THE GLOBAL SEARCH FOR YIELD

HOW TODAY'S MARKETS SHAPE TOMORROW'S COMPANIES

Citi GPS: Global Perspectives & Solutions

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It should be fairly simple. Management of public companies run their businesses well and are subsequently rewarded as investors take note of their good performance and buy the stock. This draws in more capital as markets chase positive returns, which in turn drives the share price even higher. Conversely, if management run their business poorly, the mood turns bearish and more sellers emerge. The share price starts to fall, eroding sentiment even further as investors look to shift their capital elsewhere.

But is it really that straightforward? How does this process reverse? What if investor requirements shift? And what if shareholders try to change how management run their business? To answer these questions, Citi's global equity strategists explore the connections (and dis-connections) between investor desires and corporate behaviour.

First, they highlight an obsessive investor search for yield. A multi-year asset shift, compounded by quantitative easing (QE) policies, has pushed bond yields to all-time lows. For the first time since the 1950s, global equities now trade on higher yields than government bonds. For income-hungry investors, equities are becoming the asset class of choice.

Second, Citi strategists find that this has the potential to reshape corporate behaviour. Recovering profits, rising cash on balance sheets and the search for yield are intensifying pressure on CEOs to return capital to investors. As part of the process, global equity markets are now awarding higher valuations to markets and sectors that weight dividends or share buybacks over capital investment. Many companies are shifting their behaviour in response. CEOs who do not listen to these market signals may find themselves replaced by ones who do. Activist shareholders are often the catalyst for change.

Third, while this market thirst for yield is global, the strategy team finds the corporate response to be more local. Yes, shareholders can force change in markets where management are more accountable. But this mechanism does not apply in all parts of the world. Elsewhere, other stakeholders can have a bigger influence – cross-holding structures, governments, families, management or employees. These can limit the equity market's influence over corporate resource allocation. Shareholder activism is less effective.

Finally, our strategists look for triggers that might reverse equity investors' current obsession with yield. Perhaps the end of quantitative easing and a normalisation of interest rates could push income-seekers back to the bond markets. Or maybe a sharp acceleration in the global economy could drive investors towards corporates that have been spending on capex instead. Both scenarios would relieve the pressure on CEOs to pay out cashflow. The preference for dividends and buybacks might subside and tolerance of corporate expansion would rise again.

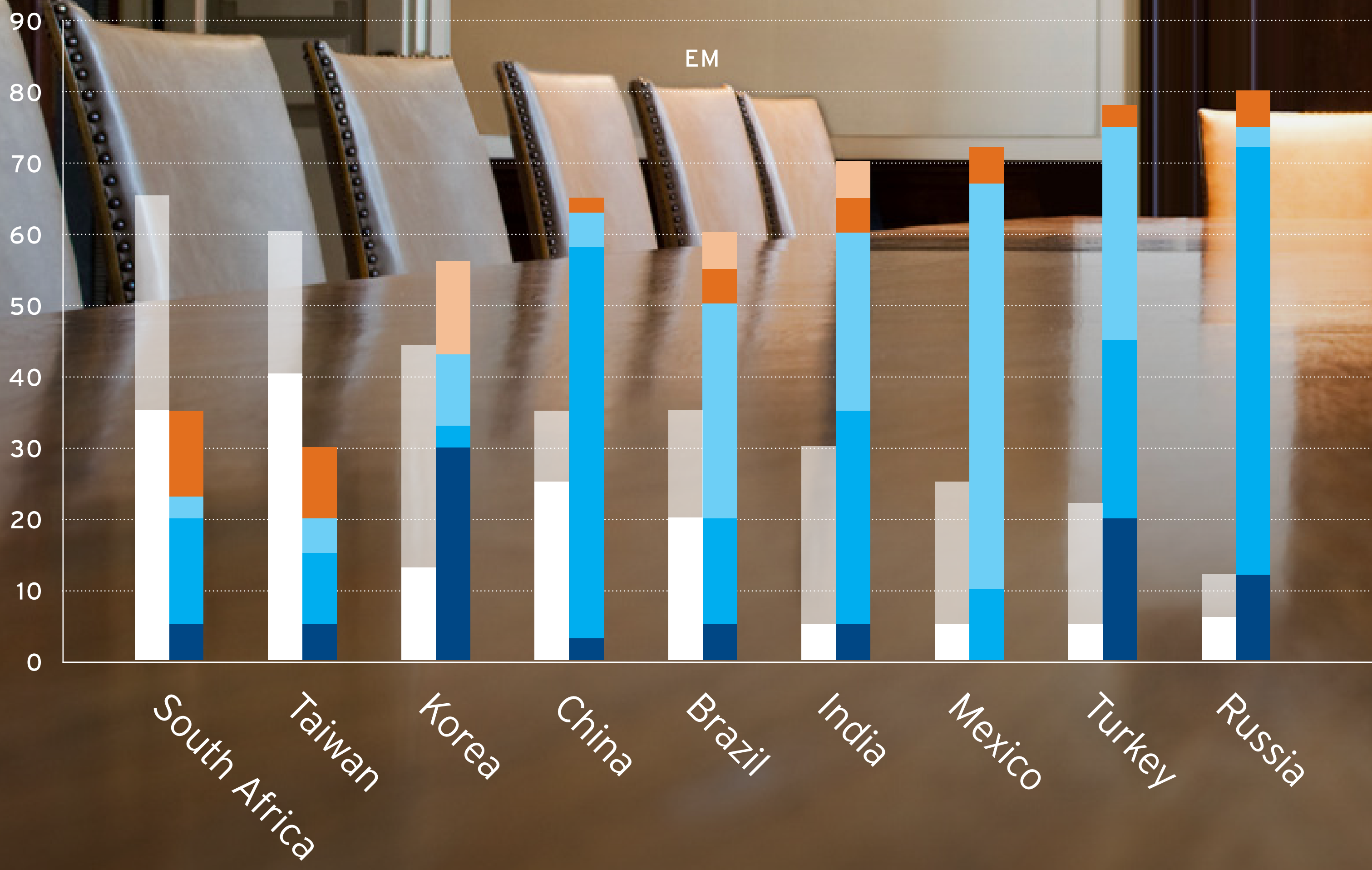
Who Shapes Corporate Strategy? All Depends Where in the World You Are.

