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Are we facing a slowdown in corporate profitability?

Macro perspectives
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Executive summary

All change – macro headwinds for corporate profitability

- Interest rates are normalising, ending a period of ultra low interest rates since 2008. The implications of this for corporate profitability are potentially profound.
- Our analysis shows that corporate profitability in recent years was largely due to supply side factors such as falling cost of production, as well as falling tax and interest rates.
- These drivers of profitability look set to have been exhausted, or even reversed, as globalisation stalls, interest rates start to rise and tax minimums are agreed internationally.
- So corporates seeking year-on-year increases in profitability need to be ready for a more adverse environment.
- To win, business leaders will need to recognise this challenge and steer value creation strategies towards resilience and modernisation.

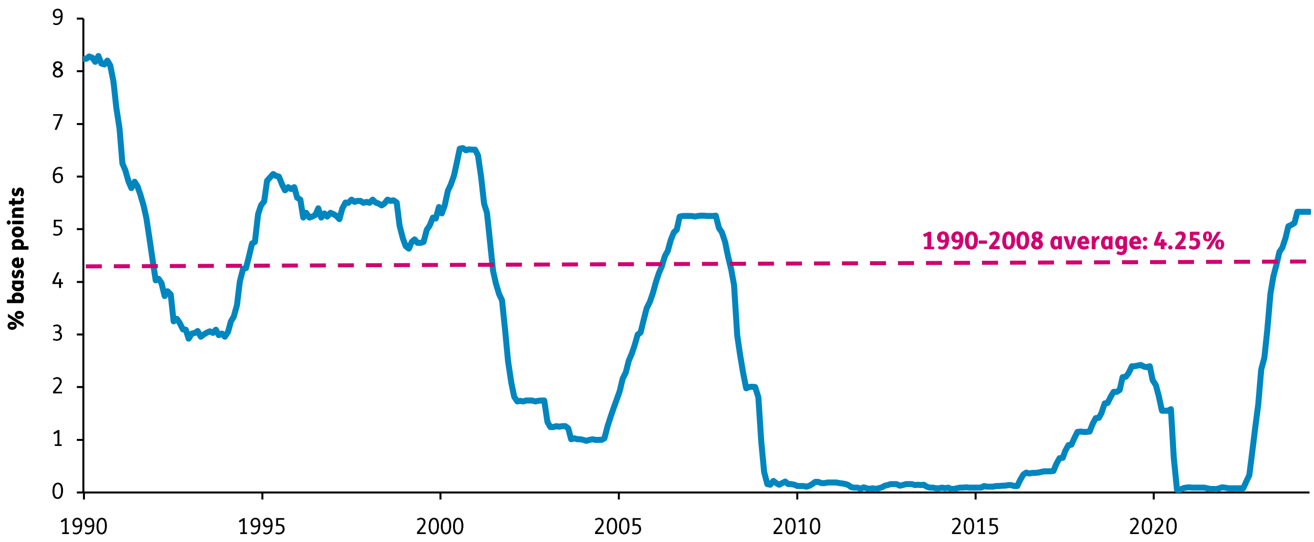
What could this mean for your business?

- Corporates should be prepared for several years of intensifying pressure on earnings performance – something that capital markets and shareholders may not be willing to support.
- Corporates have an opportunity to deliver enterprise value creation through a renewed set of lenses. A progressive understanding of where sustainable value opportunities will lie in the next 10-15 years will be key to success.
- This means being brave and making big decisions on investments, divestments, acquisitions and cost optimisation now, as well as working steadily on core capabilities and talent programmes to ensure resilience and a stable platform for future growth.
- Getting ahead of the curve will require prioritising speed to value in order to maintain momentum and appetite for change. In our conversations with business leaders, we recommend reviewing a holistic set of value creation levers as an immediate priority.

Interest rates are normalising – what does this mean?

