

Megatrends Series

THE FUTURE MEANS BUSINESS

The investment implications of transformative new corporate models

EXECUTIVE SUMMARY

A host of disruptive forces has led to the emergence of new business models that are radically changing the investment calculus for institutional investors.

In our latest Megatrends paper, *The Future Means Business: Investment Implications of Transformative New Corporate Models*, we draw on the insights of more than two dozen PGIM investment professionals across our private and public fixed income, equity, real estate and alternatives managers – as well as a new proprietary survey of 300 public and private companies around the world – to understand the changing nature of the 21st-century firm. These changes matter immensely to long-term investors given over half of a typical institutional portfolio is comprised of corporates.¹

Three new business models are emerging:

1. The Weightless Firm

Firms are shifting away from physical capital investments to a “capital-light” model centered on investments in intangible assets like R&D, data, software, IP, technology platforms, and brand. This transformation has been marked by a series of significant shifts:

- **The rise of intangible assets** – Over 70% of the market value of the S&P Europe 350 and 85% of the S&P 500 in the U.S. is now comprised of intangible assets, driven by the growing relative importance of the service sector, the outsourcing of manufacturing to emerging markets, and the central role of new technologies in reshaping traditionally “brick and mortar” industries.²
- **The vanishing employee** – Labor is capturing a smaller share of the economic gains from production, the result of the adoption of new labor-light tech-forward business models, a “hollowing out” of middle-income occupations in the U.S. job market due to automation, and a decline in full-time employees as the “gig” economy grows.
- **Flexible real estate** – Dramatic shifts in both employer and employee preferences have altered the landscape for

commercial office space, with rising occupant density, greater use of remote-work arrangements, and the emergence of flexible co-working spaces such as WeWork.

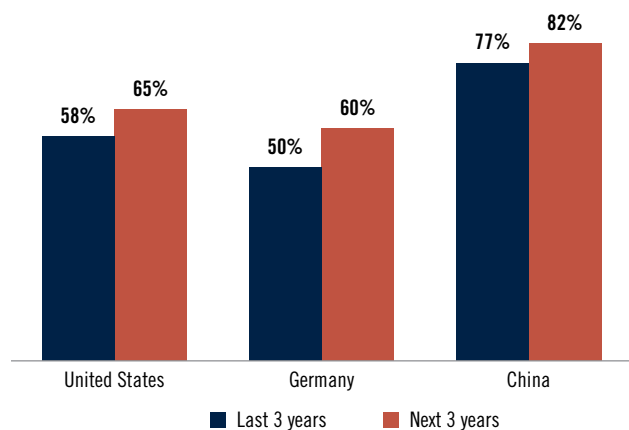
2. The Superstar Firm

Companies are leveraging technology, proprietary data and global networks to build scale in an increasingly winner-takes-all environment (Exhibit 1). In 1975, 50% of the earnings of U.S. public corporations came from 109 firms; today, it comes from just 30 firms.³

Key features include:

- The superstar firm extends well beyond the formal tech sector, reshaping multiple industries such as energy, real estate and retail.
- Superstar firms extend beyond developed markets – some of the most dominant firms are regional leaders in EMs such as China (Alibaba), India (Flipkart) and Brazil (Easy Taxi).

Exhibit 1: The percentage of companies that consider intangible assets to be more important than tangible assets



Source: PGIM 2019 proprietary survey of over 300 public and private companies across the United States, Germany and China.

- Superstar firms are sustaining their dominance not only by tech-enabled scale and the network effect, but also by their ability to effectively create “kill zones” around their area of dominance.

3. The Purposeful Firm

Companies are increasingly measuring themselves by more than just profits (Exhibit 2). A broad coalition of stakeholders – including customers, employees, investors and regulators – is holding companies accountable to a wider set of community values, well beyond quarterly earnings. This compulsion, whether thrust upon companies by external stakeholders or proactively embraced by management, has significant implications for investors:

- Companies are more proactively positioning themselves as agents of social change. Today, the global Fortune 500 spend three times as much annually on corporate social responsibility as the combined development and humanitarian aid spending by the UNDP and UNICEF.⁴
- New socially conscious business models are emerging. For example, the “B Corp” in the U.S. (e.g., Patagonia) or the industrial foundations in northern Europe (e.g., Heineken, Ikea).

Investment implications for institutional investors

The collective impact of the disruptive forces at work among corporations globally raises a range of interesting implications and potential actions for chief investment officers to consider. To highlight a few:

