the economy *(see Figure 13)*. HHI estimates are highly sensitive to market definition and are therefore illustrative, not definitive. But the pattern is unmistakable: an increasing concentration of the US profit pool among an ever-smaller cohort of firms. The top 1% of listed firms now account for 41% of total net income (up from 33% in the 1980s). The top 5% account for 74% of total net income *(see Figure 14)*.

The impact of concentration on *aggregate* returns—as opposed to the *distribution* of returns—is complex and varies across sectors. In industries with high levels of global competition, domestic concentration rates have limited impact on aggregate profitability. Yet even in primarily domestic industries, the relationship is nuanced. In some sectors, we do find a meaningful positive relationship between concentration and rising aggregate profitability, possibly at the expense of higher prices for customers.

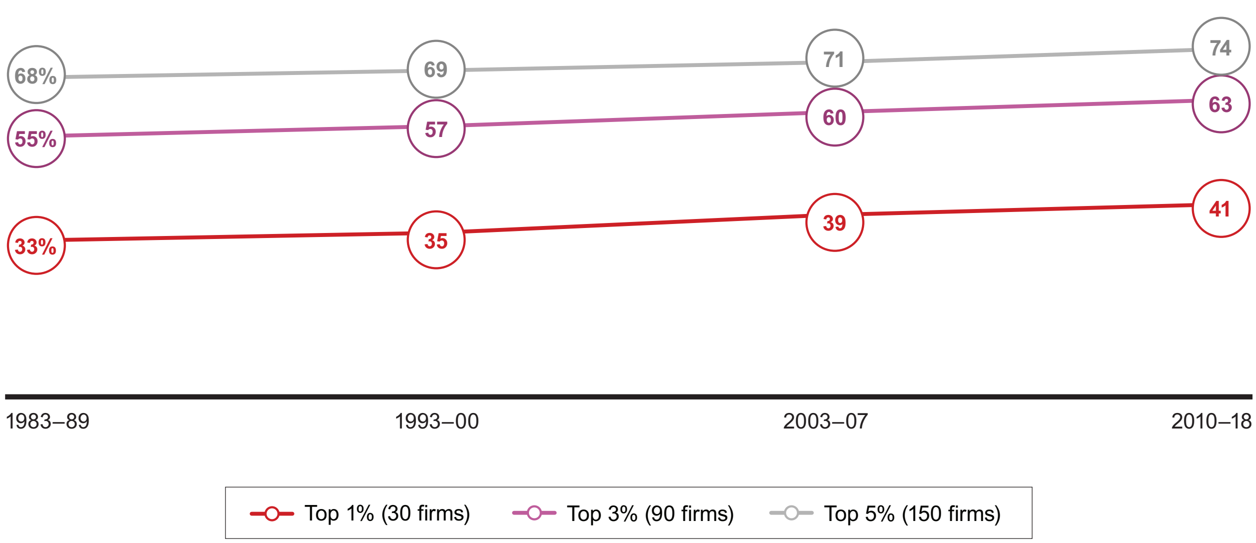
Figure 13: The pursuit of scale has led to growing concentration across much of the business landscape



* Includes major private companies; ^ HHI based on third-party estimates
Notes: Where applicable, HHI scores shown represent a weighted average of constituent subsectors; 1990 not applicable for Internet services; HHI for telecommunications based on 2000 to 2018
Sources: Refinitiv; FREOPP; AAF; company filings; Bain analysis

Figure 14: As industries consolidate, so do profits; the top 5% of companies now account for almost three-quarters of the US profit pool

Share of total net income for top US companies



Sources: Refinitiv; Bain analysis

However, this relationship is not universal. For example, the growing share of Walmart and Amazon has actually had a downward pull on aggregate profitability in the retail sector over recent decades. That's because the superior economics of their business models has led to lower overall prices for customers.

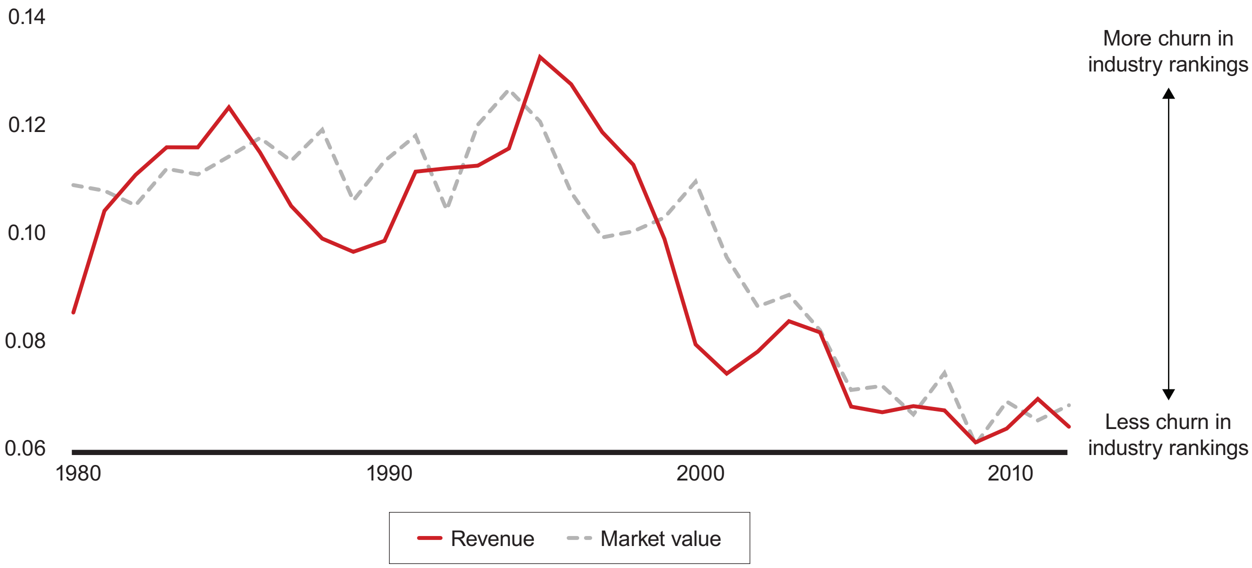
What's certainly true is that large firms have expanded their share of the profit pool in recent decades. Increasing scale advantage appears to have made it even harder for smaller rivals to unseat established incumbents, leaving them stuck with middling profitability. That explains why the churn in industry rankings for public firms has been falling over the last two decades *(see Figure 15)*.

The Covid-19 effect

The Covid-19 crisis represents a clear discontinuity in the trend of rising corporate profits. Business leaders may be waiting many years for profitability to revert to a new steady state. Across the last four recessions, aggregate equity returns have typically taken two to three years to recover, dropping by as much as 80% in the initial year. Much uncertainty remains around the pandemic and its economic consequences, but the evidence so far points to the worst downturn since the Great Depression. Japan's experience following its 1991 asset bubble demonstrates how shocks of a large enough magnitude can trigger extended periods of depressed profitability (see Part 2).

Figure 15: Because incumbents are increasingly hard to unseat, the churn in industry rankings has fallen in recent decades

Average of intra-industry reshuffling in the US



Notes: Intra-industry reshuffling calculated as 1 less the rank correlation of the firm's revenue or market value over five years; a value of 0 indicates no change in industry rankings over five years
Source: *The Great Reversal*, Thomas Philippon (2019)

Much will change as the economy runs its cycle. Prior to the Covid-19 crisis, escalating global trade tensions had already spurred many firms to begin reshoring their supply chains. Recent events suggest that this trend is likely to accelerate in response to the pandemic. Having seen what can happen when supply chains are stretched too thin, many companies are looking to reduce their reliance on foreign suppliers. Reestablishing domestic supply chains will decrease risk but create a significant cost burden for US firms. That could unwind many of the gains labor-intensive industries have made in recent decades by tapping lower-cost intermediate inputs.

