WINTHROP PARTNERS

Wealth Planning & Investment Management

Business Trend: Capitalism ~~1.0, 2.0, 3.0, 4.0~~ 5.0

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Authors' Note

We at Winthrop Partners are conservative capitalist, but even as such, its hard not see that Capitalism is due for an update. We believe that we are in the 9th inning of Capitalism 4.0. Monopolies and Oligopolies are increasing, large swaths of the population feel disenfranchised, income inequality is at record levels, anti-competitive moats are erected around most large corporations, and as a result, excessive unearned income or "rents" in America are skyrocketing compared to the rest of the world.

To confirm these trends one need look no further than the cost of your prescriptions and cable bills, the short-term nature of current employment, the endless restructurings and layoffs in large companies, the constant notice of corporate mergers & acquisitions, the dizzying level of regulations and licensing required to perform the most basic of tasks or the increasingly socialist-leaning of young voters.

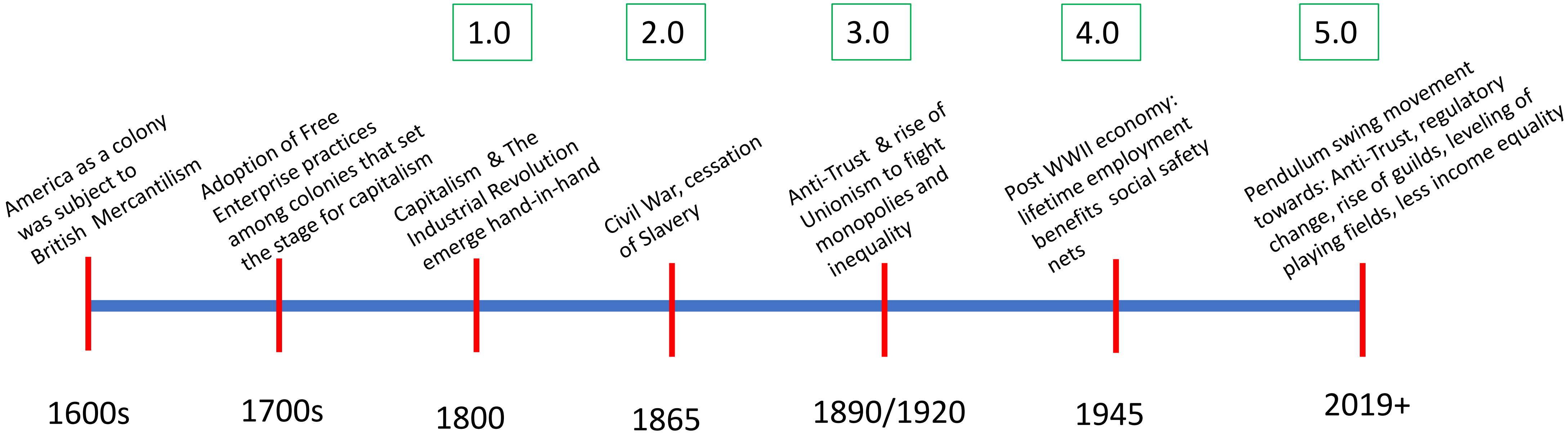
We believe that the confluence of these trends is triggering the shift of the pendulum and the dawn of Capitalism 5.0. Like most large-scale societal shifts the change is rarely the result of a single event or legislation, but rather the product of many small and seemingly unrelated changes in the economy that require the benefit of hindsight to fully view.

This report examines the present excesses or bubbles in Capitalism 4.0 and the financial, regulatory and societal trends that are emerging that will gradually reshape: work patterns, wealth creation, privacy, intra-industry competitiveness and corporations' relationships with individuals and eventually deliver Capitalism 5.0

Authors' Note (2)

This report is not politically orientated, but rather it is economically focused. However we would be foolish to understate the role of politics in economic change.

Ultimately Capitalism 5.0 will arise as the result of political debate, conflicting policy and occasionally consensus. Although America occasionally flirts with, or leans toward, alternative economic models such as communism, socialism and globalism, capitalism has shown a remarkable resiliency and ability to reset itself when the economic system gets out-of-kilter.