What weight do you give to conventional shareholders in setting corporate strategy (%)

- Foreign
- Domestic

What weight do you give other stakeholders in setting corporate strategy (%)

- Other
- Employees
- Families
- Government
- Cross Holdings




DM
US
Australia
Netherlands
Switzerland
UK
France
Germany
Spain
Japan
Italy

Executive Summary

The global economic recovery that started in 2009 has led to profit rebounds across the world — in some regions earnings per share (EPS) are back to the peak levels of 2007. This profit recovery has been faster than the increase in capital expenditures (capex), allowing corporates to repair balance sheets and in many cases, accumulate significant cash piles. Despite a challenging operating environment in some parts of the world, global listed corporates look reasonably well set to deal with the challenges that lie ahead.

While things are moving back to the pre-crisis norm on the corporate side, global capital markets remain heavily influenced by a structural transition that started well before the financial crisis. The biggest shift is a reversal of a 40-year trend that had favoured equities over bonds, most notably in the US and UK. The demise of this equity cult began as investors became disillusioned with the asset class after the tech bubble burst. They moved towards bonds instead. Bonds have also increased in popularity as an aging population in developed economies increasingly looks for income over growth, inflation fears subsided and regulatory pressure has risen. Also, investors are questioning equity diversification following two highly correlated bear markets in the last decade.

This multi-year shift out of equities has helped push bond yields to all-time lows. QE policies have compounded this trend. Now, government bonds yield less than equities in all the major markets. This has triggered a global search for yield that has profound implications for global stock markets. For companies, equity financing now looks expensive relative to debt. This is reflected in capital market activity, with equity issuance still well below the highs reached back in 2007.

Shareholder Activism On The Rise

The dividend yield premium over bonds has provoked interest amongst income-seeking investors. In the past, more growth-focused equity markets provided CEOs with capital to build empires and finance capex. But these yield-seekers are different — they would prefer CEOs return cash via buybacks or dividends rather than spend it on expansion. To reflect this preference, investors currently give higher P/E ratios to those markets or sectors that are returning the most capital.

If a CEO ignores the market's obsession with income, then he/she could be subject to unwelcome shareholder attention. Activist investors often pressurise companies to cut back on expansion and return capital. But that's not the case everywhere. Outside the more shareholder-focused equity markets, other stakeholders complicate the picture. Sure, institutional investors might want companies to maximize profits and return capital. But governments might want them to preserve jobs or expand overseas. Families might want to maintain control and increase dividends. CEOs might want to use mutually beneficial cross-holdings to protect themselves from predators or activists.

Corporate Response Differs By Region

So, how will CEOs respond to these pressures? Well, it often depends on where they're located. For example, in the more shareholder-oriented U.S., company resource allocation has shifted significantly. In 1990, capex accounted for almost 70% of corporate cashflow. Today U.S. companies distribute as much capital through dividends and share buybacks as they invest. By contrast, in Japan not much has changed — capex still dominates cashflow usage. Citi strategists suggest that this is because Japanese corporates prioritise job security for employees instead of shareholder returns. High Japan capex will support jobs but may

undermine profitability. In general, emerging market companies pay out less of their cashflow in dividends and buybacks than their developed market peers. This will partly reflect better EM growth prospects but also the lower ability of shareholders to pressurise CEOs to distribute cash.

To get a better sense of the regional differences in stakeholder influence, we surveyed Citi's equity strategy team to help identify the different stakeholders and what their influence on corporate behaviour might be. Outside Japan, developed market companies are under pressure to increase dividends and buybacks and our strategists expect to see a pick-up of M&A in Europe. Corporate responses across EM markets are likely to be varied. Animal spirits are evident in Brazil and the Turkish corporate sector looks almost as bullish, with Mexico not far behind. Asian companies seem more cautious. They are all expected to increase dividend payouts, if from a low base. Leverage is expected to rise in China, but fall in Korea and India. Russian companies are expected to increase payouts, again from a low base, but capex requirements in the commodity stocks remain significant. In South Africa, mining companies are expected to cut back on capex but the expansion of the non-resource companies into the rest of Africa is forecast to continue.

Sector Differences Too

Management payout decisions will also be affected by industry economics — some businesses are just more capital intensive. For these, less cashflow may be available for distribution to shareholders. There is also a cyclical dimension to payouts. Growth opportunities mean that the stock market gives higher multiples to an industry. This indicates greater tolerance for expansion. However, when growth prospects start to diminish, shares derate, expansionary CEOs are removed, capex falls and cash payouts rise. This can move whole industries from being capital spenders to distributors, as seen in the global pharmaceutical and telecom sectors. The end of the commodity supercycle has led to recent derating of the Mining sector. It could be the next candidate to make the shift to capital distributor.

A Shrinking Stock Market

More share buybacks, an increase in debt/cash financed M&A and current anaemic issuance points to further de-equitisation, especially in developed economies. This is the logical corporate response to strong balance sheets, cheap debt and low equity valuations. Messages from the financial markets eventually produce a corresponding response from CEOs. Less equity is issued and more equity is retired. Stock markets start to shrink. But it is harder to de-equitise markets where shareholders have less influence upon company management. So it is not surprising that de-equitisation is less evident in those parts of the world where the market's signalling mechanisms are dampened by other stakeholder interests.