At the same time, the current crisis has nearly perfectly coincided with the baby boomers reaching retirement age. Two competing factors will likely determine whether today's economic turmoil accelerates or decelerates the boomers' exit from the workforce. The first is the scale and persistence of unemployment and the degree to which it pushes older workers into early retirement. The second is the devaluation of retirement savings, which would likely spur older workers to keep working.

While it is too early to draw definite conclusions, the staggering rise in jobless claims in the US (in contrast to the recent rebound in the stock market) may suggest an acceleration in early retirement. Once the economy returns to a steady state, a drop-off in the labor force could result in growing wage pressures, dampening corporate profits into the next cycle.

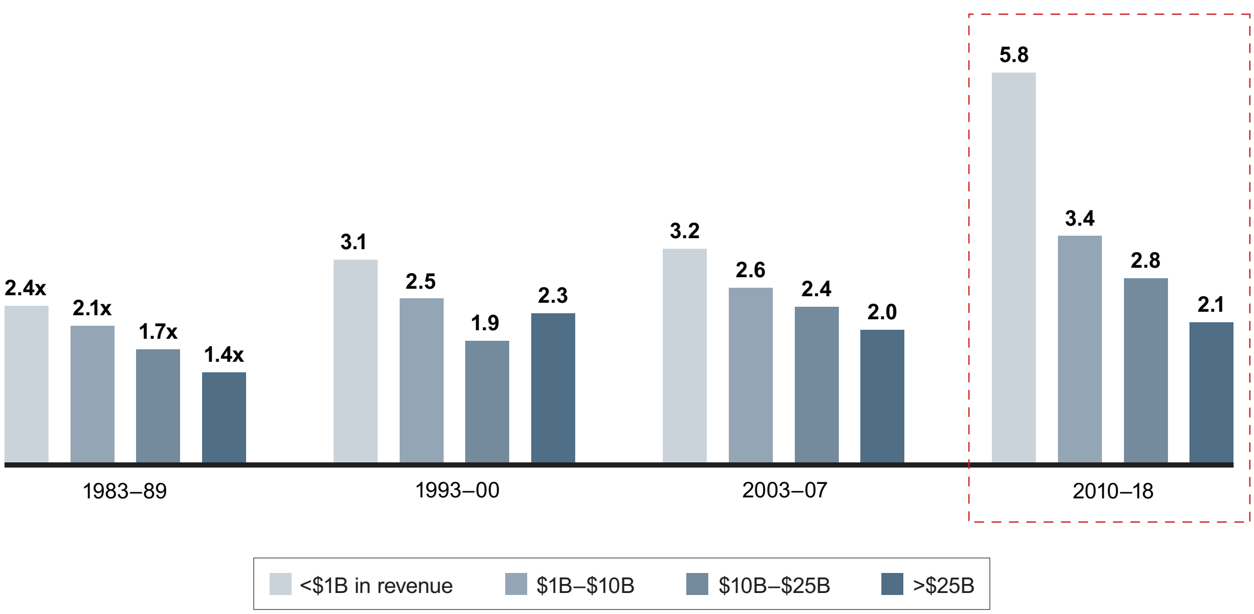
At the same time, however, many firms are responding to the Covid-19 shock by scaling up their ambitions for automation. As enabling technologies become increasingly accessible and cost effective, the failing economy is encouraging companies to cut costs rapidly. Accelerated adoption of automation may—at least in part—offset the drag on profits from deglobalization and a shrinking workforce in the next business cycle. The high fixed cost, low marginal cost nature of these investments will make them particularly attractive to larger firms.

Another factor likely to support profits is digital adoption. Covid-19 has accelerated the move from physical to digital consumption in many industries, pulling forward broad use of e-commerce, digital communication and online entertainment. The Internet giants, which have an outsize share of the profit pool, will be among the main beneficiaries of this accelerated change in consumer behavior (though the same shift may hamper the recovery in certain sectors, such as retail).

Finally, the economic shock related to Covid-19 is likely to support the continued share gain of large incumbents in many subsectors, as smaller companies are more vulnerable to the downturn. To keep up with the returns of leading incumbents, the long tail of midsize competitors have been relying on leverage to enhance their own performance in recent years *(see Figure 16)*. As a result, many of these firms will be unable to recover from the magnitude of the expected downturn and may find themselves joining the growing cohort of zombie firms surviving on evergreen loans.

Figure 16: As they scramble to keep up with larger companies, midsize firms have ramped up leverage, reducing their ability to absorb financial shocks

Debt to EBITDA ratio of US nonfinancial companies



Sources: Refinitiv; Bain analysis

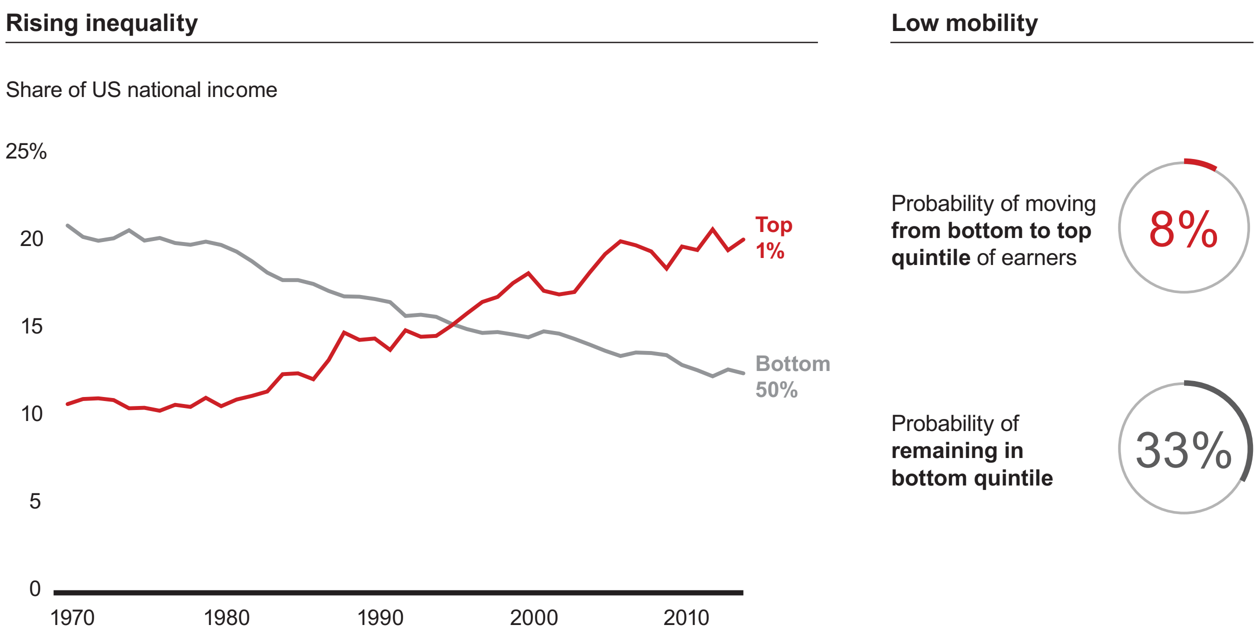
A new set of demands

Balancing these factors against each other, we start to see what sort of business cycle will emerge once the dust settles on the pandemic. While aggregate profitability will likely be dragged down by deglobalization, rising wages and an expanding legion of zombie firms, the profitability of large firms (especially the most digitally advanced) may well continue to rise.

There is, however, a wild card that could dramatically reshape the returns profile for corporate America as we emerge from this pandemic. The last 40 years have been characterized by a highly favorable social environment for business, in which civic demands were loosened and firms were able to sharpen their focus on maximizing shareholder wealth. This benign environment was a critical enabler for the surge in profitability that took place.