Interest rates are returning to their 1990-2008 average after a decade and a half of ultra loose monetary policy. This has been referred to as "normalisation", but for many will represent a new era relative to recent memory.

US federal funds effective rate (1990-2023)

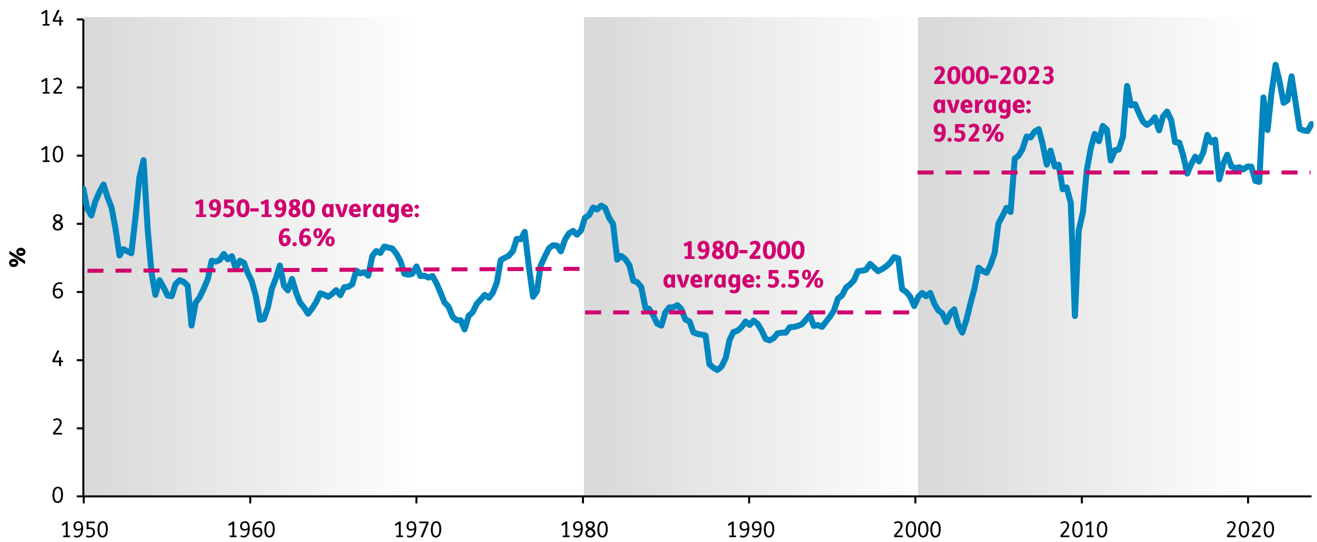


Source: FRED

Corporate profitability has been at all time highs in recent decades

Corporate profits as a percentage of GDP have been very high in recent decades. This begs the question of how sustainable this is in the years ahead.

US corporate profits as a proportion of GDP (1947-2023)