How Could This All Change?

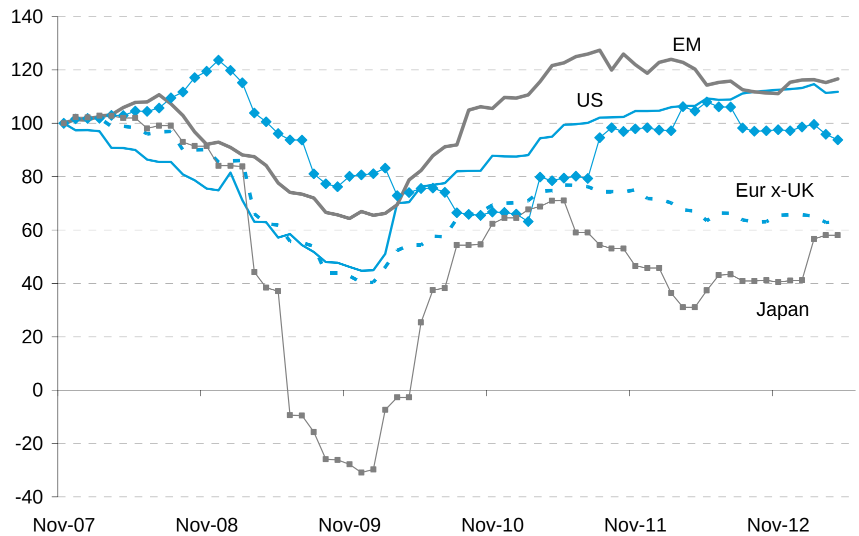
The drivers of the current environment will eventually shift, so bringing new challenges and outcomes. Eventually, equities will stop being treated as an income asset, most likely when the withdrawal of ultra-aggressive monetary policy pushes bond yields back to normalised levels. Income-seeking investors could head back to the fixed income markets. The global search for yield would become less pervasive.

Also, a re-acceleration of the global economy could also switch investor attention back towards growth versus income. Sectors that are capex-focused could again enjoy a premium, while shareholder preferences could shift away from cash distributions.

Global Corporates: Health Restored

Global economic recovery since 2009 means that listed company earnings per share (EPS) has almost recovered to previous peak levels (Figure 1). But there has been a wide range of performances across countries. The U.S., U.K. and Emerging Markets EPS rebounds have been strong. By contrast, trailing EPS in Japan and Continental Europe are still well below their 2007 highs.

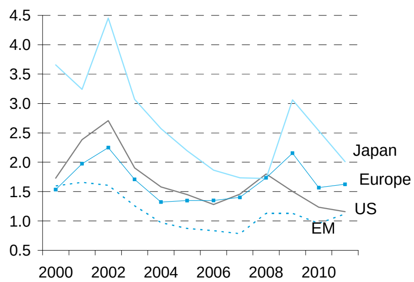
Figure 1. Trailing EPS Since 2007 Peak



Source: Factset, Citi Research, MSCI

Accordingly, listed companies in all countries have seen return on equity (RoE) recover from the lows reached in the financial crisis. Some are approaching previous highs while others are still some way off.

Figure 2. Non-Financial Net Debt / EBITDA

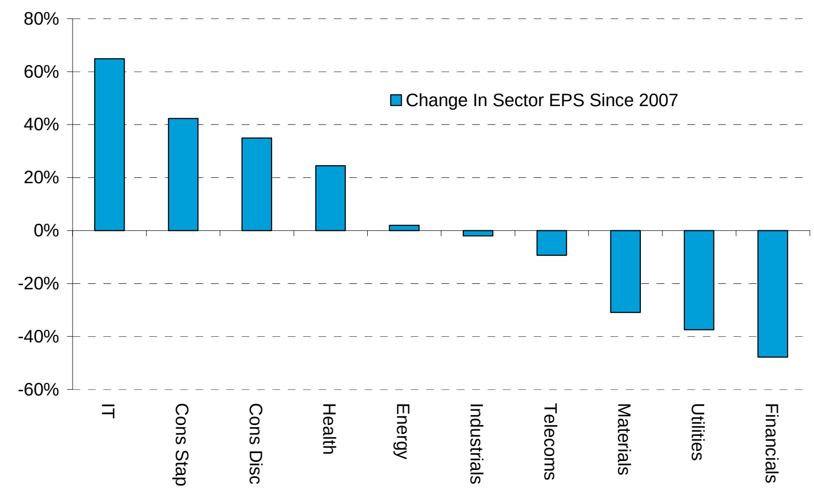


Source: Factset, Citi Research, Worldscope

The profit recovery has been faster than that in capital expenditure. Subsequent surplus cash generation has allowed companies to repair balance sheets. Net debt/EBITDA ratios around the world have fallen and remain well below peaks reached in the last cycle (Figure 2). In addition to paying down debt, many companies have accumulated significant cash piles

We can also cut the data by global sector. Figure 3 shows EPS compared to the 2007 pre-crisis peak. Most impressive is the Information Technology (IT) sector, where EPS are now 60% above levels reached back then. Consumer Staples, Consumer Discretionary and Healthcare have also made good progress. The more cyclical sectors have seen significant rebounds from the EPS lows reached in 2009-10 but have struggled to regain their previous peaks. The global Financials sector has been most disappointing. EPS are up 150% from the low of 2009, but still 40% below 2007 peaks. This reflects lower RoE as banks deleverage balance sheets in response to regulatory pressures. It also shows the impact of dilutive equity issuance.