Yet, the rise in corporate profits (particularly for large firms) has coincided with what many perceive to be a stark deterioration in social indicators in the United States. Inequality has reached record heights, with the top 1% of the population now earning more than the bottom 50% *(see Figure 17)*. Economic mobility is also stunted. Earners in the bottom 25% have just an 8% chance of making it to the top 25% (and a 33% chance of remaining at the bottom). Life expectancy is also declining in the US, particularly among adults without a college education.

Figure 17: The income gap between the top 1% of earners and the bottom 50% keeps widening, and the odds of moving out of the bottom tier are slim



Sources: World Income Inequality Database; Alesina et al. (2018)

At the same time, the current pandemic and the global financial crisis before it have exposed the increased fragility of the economic system. The growing dominance of large firms has not only inspired a leverage boom among smaller firms, but it has also created an interconnected network of firms that are simply "too big to fail," given their contributions to employment and supply chains. In the pursuit of efficiency, these firms have de-emphasized resilience in the knowledge that the state will intervene in the case of a major crisis. The result has been a nationalization of risk and a privatization of reward.

As we emerge from this crisis, the greatest change facing business and investors may be a shift in attitudes around the responsibilities of the firm vs. those of the state. The need to rebuild the economy is occurring at a time when society's list of challenges is rapidly expanding, from decarbonization to data privacy to the human costs of automation. These issues will ultimately be solved (or not) in the political arena through democratic debate. However, we believe that business leaders and investors should begin to prepare themselves for a world characterized by a far more expansive role for the state and a greatly reduced tolerance for high corporate profits.

2. The rest of the world

As Tolstoy famously wrote at the opening of *Anna Karenina*, "Happy families are all alike; every unhappy family is unhappy in its own way."

Over the past four decades, the US has been the epicenter of surging corporate returns. For American firms and investors, the transition to a new world of lower profits may therefore be the most wrenching. For many other developed economies—in Europe, Asia and elsewhere—the sun had already begun to set on the golden age of corporate profits before the present crisis. But even in these markets, profits may still have farther to fall.

Developed Europe

As recently as 2000, Europe was the largest contributor to the global profit pool, accounting for 40% of all listed company profits. Today, it accounts for just 21%.

Growth has been the main challenge—or, more precisely, the divergence in growth across European states. While the establishment of the European Union (and the eurozone) led to improved living standards in some nations, others have seen real incomes stagnate or even decline *(see Figure 18)*. This has contributed to a surge in populist movements across the continent, increasing the risk of a major unraveling of the current political and economic order.

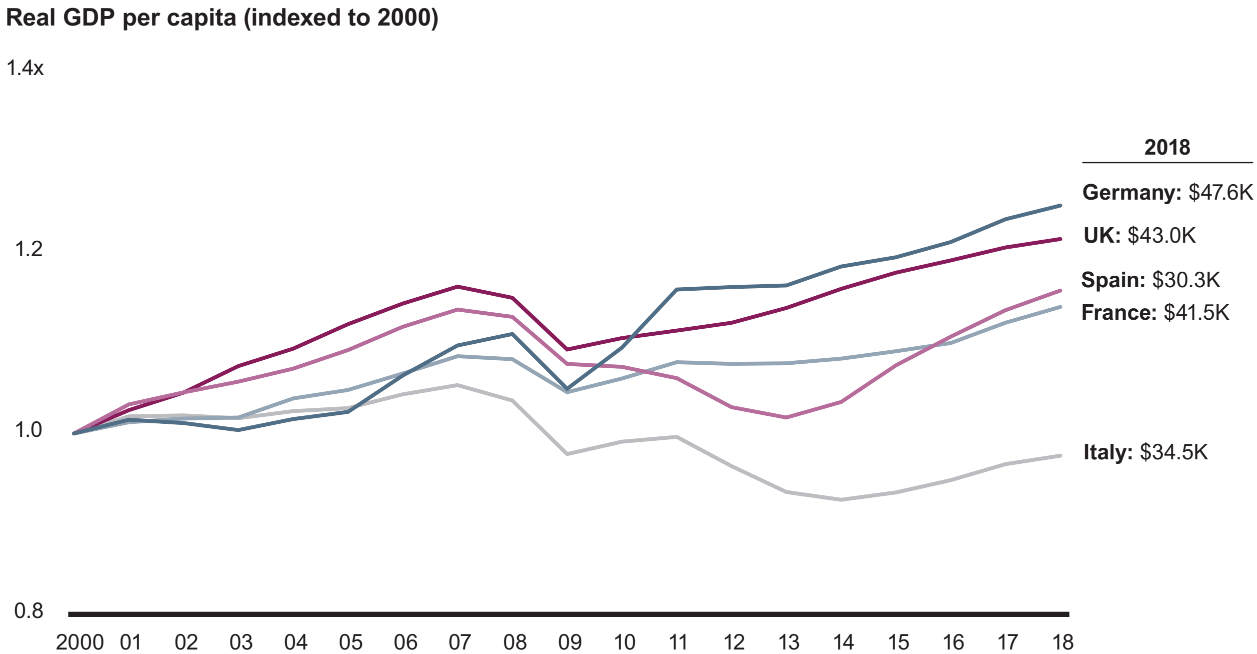
The global financial crisis of 2008–2009 brought Europe's structural imbalances into sharp relief and triggered a downward reset in corporate profits. The impact has not only been felt in the financial sector but also in the real economy, particularly in economies in the periphery of the eurozone that have struggled to resuscitate economic activity. Unfortunately, the Covid-19 crisis will exacerbate these challenges, pushing the bonds of the EU to the limit over the next business cycle.

The impact of integration. The recent history—and forward outlook—for corporate profit in Europe mirrors the promises and perils of the European integration project.

Profits surged in the early 2000s, following the 1999 adoption of the euro *(see Figure 19)*. The implementation of a single currency significantly reduced friction in cross-border capital flows, resulting in a shift out of the capital-rich core (particularly Germany) and into the capital-hungry periphery (particularly Portugal, Italy, Ireland, Greece and Spain). For the periphery countries, returns rose on the back of soaring debt. For the core, the move to a single currency served as an exchange-rate devaluation, improving margins and export growth.

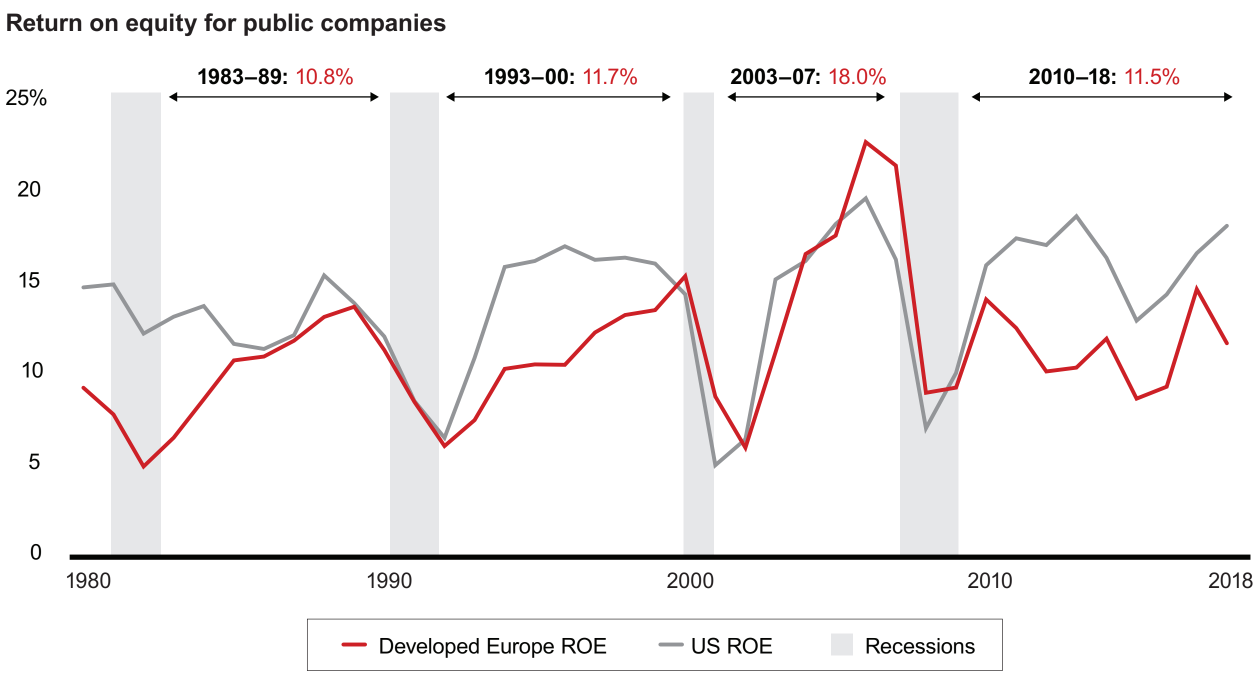
When the financial bubble burst, the result was disastrous. Without the flexibility of separate currencies, stabilization of the eurozone became a multiyear struggle that was still playing out when the pandemic hit. Fears over soaring sovereign debts complicated the matter, as already-weak economies