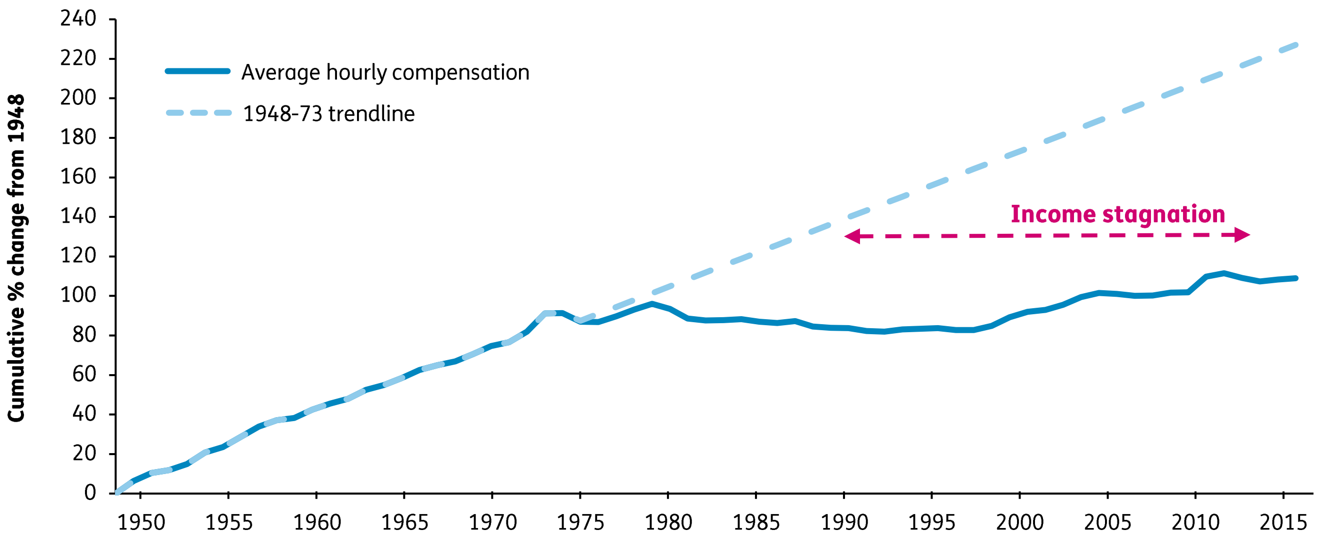


Source: FRED

Corporate profitability increased despite weak demand and stagnant real income

The high profitability is in some respects a surprise, as demand in the real economy has been weaker than previous decades, owing to a material slowdown in real income growth of consumers.

Change in US average hourly compensation



Source: Economic Policy Institute

Instead, high profitability growth has been driven by supply side forces (falling costs)

Recent highs in profitability has been driven by a large role in supply side forces, including costs, rates and taxes, with demand (sales growth) accounting for just 50% of the growth in profitability. These supply side factors include costs, rates and tax.

	1989-2020
DEMAND *See above*	Low ▼
COSTS (E&L)	Falling ▲
INTEREST RATES	Falling ▲
TAX	Falling ▲

		1989-2020
Demand	**SALES GROWTH**	50% ▼
Supply	**MARGIN GROWTH**	9% ▲
Supply	**DEBT SERVICING COST**	19% ▲
Supply	**TAX COSTS**	22% ▲

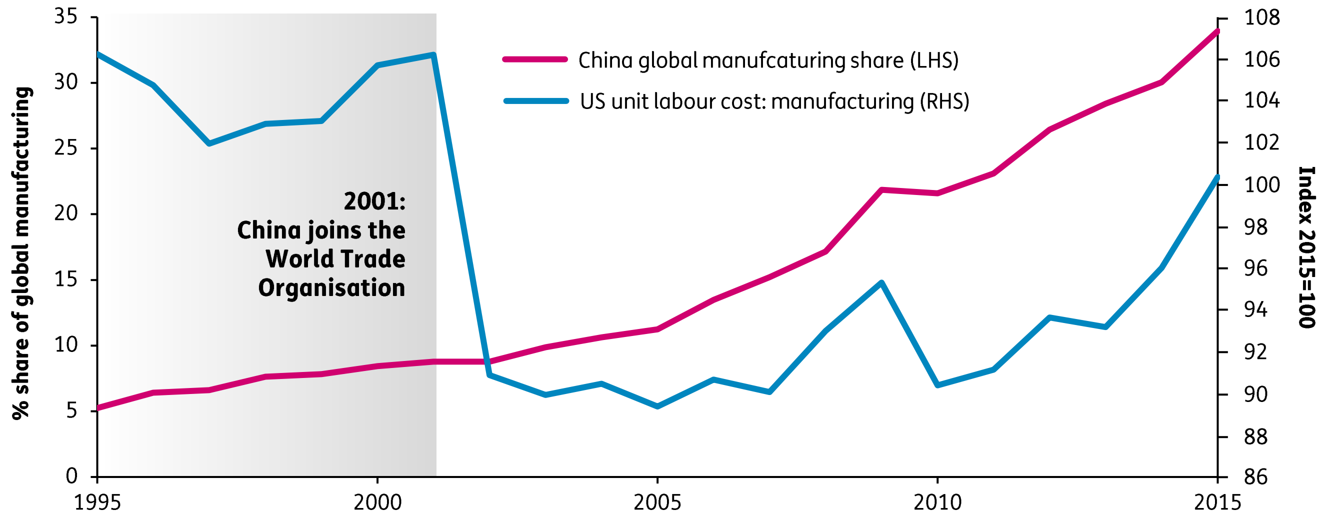
Supply side forces have had a large role to play in recent high profitability, with demand accounting for just 50% of the growth in profitability.