Figure 3. Global Sector EPS Since 2007



Source: Datastream, Citi Research, MSCI

Broad global themes mask a range of local variations

These broad global themes mask a range of local variations. Citi strategists highlight that U.S. profit margins have been restored to pre-crisis levels with the IT sector leading the way. As the cash has piled up ($2 trillion and counting) so U.S. companies have been able to repair balance sheets and boost capital returns to income-hungry investors. There is still plenty left to boost capital expenditure (capex) as CEOs become more confident about the economic outlook.

In Europe, profits have been under the most pressure in the periphery countries. But better economies in northern Europe and significant international exposure have supported profits and repaired balance sheets. In Japan, companies have also been reducing leverage. This process will be accelerated as corporate profits are boosted by recent yen devaluation. Our Japan strategist expects 48% EPS growth in 2013. In Australia, Citi equity strategists note that profit growth has been disappointing since the financial crisis, partly because domestic growth has been crowded out by the (now fading) commodity boom. Nevertheless, balance sheets look healthy given recapitalisations.

Emerging markets corporates have a lower aversion to debt

Across emerging markets (EM), Citi strategists highlight a lower aversion to debt, presumably because the scars of 2008-09 run less deep and economies look more robust. In China, companies have increased leverage to offset falling profit margins. Korean companies have increased borrowing, but leverage still remains way below levels reached prior to the 1997-98 crisis. Brazilian companies have progressively increased leverage to finance higher dividends and capex. Indian companies already built leverage aggressively in the last cycle, so are proceeding more cautiously now. Elsewhere in EM, Citi strategists report more conservative balance sheet management in South Africa, where Mining companies are under pressure to reduce capex, and Mexico where listed companies are generally less capital intensive.

Overall global corporate health is good

Overall, however, the global corporate sector looks in decent health. Earnings have rebounded, pre-crisis levels of profitability have been restored and strong cashflow generation means that balance sheets look strong. Of course, the operating environment in parts of Europe is extremely challenging, but other parts of the world look more robust, most notably emerging markets. Strong top-line growth remains elusive but much progress has been made since the worst days of the financial crisis. Global listed companies look reasonably well set to deal with the challenges that lay ahead.

Global Markets: Shift from Equities to Bonds

So that's the state of the global corporate sector, what about the capital markets?

Demise of the Equity Cult

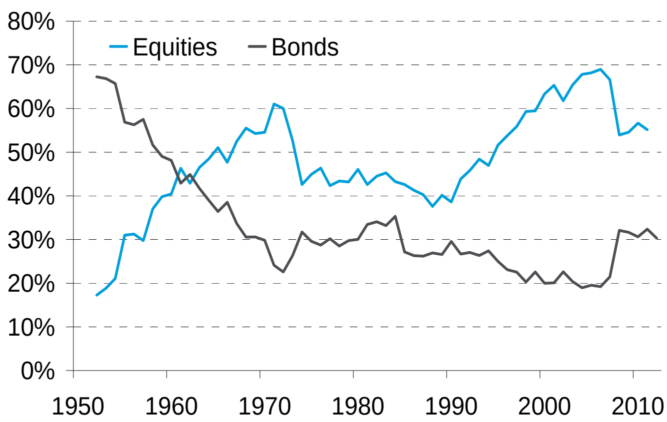
The 1990s tech bubble was the peak of the equity cult

Recent market trends should be seen in the context of a secular investor shift from equities to bonds. The late 1990s tech bubble marked the peak of a multi-decade love-affair with equities. As that bubble burst, disillusioned investors headed for the exit. Bonds were the main beneficiaries. The growth of alternative assets such as hedge funds or private equity was also fuelled by capital fleeing the equity asset class.

US pension funds are lowering equity weightings

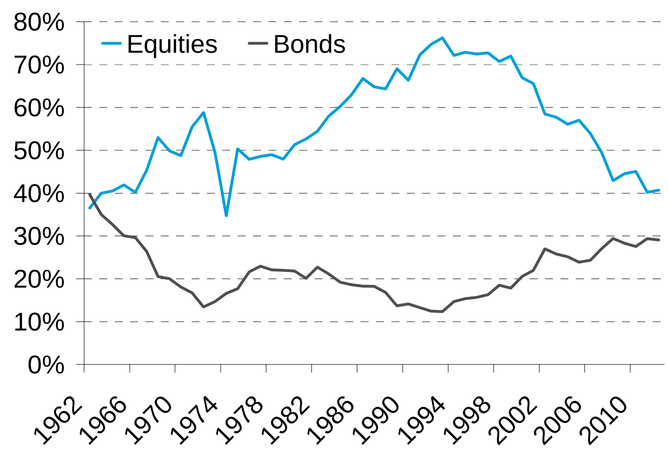
In developed markets (DM), this represents a radical reversal of the trend seen in the previous 40 years. For example, Fed data show that U.S. pension fund weightings in equities rose from 16% in the early 1950s to 69% in 2006 (Figure 4). Over the same period, bond weightings fell from 67% to 19%. But the latest data show equity weightings have fallen to 57% while bond weightings have risen to 30%.