Figure 18: Living standards have diverged widely across Europe



Source: World Bank

Figure 19: Rising profitability in Europe after adoption of the euro reversed itself in the wake of the global financial crisis



Sources: Refinitiv; Bain analysis

were forced into austerity, further depressing growth. The combination of deleveraging and wider economic malaise has depressed profitability in the most recent business cycle, especially in the periphery *(see Figure 20)*.

The current crisis is reopening these wounds. The precarious government and bank balance sheets of Italy and Spain—the two countries hit hardest by this crisis—will face rapidly mounting pressure as economic costs continue to climb. The resulting debt burden in these countries will far outlive the virus.

The structural challenges of the eurozone will once again shape the continent's next business cycle. The fastest route out of trouble would be to accept greater fiscal integration—by issuing joint European government bonds, for example, to let the hardest-hit economies avoid being held back by the debt hangover. Politically, however, this solution seems increasingly difficult.

Competitiveness and the social contract. Europe's challenges go beyond the difficulties of a currency union. Over time, the continent's global competitiveness has declined, particularly along the periphery *(see Figure 21)*. Making matters worse, this decline occurred just as a new set of emerging-market competitors was entering the scene. The deterioration has played an important role in the deceleration of Europe's growth and the decline in corporate returns.

Unlike the US, Europe has maintained relatively robust institutional protections for labor in recent decades. For example, it has extended collective bargaining agreements to all workers (not just union members) and has encouraged worker representation on company boards. Europe has also maintained a far more robust welfare system than the US. Welfare payments across major European economies (excluding pensions and healthcare) average 9% of GDP, compared with 4% in the US. The combined result has been a meaningfully lower level of inequality than seen in the US, especially after taxes and transfers.

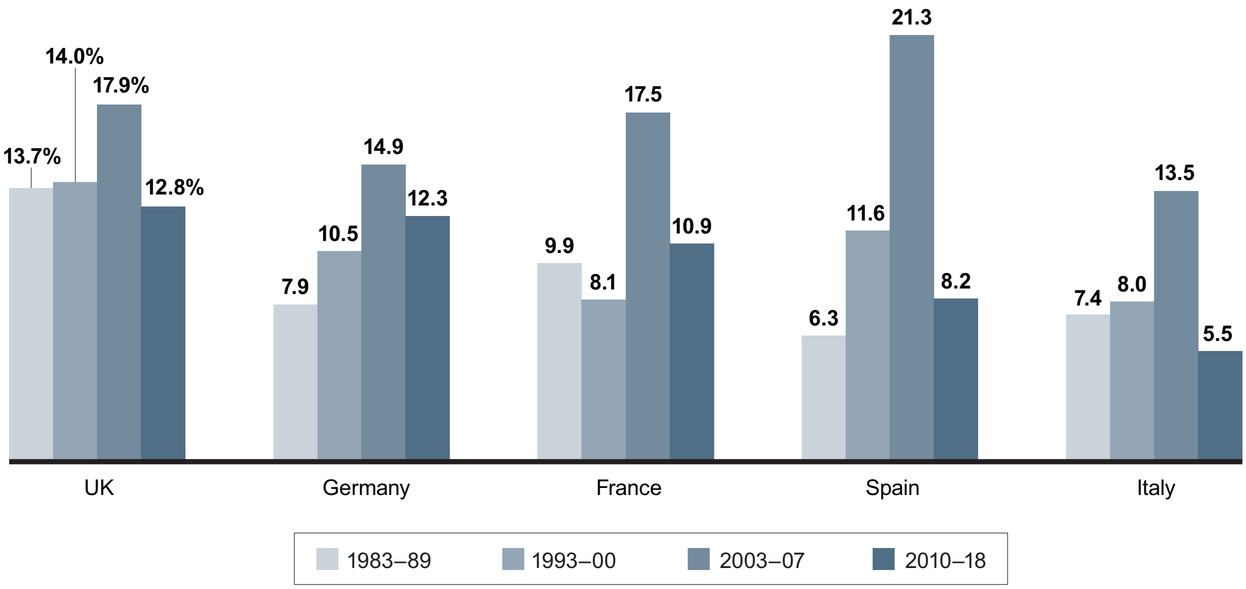
This social contract has played a critical role in European social stability since the 1950s. Indeed, recent attempts to unwind it in some countries have met with stiff political resistance. Yet a failure to find a balanced outcome between economic fairness and global competitiveness may leave Europe on a path toward stagnation rather than shared prosperity.

While the size of the European economy as a whole is similar to that of the US, the average European firm is 30% smaller than the average US firm *(see Figure 22)*. Despite the establishment of the single market in 1993, many industries in Europe remain dominated by domestic firms, limiting cross-border scale. A more activist antitrust regime than in the US has also translated into significantly lower M&A volumes, further contributing to the scale divergence with the US.

The fact that Europe has fewer very large, very profitable firms may help mitigate perceptions of an unfair divergence in outcomes between corporations and wider society. Yet it may also further undermine Europe's global competitiveness, as European firms find themselves lacking the necessary scale to go head to head with foreign competitors.

Figure 20: Deleveraging and economic malaise have depressed profitability across Europe, especially in Spain and Italy

