Dollars & Sense

Multinationals under pressure *by Briar Foster*

In my adult lifetime, the trend has been to spend more and more of my time dealing with expanding entities, most of whom take great pride in their growing girth.

My GP is now part of a clinic. The law firm I sometimes use has a national presence, possibly aspiring to be international. The store where I get my office supplies has their shares listed on the NYSE. My pharmacy is now part of a grocery chain. My accountant is being wooed by a firm whose name identifies a fifty-story office tower. I confess to buying a book at Amazon, but regret having done so because of the inundation of pushy emails following my purchase. But on the whole, bigger has been better.

Not to be left out, the investment industry finally succumbed to the bigness trend. Over many decades, the North American investment industry gradually became dominated by institutional investors who invariably prefer to deal with financial service firms of a similar size. Furthermore, the strong investment preference of both these parties has been for the investment paper of multi-billion dollar companies, notably the multinationals. Institutional investors require their investment to be liquid (ease of buying and selling) and the names identifying their investments to be sufficiently prominent and reputable to inspire public confidence. Investors have accepted this, and the regulators love it because it makes their job easier.

Some of the established names among multinationals are McDonalds, Yum! Brands (KFC), Pfizer, General Electric, Microsoft, Exxon, Barrack Gold, IBM, Coca-Cola, Ford and General Motors. However, because the world economy has gone global, nearly all the multi-billion dollar public companies have international interests. At least three of the Canadian banks have made significant investments outside Canada.

In recent years, a problem has surfaced: the profitability of the global operations of many multinational corporations has been shrinking. Overhead costs have risen, especially wages. Commodity prices collapsed. Increased competition has come from local enterprises and other multinationals. Local politicians insist on a greater share of profits and more business allocated to local suppliers. Favorable opportunities for global growth have become scarce. In their home market, politicians are working on ways to get multinationals to bring the profits home to be taxed and reinvested rather than leave the money relatively untaxed in jurisdictions that had nothing to do with how the money was earned.

The main complaint against multinational corporations is how they have been a major cause of "wealth inequality" in developed economies. Specifically, over the past twenty years the jobs exported to low-wage emerging economies undercut prospects of middle-class wage increases for North America and Europe. A few years ago, I heard Jeff Imelt, CEO of General Electric, describe how for competitive reasons he had moved manufacturing jobs to Mexico manufacturing jobs that had been paying $25 per hour in the U.S. He went on to describe how he got the union to agree to a wage cut to $15 per hour if he brought those jobs back to the U.S. For policy makers, the problem is tariffs would nullify the wage differential, but global free trade helps control the cost of living. And robotics is just as responsible for stale wage rates.

According to The Economist (Jan. 28), at their peak multinationals had an estimated 80 million workers, 50% of world trade, 40% of Western stock market cap and $1trillion in annual profits. Return on equity (ROE) on foreign operations ran as high as 18%. Recently, 40% of multinationals had ROE on foreign business slip to less than 10%, dwarfed by a 30% higher ROE from operations in their home market. Of course, tech companies like Apple, ABB (Swiss Engineers) and Schlumberger can resist the negative trend because their businesses are protected by their patents and expertise.

As the numbers indicate, the days of double-digit growth for multinationals have peaked. Opportunities to expand are limited. For the first time in years, politicians are embracing the idea of tariffs and border taxes, referring to some multinationals as disloyal corporate citizens. For the time being the dividends appear safe. Of course, a good part of their corporate undoing is their bigness. When a corporation is financially larger than some provinces, states or countries, a mere $20 million of growth is barely noticed when the revenues are measured in billions.

To regain their status as growth entities, multinationals need to get smaller by spinning off their more mature divisions. The markets always want new names to consider. Individually the parts of many large corporations are worth significantly more than the whole. General Electric, IBM and KFC, for example, have successfully started their shrinking process. In the opinion of some, the pieces of Johnson & Johnson and Corning are unrealized value within the corporations. Investors might look at the potential break-up value of multinationals as being as important as the dividend. The trend to get smaller will be here for awhile because the term "global" has lost its sex appeal.

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