Figure 4. US Pension Fund Asset Weights (%)



Source: US Fed, Citi Research

Figure 5. UK Pension Fund Asset Weights (%)



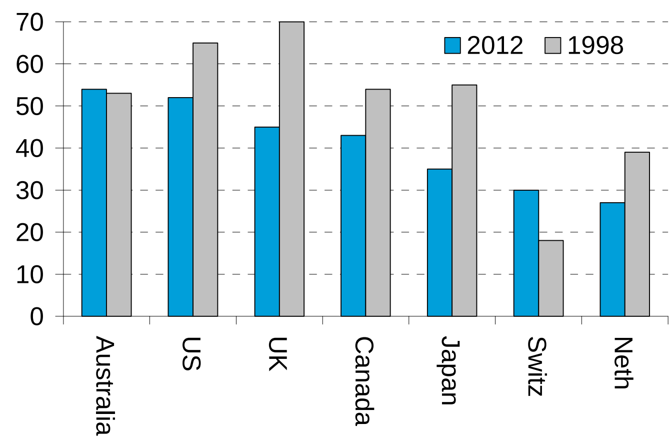
Source: ONS, Citi Research

UK pension funds are also shifting out of equities

Asset allocation shifts have been even more dramatic in the U.K. (Figure 5). Pension funds held around 40% of assets in equities and bonds in the early 1960s. The equity weighting increased to 76% in the mid-1990s while the bond weighting fell to just 12%. Since then, allocations have reversed sharply.

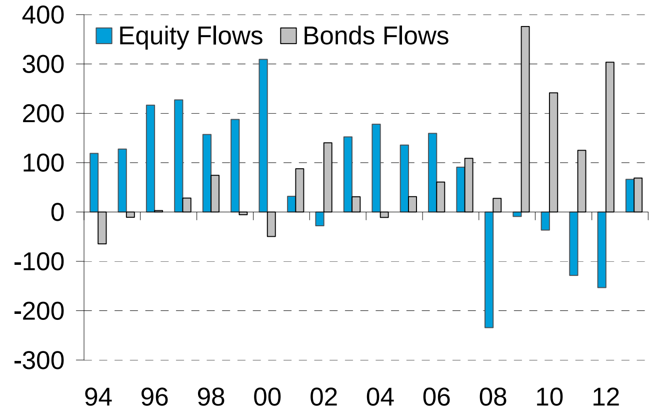
Towers Watson data (Figure 6) rank major country pension funds by both their equity weightings in 2012 as well as their 1998 allocation. Australian pension funds currently have the highest equity weighting (54%). Netherlands has the lowest (27%). But generally, most countries have seen pension funds reduce their equity weightings since 1998 while bond weightings have risen accordingly.

Figure 6. Pension Fund Equity Asset Weights (%)



Source: Towers Watson, Citi Research

Figure 7. US Retail Fund Flows ($bn)

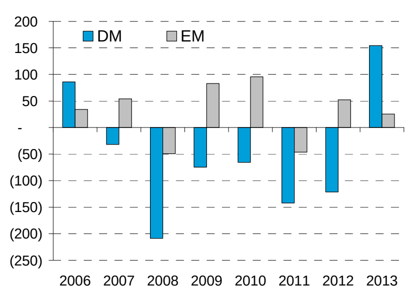


Source: ICI, Citi Research, 2013 YTD

It's not just institutional investors…retail investors are shifting too

This shift can also be seen amongst retail investors. Figure 7 shows that U.S. mutual fund flows into equities peaked at $300 billion in 2000. After falling off, they recovered in the 2003-2004 rally, but over the past five years have seen outflows of $562 billion. Some of this will reflect the rise of ETF funds. By contrast, inflows into U.S. bond mutual fund have totaled $1.1trn since 2008. The story is even more depressing for European equity mutual funds. Equity inflows also peaked in 2000 but collapsed in the subsequent bear market and have never recovered since. European investors were late to the equity party and when they arrived, they bought at the top. Perhaps that is why they seem especially reluctant to come back.

Figure 8. Equity Fund Flows ($bn)



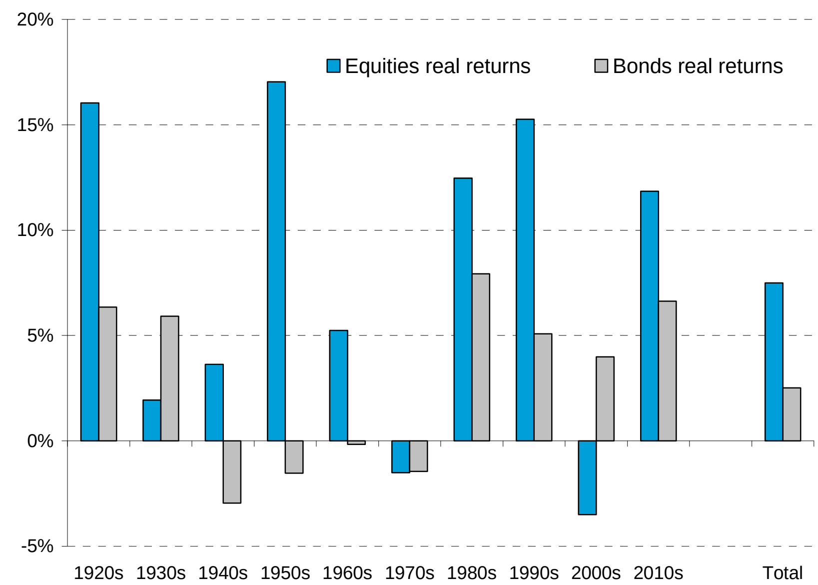
Source: EPFR, Citi Research

Demand for Emerging Market equities has been more robust. Figure 8 compares EPFR Global fund flow data for emerging and developed market equities. In contrast to developed markets, EM equities have in aggregate seen inflows since 2008.

So, while there have been some exceptions (most notably in Australia and Emerging Markets), there has been a radical shift away from equities towards bonds over the past ten years. The fall in equity demand has been particularly notable in Europe.