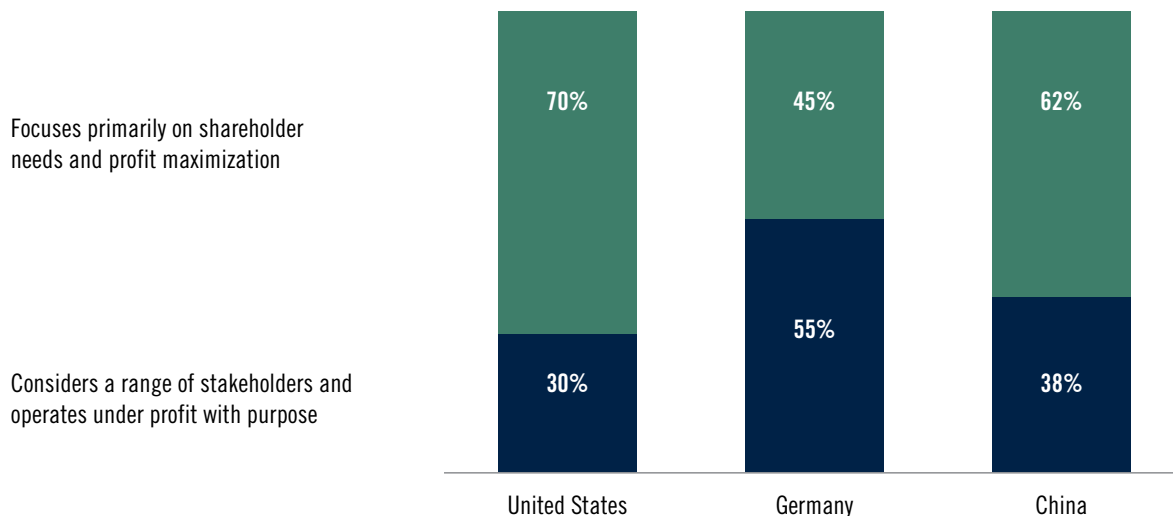
- **Re-evaluate public-private allocations.** Weightless firms are staying private for longer, driven by lower capital requirements compared to physical capital-intensive firms, a lower fixed-

cost base, and access to the glut of late-stage private capital. Investors seeking to participate in the new weightless economy, in particular technology-forward companies in developed markets, will want to evaluate shifting allocations to private equity and debt.

- **Adjust risk models to appropriately evaluate intangible-driven firms.** Rating agencies continue to emphasize tangible assets in their evaluation of credit risk. Firms of the future will be leaner on tangible capital than their predecessors but, especially with high variable costs and more limited capex requirements, their cash flows can be just as stable and dependable. The resulting mispricing can potentially create opportunities in both public and private debt markets for savvy investors.
- **Develop an investment framework to identify next-generation national superstars, while positioning the portfolio to tackle growing obsolescence risk.** With rising firm concentration, declining entrants, and expanding “kill zones,” successful investors will need to identify potential superstars with strong staying power relatively early on. We identify a handful of lead indicators that characterize superstars across multiple sectors based on an active equity investment approach. Equally important, CIOs will want to find ways to safeguard against growing obsolescence risk in their corporate holdings. They may consider more frequent portfolio reviews and forming a cross-asset class team to evaluate the impact of disruptive new business models on all of their holdings. Investments with especially long lock-up periods or long duration are particularly susceptible to disruptive change from these emerging forces.

Exhibit 2: Purpose is being adopted by a growing number of companies

Which of the following statements applies more to your company?



Source: PGIM 2019 proprietary survey of over 300 public and private companies across the United States, Germany and China.

- **Transition to next generation ESG approaches:** Not all ESG metrics are material for firms across all industries. It follows, therefore, that formulaic, “check-the-box” approaches to ESG may not be very useful for achieving either investment or ESG objectives. Instead, by employing a more nuanced framework that focuses only on relevant metrics for an industry, or even an individual firm, investors can “do good, while doing well.”

The companies that investors hold in their portfolios look decidedly different than just a decade ago; the growing

importance of intangible assets and flexibility, the rise of national superstars, and the shifting stakeholder expectations around a firm’s role in society have led to dramatic changes in the way firms think and operate. At PGIM, we believe these changes will have profound implications for how investors build and protect their portfolios.

Across public and private markets, and across fixed income, equities and real estate, investors must position their investment strategies for the transformations reshaping firms.

¹ Based on the portfolio allocation of a large, U.S. pension fund. Values were derived from the market value of the assets, as of June 30, 2018.

² “Intangible Asset Market Value Study,” Ocean Tomo, 2017.

³ Gross, Peter M.J., “Investing in a Winner-Take-All World”, CFA Institute, October 25, 2018. <<https://blogs.cfainstitute.org/investor/2018/10/25/investing-in-a-winner-take-all-world/>>

⁴ “Business Backs Education: Creating a Baseline for Corporate CSR Spend on Global Education Initiatives,” UNESCO and Varkey Foundation, January 2015. <<http://www.unesco.org/education/BBE-EPG-Report2015.pdf>>; “UNICEF Humanitarian Action Study 2017: A synthesis of UNICEF’s response,” United Nations Children’s Fund, 2017. <https://www.unicef.org/appeals/files/HAS_Study_2017_Final.pdf>; UNDP Transparency Portal, 2017. <<https://open.undp.org/>>

For Professional Investors only. All Investments involve risk, including possible loss of capital.