Corporate Consolidation & Concentration

According to The University Of Chicago Center for Research in Security Prices , the number of Public companies in the U.S. has reduced by more half to 3,618 since the peak of 7,568 in 1999.

The World Bank Estimates that the market capitalization of the surviving entities has increased 150% over the 1980-2018 period.

Some of this consolidation and concentration is due to the 2000.COM bust and the introduction of Sarbanes Oxley which imposed expensive regulatory burdens, but most of the consolidation arose from Merger & Acquisition activity.

The National Venture Capital Association provided a good example of consolidation: In 1985 the percentage of venture capital backed companies that conducted an IPO to raise capital was 89% (11% were acquired by a public company), by 2017 this ratio flipped with 85% of venture capital backed companies being acquired and only 11% sought an IPO.

Consolidation has risen in 66% of American industries. Ten percent of the economy is comprised of industries where four firms control 2/3 of the market. A recent Economist article noted the unhealthy level of consolidation in a number of industries: 1)Credit Cards – 3 companies control 95% of the market, 2) Telecommunications – 3 companies control 78% of the market and 3) Airlines – 4 companies control 69% of the market

Industry after Industry has similarly consolidated: Autos, Technology, Home Builders, Defense, Steelmakers, Media, Entertainment, Search, Social Media, Pharmaceuticals and Banks and Financial services have all thinned the competitive ranks.

Corporate Consolidation & Concentration (2)

Why are corporations consolidating:

Eliminate Competitors – *Reducing competition provides them freer reign to pursue self-serving interests*.

Create Synergies – *Synergies used to mean 1+1=3, a combination of cost reduction and value creation. Today's mergers are focused on cost reduction and market or vertical market dominance. Value creation is silent.*

Create Moats / Barriers to Entry - By virtue of size, the amassing of key intellectual property or the assembling or critical licenses make it as difficult as possible for another competitor to enter the market

Dominate Markets – When a handful of competitors dominate a market (telecoms, airlines, search, etc.) the participants can more easily telegraph to each other anti-competitive acts like price increases without overtly breaking laws.

Dictate pricing – When the number of suppliers are reduced, pricing leverage flows to the remaining suppliers not customers. This allows the supplier to garner excessive profits (Rents)

Become Too Big to Fail - Banks have known this for quite a while, the defense and telecoms industries are quickly learning this lesson. No matter how mismanaged or risky your behavior, taxpayers will bail you out.

Corporate Ownership Is Even More Consolidated

Just a small number of investment managers exercise practical power over US public and private companies.

Institutions own about 78% of the market value of the U.S. broad-market Russell 3000 index, and 80% of the large-cap S&P 500 index. In dollars, that is about $21.7 trillion and $18 trillion, respectively.

Just three fund managers control 81% of Index Funds --about 20% of all Public Equity (Vanguard, State Street and Black Rock) The Wall Street Journal predicts that if index funds continue to grow at present rates the Big Three will control 30% of the US stock Market.

Not only is there a concentration of ownership in the Public markets its even more concentrated in the Private Markets. In 2018 50% of the $4.3 Trillion Private Equity Market is controlled by 10 firms: Blackstone Group, Kohlberg Kravis Roberts, Carlyle Group, TPG Capital, Warburg-Pincus, Advent International, Apollo Global Management, EnCap Investments, Neuberger Berman Group and CVC Capital Partners.

Concentrated Ownership impacts managers' decisions such as creating desires to: 1) Not upset the apple cart 2) encourage continued consolidation and 3) wring additional profits from the merged industries with fewer competitors . Most importantly the Economist cites that the returns for dominant competitors "oligopolies" in highly concentrated economic sectors beat the global stock market by 484% over the last decade.

Public Sentiment

Public sentiment will be the largest driver in forming Capitalism 5.0 and can be broadly grouped into three areas:

1) Job Security and Income Equality: *Do citizens feel they are getting a fair shake now and do they have a secure future?*

Large contingencies in both the left and the right feel disenfranchised from the new economy. A 2018 Thompson Reuters poll indicated that about 65% of Americans believe that their jobs are less secure now that twenty years ago. GM's recent announcement that it was not allocating any automobile production to 3 north American plants idling 10,000 workers adds to that sentiment. In response President Trump mentioned that he would look into clawing back 2008 era benefits awarded to the auto company.