What is going on here? What drove the rise of the global equity cult in the last century, and why has it reversed since then? The most obvious reason is performance-chasing. The birth of the equity cult in the 1960s followed spectacular performance in the 1950s. Figure 9 shows that the S&P generated an annualised real return of 17% from 1950-60. U.S. Treasuries in the same time period returned -2% real. Such significant outperformance of the main competitor asset class proved hard to ignore. Investors switched from bonds to equities. U.S. equities continued to outperform treasuries handsomely over the next 40 years. That all changed in the last decade. From 2000-2010 U.S. equities returned -4% real per year. Bonds returned +4% real. Global equities halved twice. Even though the current decade looks better for equities, performance chasers will still prefer bonds.

Figure 9. Annual US Equity And Treasury Returns (%)



Source: Global Financial Data, Factset, Citi Research

Initial drivers of investors into equities seem less relevant now

Other drivers behind the rise of the equity cult also seem less relevant now. The long-term nature of the asset class suited the investment strategy of immature baby-boomer pension funds. As those baby-boomers approach retirement, so their maturing savings pots will be shifted into bonds.

The equity cult was boosted by inflation fears in the 1970s and 1980s. In the absence of a meaningful global index-linked bond market, equities offered the most obvious hedge against the wage-linked liabilities of pension funds. But this is less relevant right now. First, it is not especially clear that equities do hedge effectively against inflation. Second, inflation is now less of a concern. And third, the index-linked market offers a much more direct hedge.

Two highly correlated bear markets lead investors to question modern portfolio theory

Another key driver was the advent of modern portfolio theory. This provided the equity cultists with a powerful preaching aid: a diversified portfolio of individually risky equities could be constructed to maximise return and minimise risk. This was crucial in transforming equities from speculative vehicles to the asset class of choice. But two savage and highly correlated bear markets in the last decade have led investors to question just how diversified global equities really are.

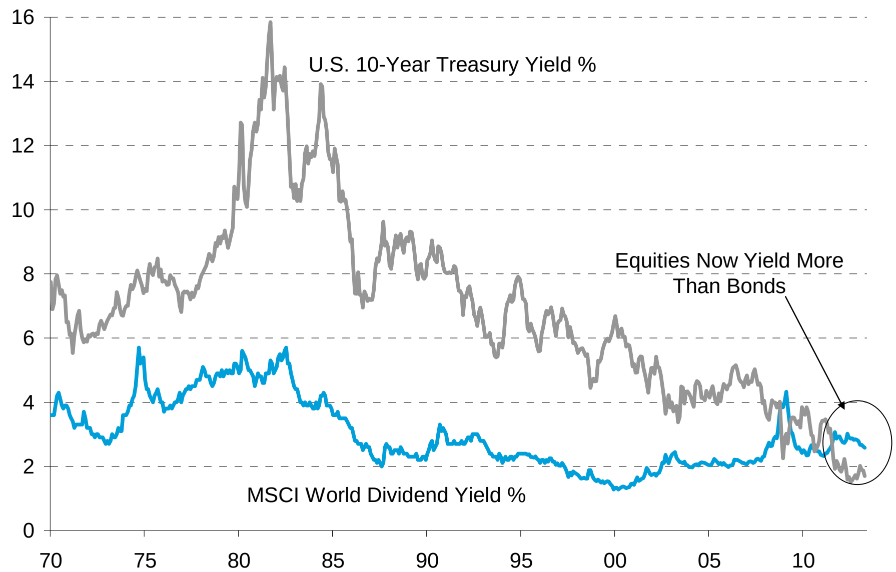
Regulatory pressures have also helped push investors from equities to bonds. For example, given high historical volatility, European insurance company equity holdings have been discouraged by more stringent risk-adjusted capital requirements. Pension funds have increasingly favoured bonds as regulators require more visible tracking of liabilities.

The Global Search for Yield

Equities are the new yield play

We've illustrated how the equity cult has faded since its 2000 peak and a bond cult has risen to take its place. These tectonic shifts in investor appetites have driven profound moves in the relative pricing of those assets. Figure 10 shows that global equities (as represented by the MSCI AC World benchmark) now trade on a dividend yield of 2.6%, above the 1.9% yield on benchmark 10-year U.S. Treasuries. This represents a radical reversal of the valuation relationship seen for the last 50 years. Over that period, equities consistently yielded less than bonds. Now they yield more.

Figure 10. Global Dividend Yield and U.S. 10-Yr Treasury Yield (%)



Source: Factset, Citi Research, MSCI

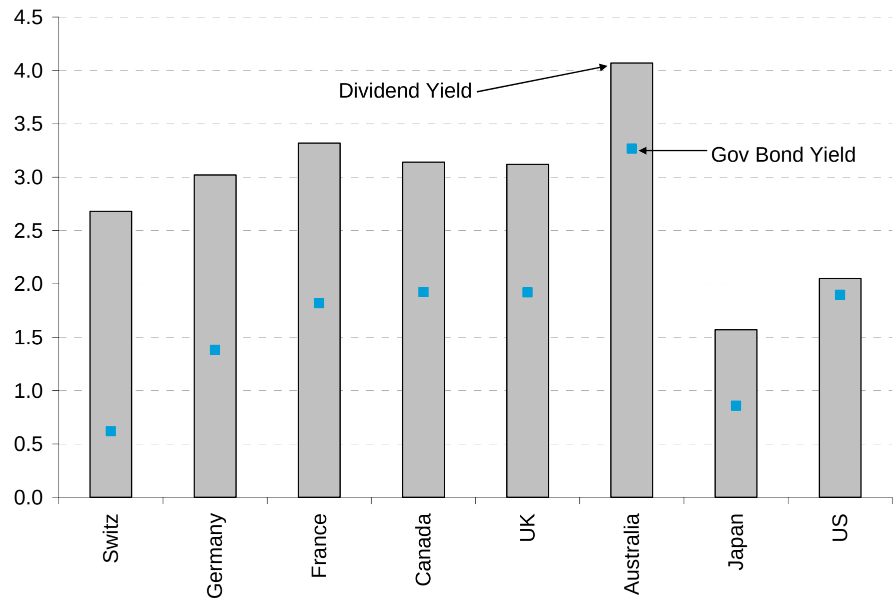
QE has compounded the trend but isn't the cause