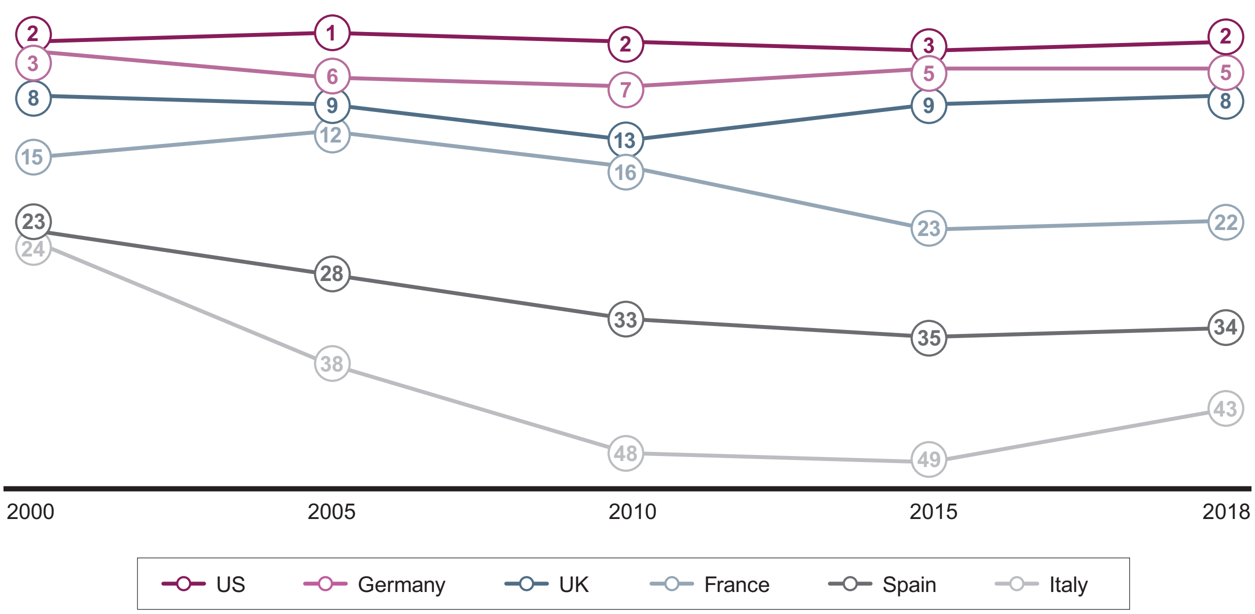
Return on equity for public companies



Sources: Refinitiv; Bain analysis

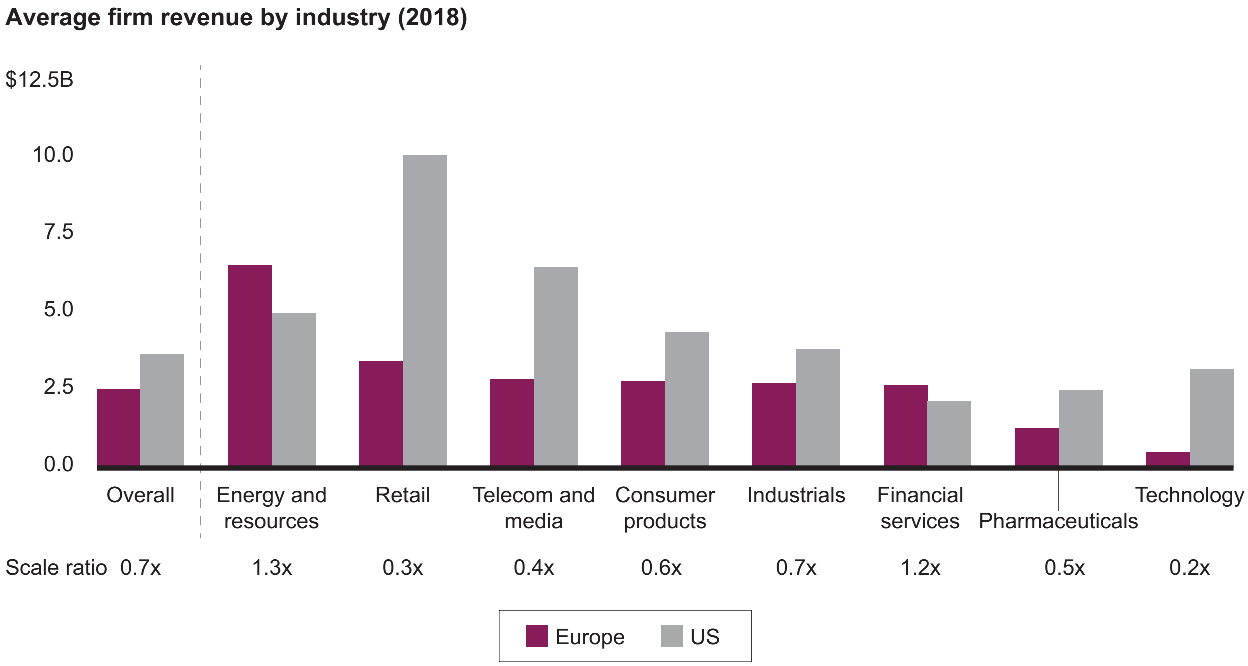
Figure 21: Europe's global competitiveness has deteriorated

Global Competitiveness Index rank



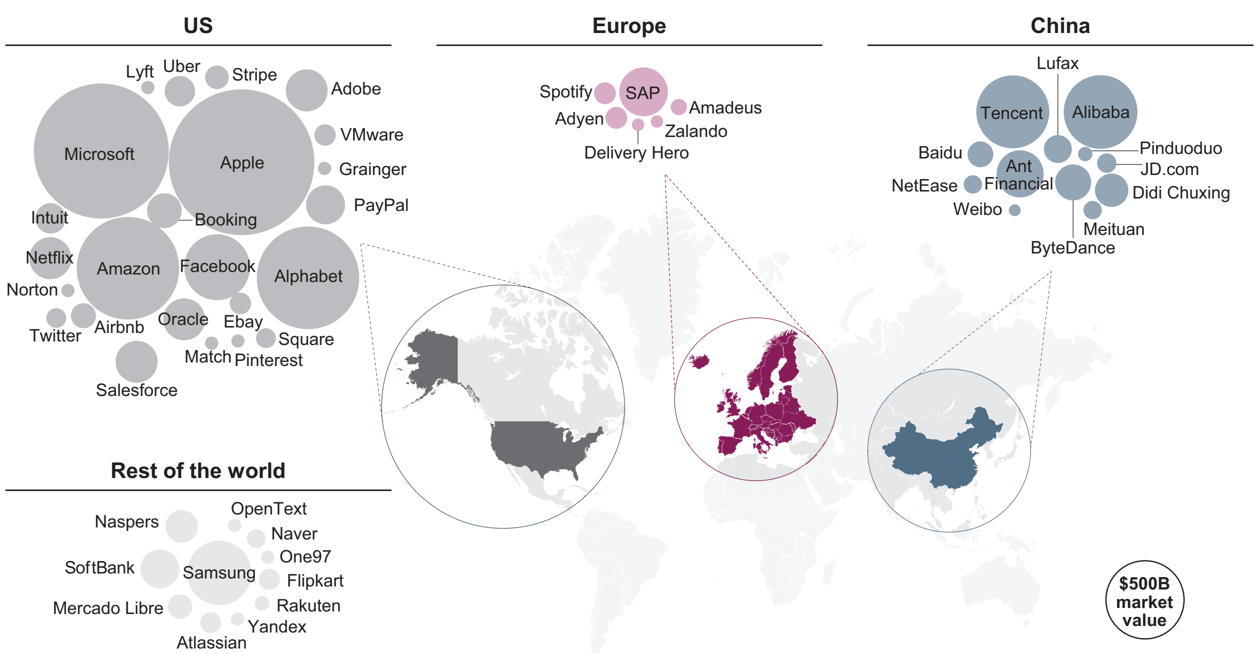
Source: Global Competitiveness Index, World Economic Forum

Figure 22: On average, European firms are roughly 30% smaller than their US counterparts



Sources: Refinitiv; Bain analysis

Figure 23: Fewer highly profitable technology giants have emerged in Europe than in the US or China



Notes: Market valuations as of December 31, 2019; firms with market value of less than $10 billion not displayed
Sources: S&P Capital IQ; European Policy Centre; literature search

This is most apparent in the technology sector, where Europe has been unable to develop an ecosystem on the scale of that found in China or the US *(see Figure 23)*. Without major progress, Europe may miss out on one of the most important waves of change supporting corporate profits, rising productivity and living standards more broadly.

In summary, Europe is at a critical juncture. Without concerted action and reform, it may find itself continuing its trajectory toward an ever-smaller share of the global profit pool and stagnating real incomes. At the same time, the sense of common purpose that permeates Europe is a powerful weapon in a world of increasing turbulence and complex societal challenges. If properly harnessed, Europe—and its leading firms—may yet find a path back to more prosperous times.

Developed Asia

Asia has been seen as the new frontier of growth since the second half of the 20th century. As its economies have progressed toward economic convergence with the West, opportunities for value creation have been plentiful. But it's also true that those economies are at differing stages of the development life cycle. For the purposes of our research, we focused on the developed markets with income levels similar to those in the West.