Income inequality has risen at a high rate since the 1980s. The most recent information is from 2015 showing that the lower 90% of taxpayers earn on average $34, 074, the top 10% earn on average $312,536 (or 9.17X more than the lower 90%), the top 5% earn on average $477,293 (or 14X more), the top 1% earn $1,363,977 (or 40X more) an the top .01% earn $6,747,439 (or 198X more). Since 1980 the top .01% of Americans have more than doubled there share of total earnings to 5.1% at 2015. Senator Bernie Sanders is introducing a bill that will require that companies like Walmart pay a $15.00/Hr. minimum wage or face restrictions on share buy-backs which largely benefit higher income individuals.

A 2016 study found that more than 50% of young Americans no longer support capitalism

As of 2016, 15 percent of millennials between the ages of 25 and 35 were living with their parents. That compares to 10 percent of Gen Xers when they were at that age in 2000.

Public Sentiment (2)

2) <u>Privacy and Security:</u> Are big corporations amassing and monetizing too much information and are they protecting it .

Data Privacy and Data Security. Although data privacy has been a hot topic in Europe for a number of years, the issue is just starting to come to the forefront in the U.S . as questions about Facebook, Amazon and Googles uses and potential abuses of consumer data emerge.

Americans are quickly becoming concerned that the vast amounts of data gathered about them when they use: 1) “free” search, shopping, communications and social media services, 2) cable, and banking services, 3) supermarket discount cards and 4) ancestry or DNA services. Highly personal data is being gathered, appended, parsed and sold at tremendous profit to a few and at a detriment to many.

Some data consumers use this flood of highly personal data in questionable ways such as methods to direct fake news towards receptive marks, categorize individuals (insurance) or otherwise discriminate against consumers.

With 2.5 quintillion bytes of data being created every day, and a large portion of that being mined and stored by corporations, individuals are increasingly concerned with how this data is being protected from theft and other breaches.

More recently the theft of up to 500 Million American’s financial and personal data, including passport data was stolen from Marriott Hotels, prompting Senator Elizabeth Warren to comment that Executives jobs should be tied to data breaches because they have done too little to protect this information.

Public Sentiment (3)

<u>3) Corporate Sentiment: </u> Have corporations become too big and powerful / should they be broken up?

Do investors, regulators and consumers believe that market leading companies have become too big to fail or at least efficiently manage and regulate? And has their size and market dominance harmed consumers?

Although there has been an outsized trend of mergers and acquisitions, some pain points with this strategy are beginning to emerge. GE, Dow Dupont, Campbell's Soup and United Technologies have all been forced to break up. Large Banks and Insurance Companies have been forced to spin-off or sell hundreds of subsidiary corporations. The activities of Activist-investors, proxy-voting advisors, funds, special interest groups and in certain cases, consumers have increasingly been successful in influencing hitherto hidebound corporate boards to become more responsive to shareholders and other stakeholders.

Changes in investor sentiment are occurring. The ranks of conglomerates has thinned in recent years as investors adopted the belief that its better for managers to be focusing on a single line of business rather than a multiple businesses. These same investors are also adopting the point-of-view that excessive size can breed inefficiency and hamper the corporation's nimbleness.

What Might Happen

Over the coming years the conversion to Capitalism 5.0 will manifest itself in many ways and probably not in an organized or coherent pattern, but rather in fits and starts with plenty of contradictory actions. Below are some key activities to watch as well as some recent and potential actions in these areas.

Anti- Trust and other Regulations:
Actions:
AT&T -Time Warner Merger, The justice Department sued to prevent the merger claiming anti trust violations, but Federal Judge Leon sided with the defendants and approved the merger, a major set-back for the justice department

CVS – Aetna merger was questioned by Federal Judge Leon indicating it didn't comply with the Tunney Act provision of the Anti-Trust statutes even though the justice department signed off on the merger.

The Big 4 Banks (JPM, BA, WFC CITI) are effectively blocked from future acquisitions due to banking regulations governing the percentage of national deposits each can maintain, WFC is also prohibited from increasing in size.