Source: Smolyansky, 2023.

Supply 1: Globalisation supported margin growth through lower labour and input costs

Globalisation helped reduce costs for businesses, supporting widening margins for corporates. For example, US manufacturing costs fell markedly as China joined the WTO in 2001. Greater competition led to wage compression at home, supporting reduced costs for manufacturers.

Change in share of global manufacturing output 1995-2020

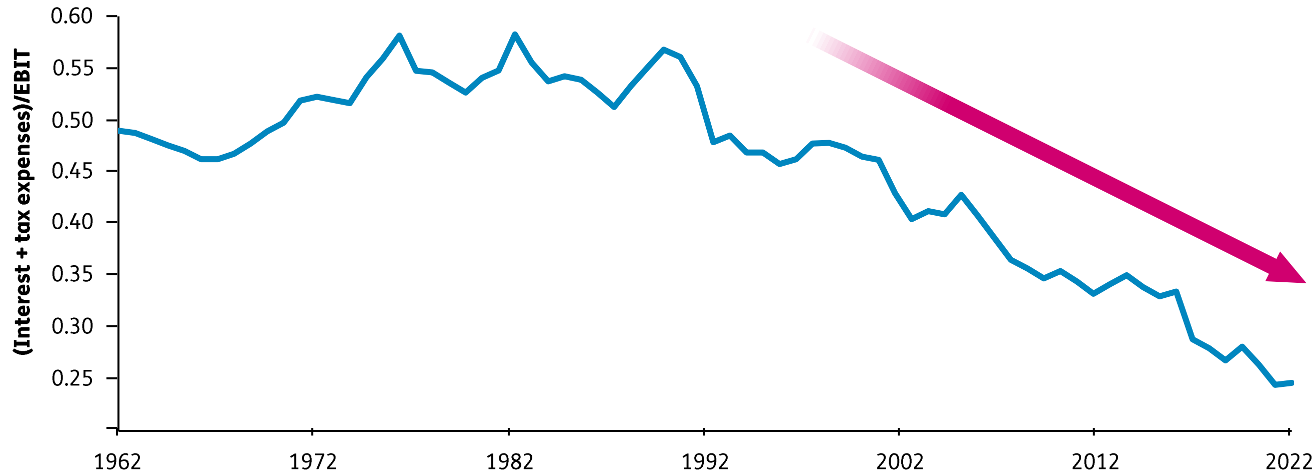


Source: Economic Policy Institute

Supply 2 and 3: Falling interest and tax rates since the 1990s reduces earnings before interest and tax (EBIT) costs

At the same time interest rates and taxes fell. LHS shows the share of interest and tax expenses as a proportion of EBIT for US corporates.

Interest and tax expense as a share of EBIT (1962-2022)



Source: Federal Reserve

Previous drivers of profitability appear exhausted

We are now entering a period where these benign supply side forces are swinging into reverse with significant implications for corporate profitability.