Even within this group, we see two distinct stories emerging. Japan, once the engine of global growth, has suffered from economic stagnation and depressed profits in recent decades. Its experience sits in stark contrast with that of the Asian Tigers—South Korea, Singapore, Taiwan and Hong Kong—which have achieved high growth and sustained profitability.

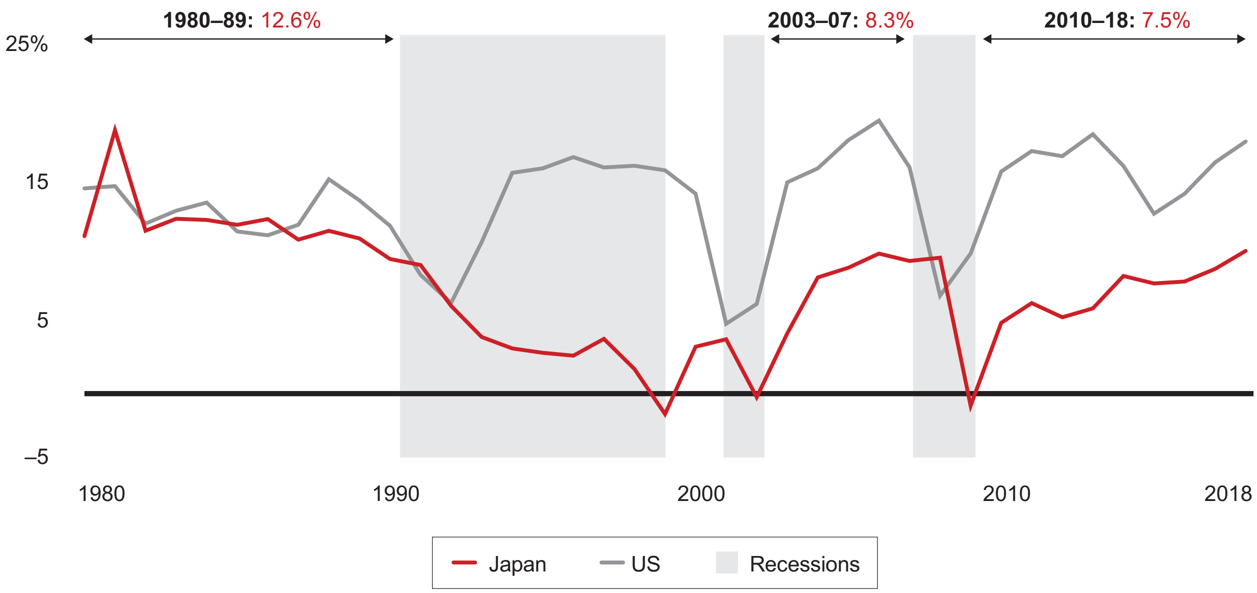
Japan. Japan began its economic divergence from the West when its asset bubble burst in the 1990s. Following the crisis, corporate return on equity collapsed to low single digits as the economy entered a period of sustained weakness *(see Figure 24)*. Households cut back spending to rebuild their savings. Firms sought to unwind excessive leverage. Those that could not deleverage often became zombies, unable to repay their debts yet perpetually propped up by banks unwilling to accept the capital loss. At the same time, manufacturing competition—from South Korea and, later, China—intensified.

The two decades from 1991 to 2010 are now referred to as the Lost Score. As a result of structural reforms—for instance, around corporate governance and cross holdings—dynamism is returning to Japan's economy and capital returns are improving to levels comparable with other markets. But this comes at a time when the country's demographic wave is leading to a shrinking workforce, which may put upward pressure on wages and downward pressure on corporate profits (depending on how fast Japanese companies bring on automation).

The Asian Tigers. In contrast with Japan, the story for South Korea, Singapore, Hong Kong and Taiwan has been one of rapid growth across multiple decades. Industrialization in these economies began in the 1960s and has ushered in a dramatic rise in incomes *(see Figure 25)*. Indeed, the rising tide of economic development has generally led even those in the lower half of the income pyramid to see significant improvements in living standards.

Figure 24: Profitability in Japan has suffered since its asset bubble burst in 1990

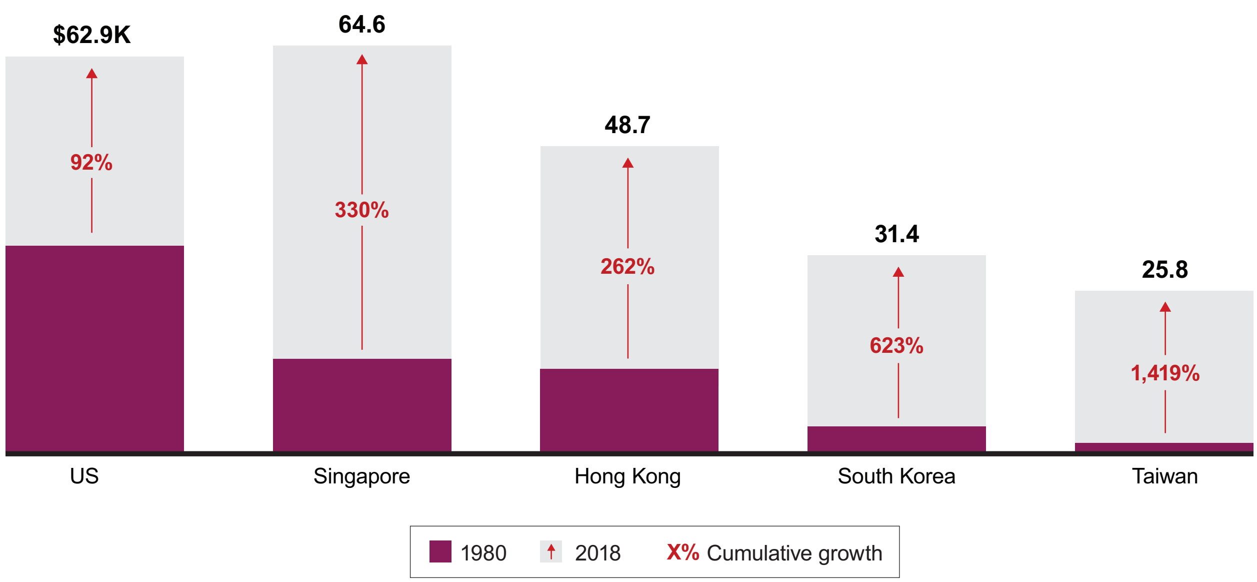
Return on equity for public companies



Sources: Refinitiv; Bain analysis

Figure 25: Industrialization in the Asian Tiger economies has led to rapid gains in income