Amazon- Germany's Anti-Trust Authority has launched an investigation as to whether Amazon is impeding commerce.

Potential Actions:
Tech companies like Amazon, Face Book and Google could be challenged as monopolies and subject to break up or future acquisitions could be hampered due to ani-trust concerns. The airline, pharmaceutical, financial services, communication and entertainment industries could face similar regulatory and anti-trust issues.

What Might Happen

Investigation and fining of large firms with commensurately large fines:
Actions:
Since 2008, Banks were fined $185 Billion, Brokerages $38 Billion and Insurance Companies $3.8 Billion, largely for their misdeeds associated with the 2008 recession, but Banks such as Wells Fargo and Deutsche Bank continue to garner large fines. European regulators who have been more attuned to anti trust and privacy issues in the tech sector have fined the following companies: Google - 2.4 B Euros, Facebook -110 Million Euros, Intel - 1.06 Billion Euros and Microsoft -1.56 B Euros. Other Corporations like British Petroleum $20B, Anadarko $5.1B, VW $14.7B Glaxo $3B have all recently paid outsized U.S. penalties.

Potential Actions:
The U.S. is now considering levying more fines that are commensurate with the size of the entities being fined so that the penalties act as functional deterrents. It appears that Tech, Big Pharma and Energy companies will be future targets.

Break up of mega firms:
Actions:
Activist investors have been instrumental in the breakup or restructuring of several Mega conglomerates from GE and UTC to Dow Dupont and Dover Corp and P&G and Campbell's Soup. To date, these firms have been dismantled based upon economic factors as opposed to social, environmental or privacy related considerations.

What Might Happen

Break up of Mega Firms (continued) :
Potential Actions:
Going forward, factors such as pure size, ideology or outsized influence could trigger future breakups, Although Banks have dodged “too big to fail” breakup legislation so far, they continue to be susceptible. Tech companies, Drug Companies, Insurance and Healthcare Concerns are also susceptible to similar regulation particularly if they engage in anticompetitive, deceitful or illegal acts.

Market stops rewarding size in favor of nimbleness and subject matter expertise:
Actions:
GM and Ford have slimmed down and jettisoned product lines in order to become more focused and nimble players in their chosen industries and geographies. On average the big four Banks each divested more than 30 business lines in the last five years. Proctor and Gamble divested or consolidated 100 Brands as it streamlines operations. As previously stated, GE and UTC have also divested or otherwise broken-up their operations.

Potential Actions:
Gigantic firms can no longer rely on size and inertia to protect them as activist and other investors demand higher returns, the reduction of regulations chip away at their moats and disruptive competitors invade their turf. Look at Netflix simultaneously disrupting the motion picture and cable industries, Spotify, Apple and Amazon upended the music industry, and Square, PayPal/ Venmo, target Visa and MasterCard. Highly regulated industries like Healthcare, Financial Services, Transportation and Utilities all could face new and disruptive competitors.

What Might Happen

Workers gain leverage:

Actions:

Unemployment is at an all time low. The workforce is shrinking as individuals age-out, and intelligent systems and robotics aren't necessarily supplanting skilled human labor, but rather enhancing their labor.   Additionally social media and other technologies might allow workers to form guilds that allow them to leverage their skills.

Future actions:

As long as the economy remains strong, supply and demand will allow workers to exert more power in the labor market.   The continued reduction of regulations such as licenses (20% workers are now licensed vs 5% in 1950) may allow more mobility between job classes and state and federal courts chip away at the validity of non-compete agreements fewer people will be tethered to a single company.

Also as companies are forced to become more nimble and flexible job tenure will continue to erode and there is a strong possibility that workers will no longer look to employers as the repository of benefits (Healthcare, Life insurance) or savings (401K) and pensions. Instead workers may take a cue from movie actors and form industry guilds that manage and negotiate benefits, serve as de facto union halls and dictate the basic terms of employment that guild members will accept.

Conclusion

If the trends described herein continue to manifest themselves, there is the possibility that the next decade could resemble the two decades on either side of 1900, where business-owners, managers, workers, consumers and governments were forced to equitably manage a new economy brought about as a result of large technological shifts (petroleum, transportation, electricity, telephones, etc) that caused large distortions in wealth and social order.