	Globalisation	Interest rates	Tax rates
1989-2020	Rising	Falling	Falling
2020+	Stalling	Normalising	Bottomed-out

... signalling a slowdown in profitability growth under the current trajectory

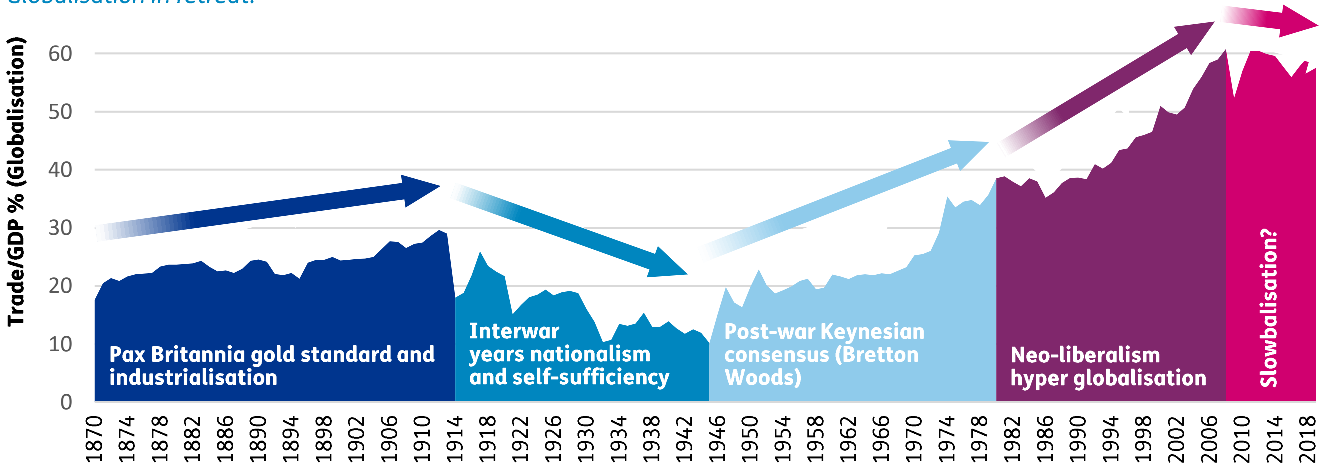
Given the costs have stopped falling, to maintain high rates of corporate earning growth a stronger demand environment would need to materialise, which appears unlikely.

	Economic environment		Outcome
Current trajectory	Continued weakness in consumer demand	Falling cost dynamic looks to end Globalisation stalling, interest rates normalising, tax reduction ended	Slowdown in profitability growth

1a: A period of hyper globalisation appears to have stalled

Globalisation appears to have peaked. Trade as a percentage of GDP is no longer experiencing a rapid rise, instead it is plateauing.

Globalisation in retreat?