Real GDP per capita



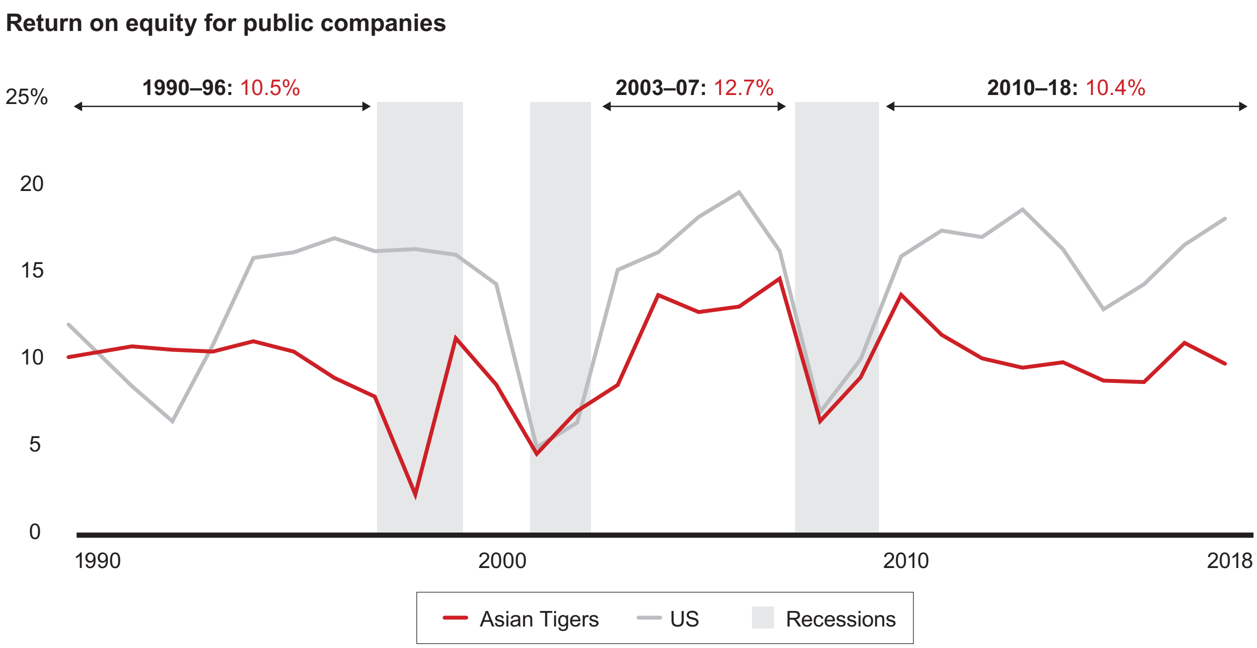
Source: World Bank

Without the economic malaise suffered by Japan, these economies have produced relatively stable equity returns, with the exception of some bumpiness in the 1990s and a big hit during the global financial crisis *(see Figure 26)*. Combined with high growth, this has been a recipe for impressive value creation in these markets.

In recent years, however, this rapid growth story appears to have tapered off, as GDP growth begins to converge with that of other developed economies. Equity returns, which fell during the last cycle, are also meaningfully below those in both the US and Europe. This is primarily because the Asian Tigers are highly exposed to globally competitive markets such as cross-border financing and semiconductor manufacturing. Much of the vigor these four economies have experienced has come in large part from the crucial role they play in global supply chains and trade flows. Imports and exports as a share of GDP are far higher in these markets than in the US, Europe or Japan *(see Figure 27)*.

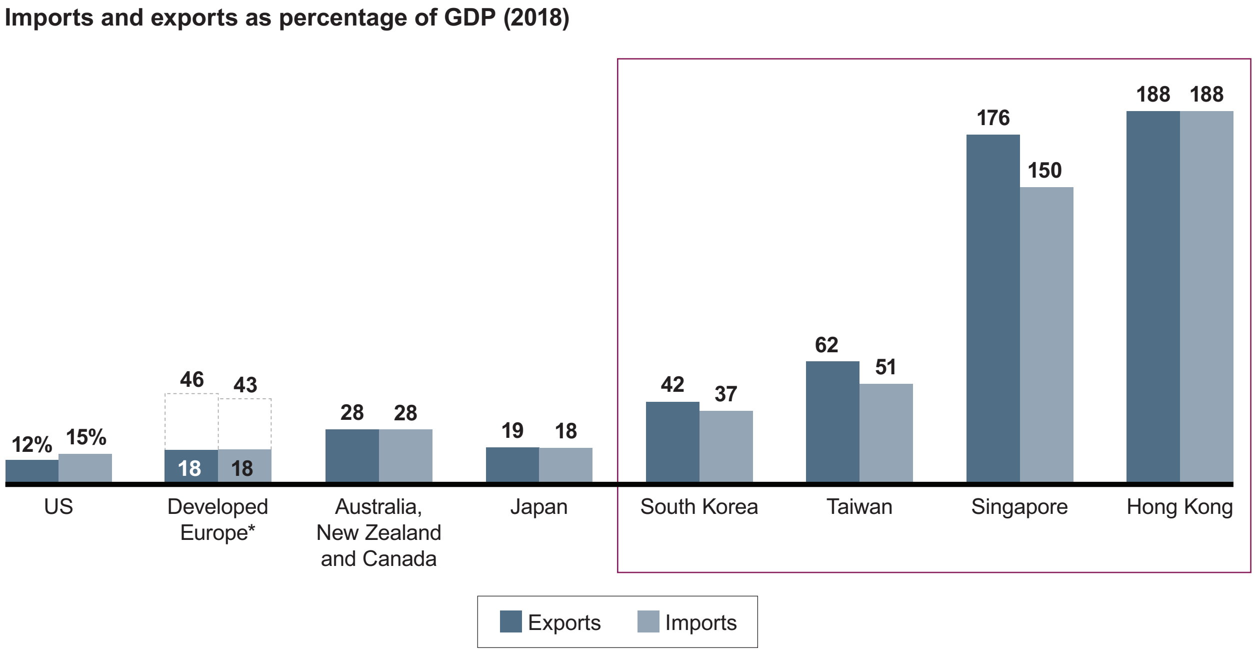
Looking forward, the Asian Tigers may therefore have much to lose as globalization wanes and tensions continue to mount between the US and China. The process of industrialization has now largely run its course, meaning the high growth and reliable returns of recent decades may give way to a less favorable environment for corporate profits.

Figure 26: Profitability in the Asian Tiger economies has been strong and stable



Note: Asian Tigers are Hong Kong, Singapore, Taiwan and South Korea
Sources: Refinitiv; Bain analysis

Figure 27: The Asian Tigers are much more dependent on global trade than other parts of the world



* Dotted segments represent intra-European trade
Sources: OECD international trade database; World Bank; National Statistics, Republic of China (Taiwan); Ministry of Finance, ROC

Australia, New Zealand and Canada

We round out our perspective by looking at the remaining developed economies: Australia, New Zealand and Canada. For ease, we consider Australia and New Zealand (ANZ) together, given their close proximity and economic interconnectedness.

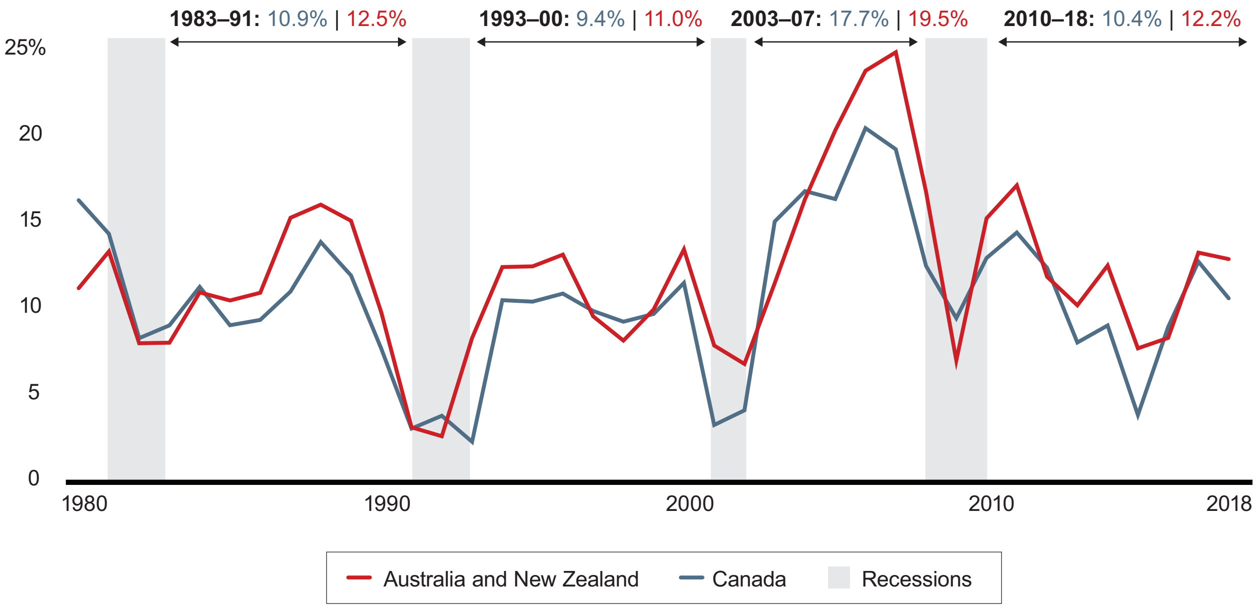
The first point to note is how closely returns in these markets track each other *(see Figure 28)*. The reason is that they are all heavily reliant on resources *(see Figure 29)*. Even activity in nonresource sectors (such as industrials) often depends on demand from the resources industry, given its importance to local supply chains.