The current global search for yield is not just a product of recent quantitative easing (QE) policies. Multi-year asset shifts mean that U.S. Treasury yields have been falling towards the global equity dividend yield for many years before QE came along. QE has compounded a trend that was already in place. And by doing so it has finally pushed the yield on US Treasuries below that on global equities. The global search for yield is now on, and equities offer a higher yield. And even if this does trigger the beginning of a great rotation back to equities, the new investors will have different priorities to those who drove the 1990s bull market: more interested in yield than growth.

The equity yield premium is a global theme

This is a global theme. Figure 11 plots local equity against government bond yields across the world. The biggest premium is to be found in Switzerland where currently equities trade on a dividend yield of 2.7% compared to 0.6% from domestic bonds. The U.S. is the only market where bonds yields are competitive with equities.

Figure 11. Equity And 10-Year Government Bond Yields



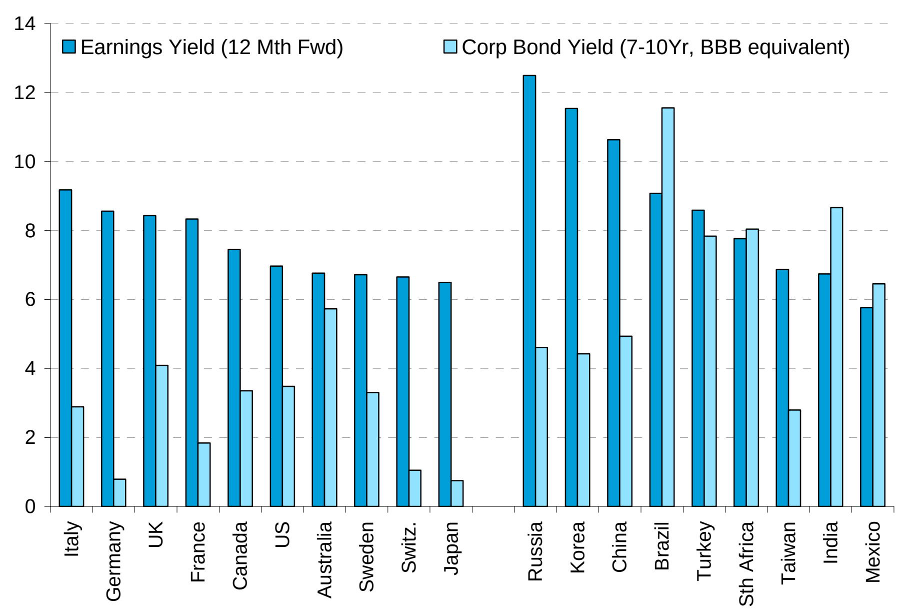
Source: Citi Research, Datastream

Cost of Capital: Favours Debt Over Equity

Cost of equity is more expensive than the cost of debt

What are the implications of all this for corporate finance? Figure 12 plots measures of the cost of equity and debt across global markets. For the cost of equity we use a simple earnings yield. For debt we use corporate bond yields or a proxy based on government bond yields and US credit spreads.

Figure 12. Global Cost Of Equity And Debt (%)



Source: Factset, Citi Research, Datastream

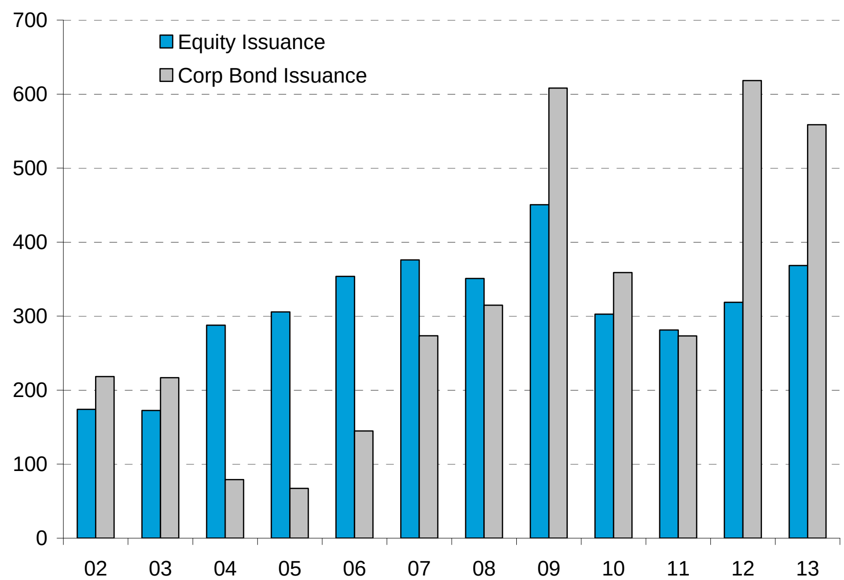
Debt is cheaper relative to equity in almost every market

In almost every market, equity financing looks expensive relative to debt. This was already evident in the last market cycle, and QE has exaggerated this trend. In developed markets, only Australian equity financing looks competitive. In Emerging Markets, the picture is more mixed. Equity financing looks unattractive in lowly rated Russia, Korea and China. It makes more sense in Brazil, Turkey, South Africa, India and Mexico

Equity issuance is down while debt issuance is strong

This has already been reflected in capital market activity. Figure 13 plots US + European equity (IPOs and secondary) and debt issuance. Debt issuance has been on a path to overtake equity issuance for some time and 2013 bond issuance is on track to approach previous annual highs. Equity issuance is still some way off. Citi's fixed income strategists suggest that most of the debt issuance reflects refinancing as companies have replaced bank loans with bond debt. Hence the sharp 2012-13 increase has not been accompanied by an increase in company leverage. Within equities, the better state of emerging markets is shown by their rising share of global capital-raising. Over the last five years, EM IPOs made up around 50% of the global total, way ahead of their 12% weighting in equity market capitalisation.