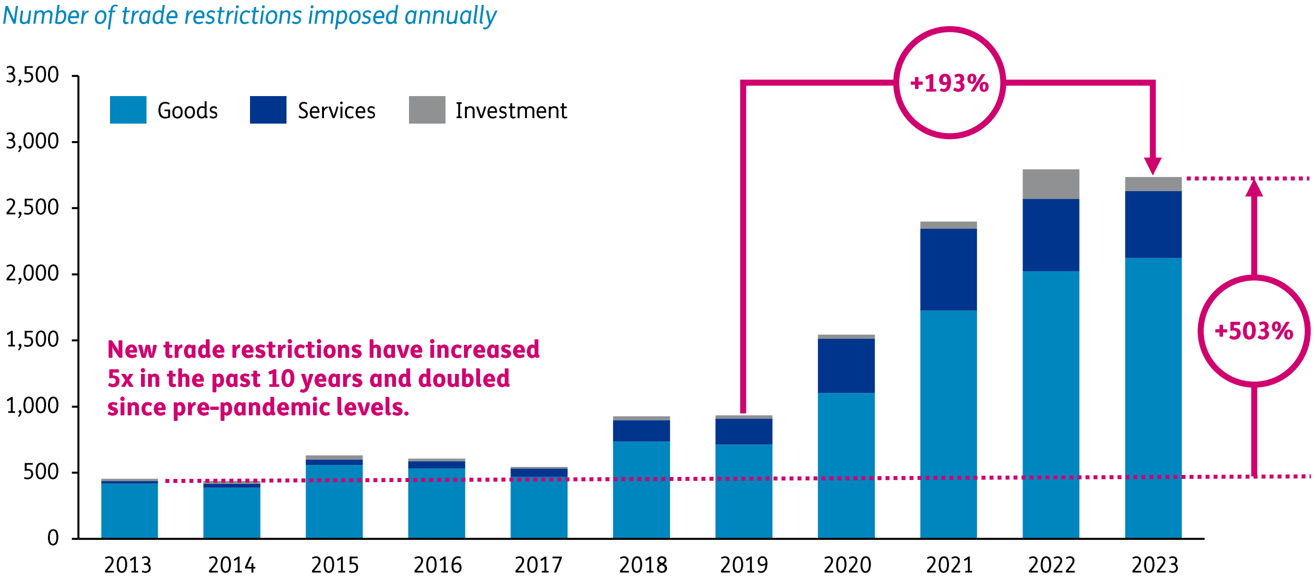


Source: OWID, Fouquin and Hugot (CEPII 2016)

1b: With rising protectionism reducing further gains from trade

Protectionist impulses are rising as the consensus on free and open multilateral change comes under pressure from disenfranchised workers as well. At the same time, concerns over national resilience and carbon dumping from foreign markets.

Number of trade restrictions imposed annually

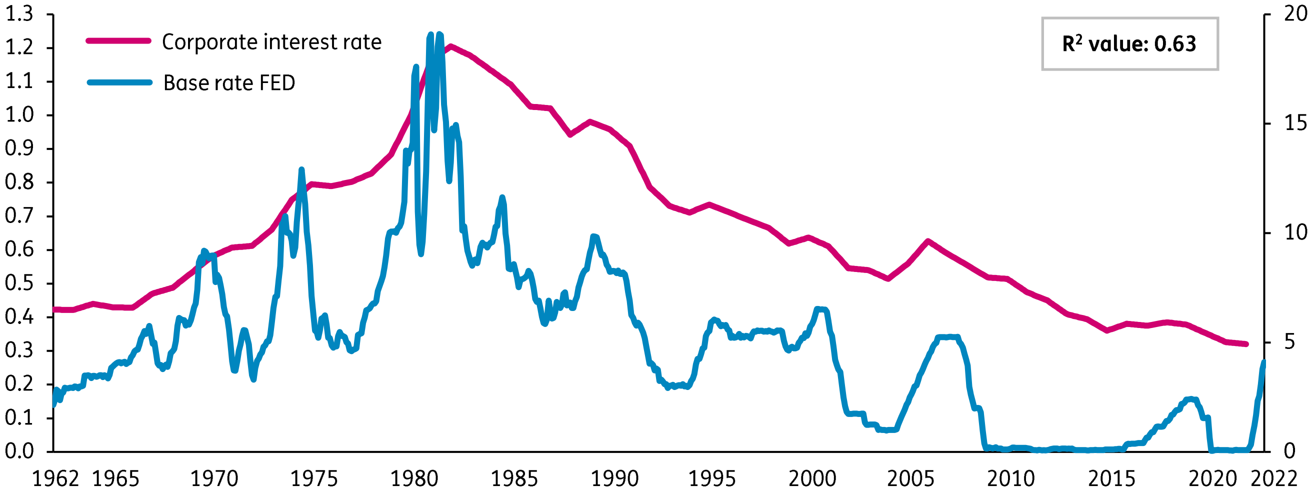


Source: IMF, Global Trade Alert

2. Interest rates have reached bottom: now normalising after decades of decline

Equally interest rates reached bottom and are now normalising as a spike of inflation after Covid 19 and the invasion of Ukraine drove real interest rates back up into positive territory.