Since the downswing in commodity prices starting in 2010, profitability has fallen back down to historical levels in ANZ and Canada. The effect on the last business cycle was magnified by the decline in financial services returns since the 2008–2009 crisis.

The pull on the labor supply from the resources sectors in these markets means unit labor costs are meaningfully higher in ANZ and Canada than in other economies. That reduces their ability to compete in the production of other tradable goods. Upswings and downswings in commodity cycles will continue to dictate the future outlook for profitability in these markets. As the most recent supercycle dissipates, aggregate returns are unlikely to return to their previous heights any time soon.

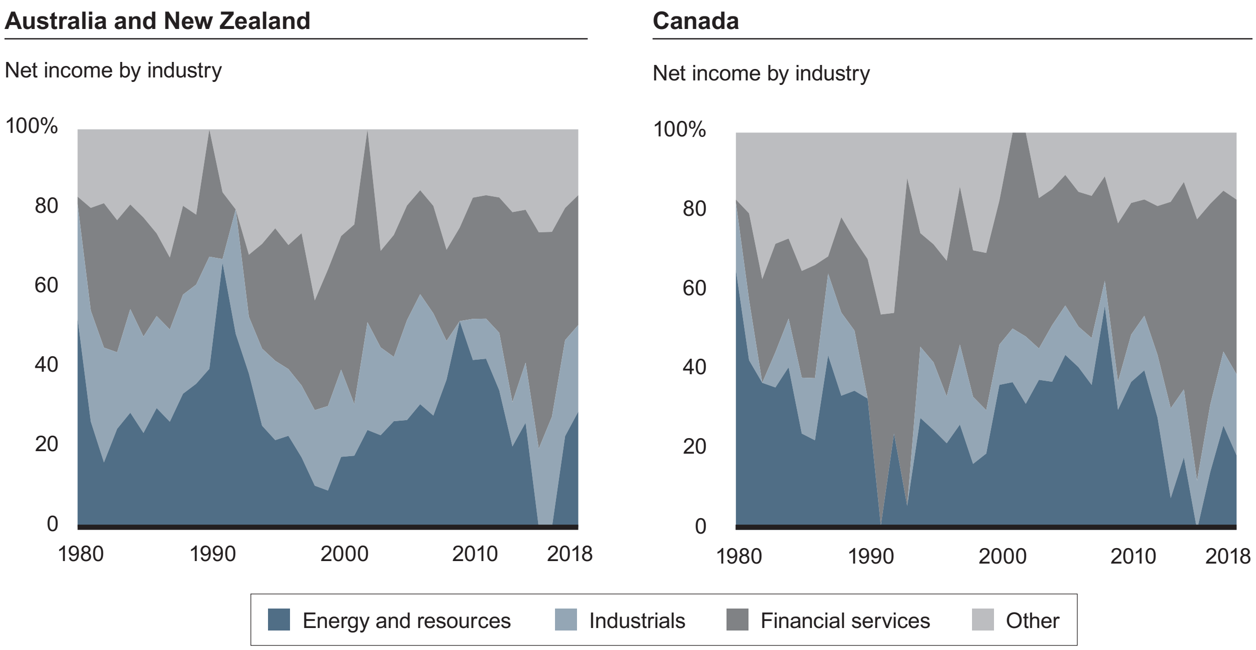
Figure 28: When the most recent commodity super-cycle ebbed, so did profitability in Australia, New Zealand and Canada

Return on equity for public companies



Sources: Refinitiv; Bain analysis

Figure 29: Profitability in Australia, New Zealand and Canada depends heavily on natural resources



Notes: Public companies only; negative values not displayed
Sources: Refinitiv; Bain analysis

3. Navigating the new world

The shifting patterns of corporate profit have profound implications for business leaders. We see four key messages emerging for our clients, which we will continue to develop in future research as the post-pandemic world begins to unfold.

Sharpen your competitive edge. For firms (and investors), the days of easy profits are over. As the total profit pool shrinks, head-to-head competition for customers will intensify. To stay in the game, firms will need to double down on efforts to reduce costs sustainably, with automation playing an increasingly important role. At the same time, technological advances have made it possible for leading firms to offer increasingly tailored products and services with greater coverage across the elements consumers value. By delighting customers, firms will be far better positioned not only to protect margins but to seize market share.

Rediscover business building. In a world of favorable macro tailwinds, firms and investors over the last 40 years have been able to rely on a playbook that emphasized generating value through incremental growth and scale advantage. They have lost the art of business building. In a world of structurally lower returns, this approach will no longer be enough. Value creation will demand creative thinking about how to develop and scale new engines of growth. If governments raise barriers to M&A, it will reduce firms' ability to buy their way out of the problem.

Build resilience. As aggregate returns revert to their historical mean, the temptation for firms and investors will be to work harder than ever to use efficiencies to generate financial outperformance. Yet higher leverage, excessive cost-cutting and tighter supply chains will only leave firms brittle in a world made increasingly turbulent by geopolitical and social change. Financial, operational and organizational resilience will be essential for long-term shareholder value creation, as well as for maintaining a social license to operate.

Raise your game on citizenship and sustainability. As society grapples with an increasingly diverse set of challenges—racial and social justice, automation, climate change, nationalism and data privacy, to name just a few—calls for businesses to accept an expanded civic role will mount. These calls may be "soft" (demanded by customers, employees and activist investors) or "hard" (instituted by the state). Sustainability will become more important than ever, but its definition will dramatically expand. Business leaders will need to learn how to navigate the inevitable conflicts that emerge between the demands of different quarters of society. Today's winners will not necessarily make that transition smoothly.

• • •

For all of us, the months ahead will continue to be shrouded in uncertainty, while the pressures of the present moment remain immense. Looking ahead to the future may feel overwhelming. Yet it is exactly during crises such as this that keeping an eye on the long game is most important. The world is changing—the winners will be prepared for what emerges on the other side.

Methodology

Our insights are based on a firm-level database consisting of all listed companies with at least $100 million revenue in at least one year of listing. By focusing on listed firms, we could significantly increase the specificity of our analysis while maintaining good coverage of the overall economy. (Net income of listed firms in the US represented just over 65% of total corporate net income in 2018.)

We looked primarily at return on equity, as it provides the best view of how underlying returns for shareholders have evolved. For nonfinancial companies, we also considered return on invested capital, to isolate out the effect of financial leverage and interest rates on returns. Our preferred measure of ROE and ROIC excludes goodwill. Goodwill is added to the balance sheet when one company acquires another, and represents the difference between the price paid for the acquisition and the fair market value of the assets and liabilities acquired.

We excluded goodwill from the calculation for two reasons. First, new accounting standards that came into effect in 2002 ended the amortization of goodwill, distorting before and after comparisons of returns. Second, goodwill represents a transfer of economic value (from the owners of the acquiring company to the owners of the target), rather than the creation of new capital, and is therefore less relevant when assessing aggregate returns to capital holders. For ROIC, we excluded goodwill from invested capital. For ROE, we attributed goodwill to equity in proportion to the ratio of equity to debt, and we also removed goodwill impairment from net income for equivalence.

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