The information contained herein is provided by PGIM, Inc., the principal asset management business of Prudential Financial, Inc. (PFI), and an investment adviser registered with the US Securities and Exchange Commission. PGIM is a trading name of PGIM, Inc. and its global subsidiaries and affiliates. PFI is not affiliated in any manner with Prudential plc, a company incorporated in the United Kingdom. In the United Kingdom and various other European jurisdictions information is issued by PGIM Limited, an indirect subsidiary of PGIM, Inc. PGIM Limited registered office: Grand Buildings, 1-3 Strand, Trafalgar Square, London, WC2N 5HR is authorised and regulated by the Financial Conduct Authority of the United Kingdom (registration number 193418) and duly passported in various jurisdictions in the EEA. These materials are issued to persons who are professional clients or eligible counter-parties for the purposes of the Financial Conduct Authority’s Conduct of Business. In Singapore, information is issued by PGIM (Singapore) Pte. Ltd. (PGIM Singapore), a Singapore investment manager that is licensed as a capital markets service license holder by the Monetary Authority of Singapore and an exempt financial adviser (registration number: 199404146N). These materials are issued by PGIM Singapore for the general information of “institutional investors” pursuant to Section 304 of the Securities and Futures Act, Chapter 289 of Singapore (the “SFA”) and “accredited investors” and other relevant persons in accordance with the conditions specified in Section 305 of the SFA. In Japan, information is presented by PGIM Japan, Co. Ltd., (“PGIM Japan”), a registered Financial Instruments Business Operator with the Financial Services Agency of Japan. In October 2004, PGIM, Inc. received a discretionary investment management license in South Korea and accordingly is licensed to provide discretionary investment management services directly to South Korean investors. In Hong Kong, information is presented by representatives of PGIM (Hong Kong) Limited, a regulated entity with the Securities and Futures Commission in Hong Kong to professional investors as defined in Part 1 of Schedule 1 of the Securities and Futures Ordinance. PGIM, Inc. is exempt from the requirement to hold an Australian Financial Services License under the Corporations Act 2001 in respect of financial services. PGIM, Inc. is exempt by virtue of its regulation by the Securities and Exchange Commission under the laws of the United States of America, including applicable state laws and the application of ASIC Class Order 03/1100. The laws of the United States of America differ from Australian laws. These materials are for informational or educational purposes only. The information is not intended as investment advice and is not a recommendation about managing or investing assets. In providing these materials, PGIM is not acting as your fiduciary. These materials represent the views, opinions and recommendations of the author(s) regarding the economic conditions, asset classes, securities, issuers or financial instruments referenced herein. Distribution of this information to any person other than the person to whom it was originally delivered and to such person’s advisers is unauthorized, and any reproduction of these materials, in whole or in part, or the divulgence of any of the contents hereof, without prior consent of PGIM is prohibited. Certain information contained herein has been obtained from sources that PGIM believes to be reliable as of the date presented; however, PGIM cannot guarantee the accuracy of such information, assure its completeness, or warrant such information will not be changed. The information contained herein is current as of the date of issuance (or such earlier date as referenced herein) and is subject to change without notice. PGIM has no obligation to update any or all of such information; nor do we make any express or implied warranties or representations as to the completeness or accuracy or accept responsibility for errors. These materials are not intended as an offer or solicitation with respect to the purchase or sale of any security or other financial instrument or any investment management services and should not be used as the basis for any investment decision. No risk management technique can guarantee the mitigation or elimination of risk in any market environment. Past performance is not a guarantee or a reliable indicator of future results and an investment could lose value. No liability whatsoever is accepted for any loss (whether direct, indirect, or consequential) that may arise from any use of the information contained in or derived from this report. PGIM and its affiliates may make investment decisions that are inconsistent with the recommendations or views expressed herein, including for proprietary accounts of PGIM or its affiliates. Any projections or forecasts presented herein are as of the date of this presentation and are subject to change without notice. Actual data will vary and may not be reflected here. Projections and forecasts are subject to high levels of uncertainty. Accordingly, any projections or forecasts should be viewed as merely representative of a broad range of possible outcomes. Projections or forecasts are estimated, based on assumptions, and are subject to significant revision and may change materially as economic and market conditions change. PGIM has no obligation to provide updates or changes to any projections or forecasts. The opinions and recommendations herein do not take into account individual client circumstances, objectives, or needs and are not intended as recommendations of particular securities, financial instruments or strategies to particular clients or prospects. No determination has been made regarding the suitability of any securities, financial instruments or strategies for particular clients or prospects. For any securities or financial instruments mentioned herein, the recipient(s) of this report must make its own independent decisions. Conflicts of Interest: PGIM and its affiliates may have investment advisory or other business relationships with the issuers of securities referenced herein. PGIM and its affiliates, officers, directors and employees may from time to time have long or short positions in and buy or sell securities or financial instruments referenced herein. PGIM and its affiliates may develop and publish research that is independent of, and different than, the recommendations contained herein. PGIM’s personnel other than the author(s), such as sales, marketing and trading personnel, may provide oral or written market commentary or ideas to PGIM’s clients or prospects or proprietary investment ideas that differ from the views expressed herein.

© 2019 PFI and its related entities. PGIM, the PGIM logo and the Rock symbol are service marks of Prudential Financial, Inc., and its related entities, registered in many jurisdictions worldwide.