Corporate interest rates (1962-2022)

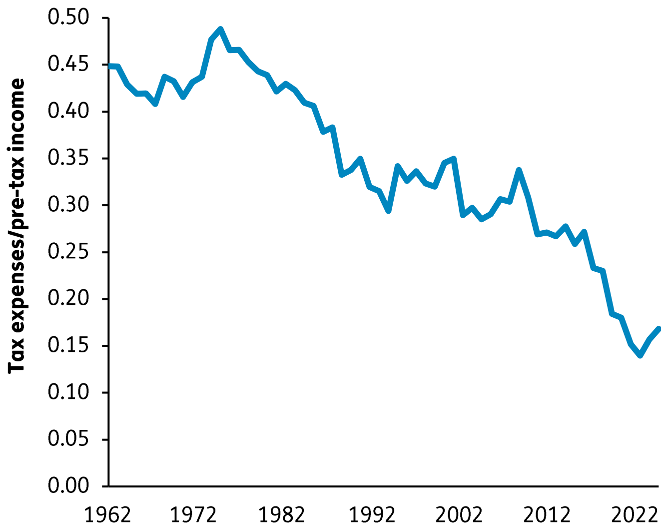


Source: Federal Reserve

3. The race to the bottom on tax has ended with global tax minimums

Fears over a race to the bottom on global tax rates have led to new multilateral agreements to create tax minimums. Demographics, remilitarisation and the energy transition have placed greater strain on developed markets to increase tax revenue, pointing to an end to the falling corporate tax rates of recent years.

Effective corporate tax rates (1962-2022)



Source: Federal Reserve

	1990s	2000s	2024
US	34%	35%	21%
UK	33%	30%	25%
FR	37%	35.4%	25.8%
AUS	36%	30%	30%
OECD	New global minimum rate		15%

Source: Federal Reserve, Institute for Fiscal Studies, OECD, Australian Treasury

In summary what does this mean for organisations?

In abstract these symptoms are not interlinked, but together they represent a significant squeeze on profitability and budget management.

From cost pressures and insecurity in global supply chains, through the new normal of finance and debt market costs organisations need to quickly switch to a more cost and margin conscious way of operating.

They can start by considering a few priorities we've laid out below.

	Globalisation	Interest rates	Tax rates	Outcome
1989-2020	Rising	Falling	Falling	Rising profitability
2020+	Stalling	Normalising	Bottomed-out	Stagnant profitability

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In response, we are seeing organisations take similar steps to mitigate the impacts of the profitability squeeze

Streamline global operations: being deliberate about what work is done where, to realise value and performance benefits

Build resilience into the supply chain: being realistic about the risk in your fulfilment and trade routes, selecting and investing in more reliable options

Make space to pursue CAPEX projects focussed on future growth, for example AI capabilities or building new next generation assets

Strengthen short-, medium-, and long-term business planning capabilities to maximise cash and budgetary efficiencies

Drive adoption of AI solutions focused on productivity and growth, accelerating digital transformation across the organisation while reducing OPEX.

Build and deliver on **a workforce strategy which prioritises skills for future** growth capabilities

Eradicate revenue leakage through commercial excellence and break down internal barriers to maximise value from key customer segments

Make brave decisions fast about divestment or acquisition to simplify or capitalise on competitive advantage

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We help clients take a considered approach to value creation that achieves sustainable outcomes in-year

Delivering your desired outcomes...

Drive revenue and reduce commercial leakage (price, product, volume, conversion, velocity)

Optimise the cost base to delivery strategy (COGs, People, 3rd Party)

Improve operational effectiveness & efficiency

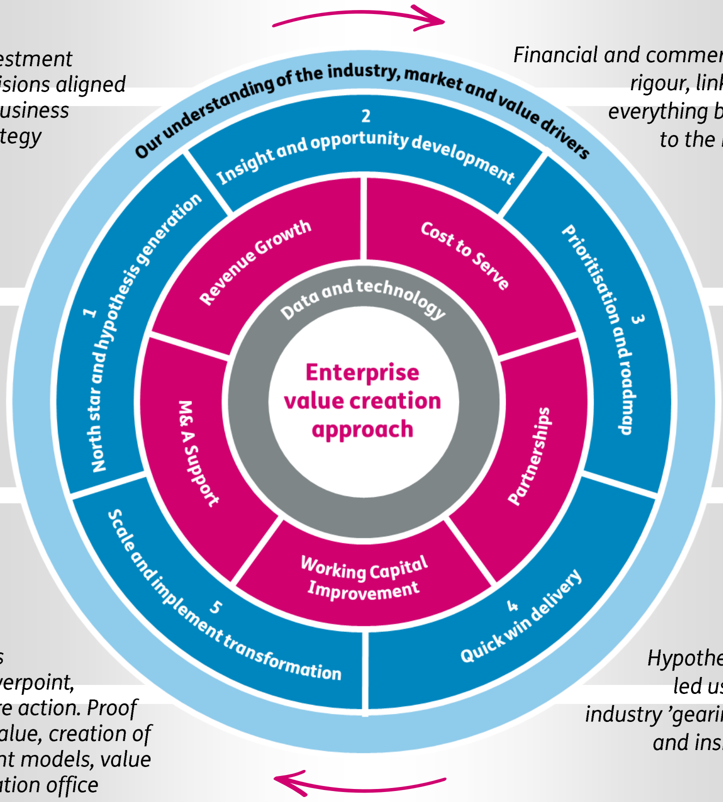
Exceed business plan (EBITDA)

Improve operating cash flow

... using our EVC approach...

Investment decisions aligned to business strategy

Financial and commercial rigour, linking everything back to the P&L



Less powerpoint, more action. Proof of value, creation of client models, value creation office

Hypotheses led using industry 'gearings' and insight

... will deliver these results

3-8% Revenue

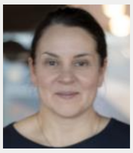
10-15% Sustainable cost reduction

15-25% Productivity

5-12% EBITDA improvement

5-20% Operating cash improvement

Steps to mitigate

	Steps to mitigate the impacts of the profitability squeeze	The Baringa experts to speak to
01	Streamline global operations	 **Ben Monks** Partner, expert in Value Creation ben.monks@baringa.com
02	Eradicate revenue leakage	 **Laura Higgins** Partner, expert in Value Creation laura.higgins@baringa.com
03	Pursue CAPEX projects focused on future growth	 **Bernice McNaught** Partner, expert in Operations and Organisational Transformation bernice.mcnaught@baringa.com
04	Adopt AI for productivity and innovation	 **Sam Atkins** Expert in Operational Excellence and AI sam.atkins@baringa.com
05	Build resilience into the supply chain	 **Rob Gilbert** Partner, expert in Supply Chain and Procurement rob.gilbert@baringa.com
06	Make brave decisions fast about acquisitions, organic growth, and divestment	 **Chetan Chatwal** Partner, expert in Transaction Advisory and Growth Strategy chetan.chatwal@baringa.com
07	Workforce strategy which prioritises skills for future	 **Katharine Henley** Partner, expert in People, Talent and Change Katharine.henley@baringa.com
08	Strengthen business planning capabilities	 **Mandeep Gill** Partner, expert in CFO Advisory mandeep.gill@baringa.com

If you are interested in hearing more, please get in touch with our experts:

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Major work cited: Smolyansky, Michael (2023). “End of an era: The coming long-run slowdown in corporate profit growth and stock returns,” Finance and Economics Discussion Series 2023-041. Washington: Board of Governors of the Federal Reserve System