Figure 13. US + Europe Equity and Corporate Bond Issuance ($bn)



Source: Dealogic, Citi Research, 2013 is YTD Annualised

Primary reason for slowdown in equity issuance is that it's expensive

There has been much soul-searching about these trends. In particular, policy-makers worry that the IPO market may be "broken" in developed markets. There are concerns that not enough equity capital is being provided to companies. Various reasons have been suggested to explain this: low confidence in the global economic outlook, volatility of recent new issues, loss of confidence in equity markets following the US "flash crash". We suspect that all have contributed. But, for us, the key reason is that equity financing now looks very expensive compared to debt. Unsurprisingly, the number of companies willing to use equity markets to raise capital has diminished.

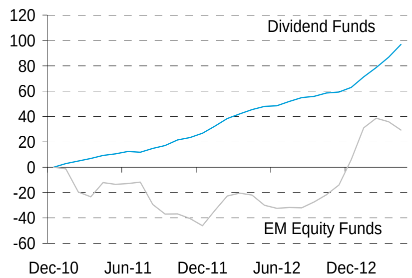
Shareholder Requirements

Next we consider what shareholders want. This can vary over time, country and sector. In the late 1990s bull market investors favoured expansion, especially in the Tech, Media and Telecom sectors. They provided ambitious CEOs with vast amounts of capital to build empires and finance capex. Much the same happened in Japan in the late 1980s. The capital raised in both bubbles generated little return.

Equity inflows tend to be towards dividend funds

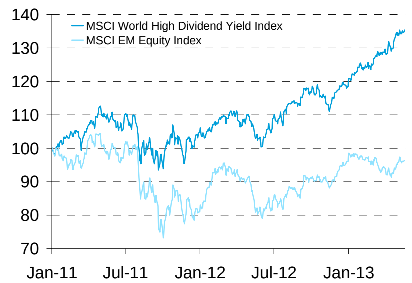
The world looks different now. Although showing recent signs of life, overall equity fund inflows are still low. Any flows have been mostly directed towards global dividend funds (Figure 14). These have overtaken the more growth-oriented EM equity funds that were previously fashionable. These flows will partly reflect performance-chasing. The MSCI World High Dividend Yield Index has handsomely outperformed the MSCI EM market index since the start of 2011 (Figure 15). These fund flows can also become self-fulfilling. Dividend strategies outperform EM growth strategies because more investors are chasing the dividend theme.

Figure 14. Equity Inflows Since 2011 ($bn)



Source: EPFR, Citi Research

Figure 15. Total Return Since 2011

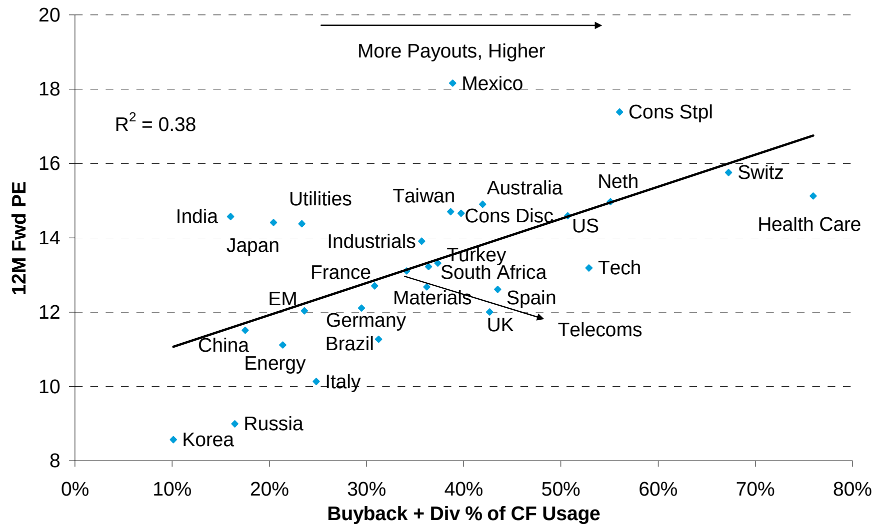


Source: Citi Research, Datastream, MSCI

Yield-hungry investors will pressure CEOs to return cash via dividend and buybacks

This income-hungry capital will, at the margin, pressurise CEOs to return cash via buybacks or dividends rather than spend it on expansion. These preferences can be seen in Figure 16 which plots country and global sector valuations against the percentage of cashflow returned to investors via dividends or share buybacks. Investors currently give higher PE ratios to those markets or sectors that are returning the most capital. By contrast, those markets or sectors which pay out less trade at lower valuations. The difficult global economic outlook will compound this issue. Wary investors want CEOs to return cash for today rather than risk capex for tomorrow.

Figure 16. Buyback + Dividend / Cashflow Usage Versus Current Valuation



Source: Factset, Citi Research, Worldscope

Certain sectors and regions still attract growth-seeking investors

Of course, there are exceptions to these themes. In specific areas of the global equity market, investors may be less income-obsessed and willing to tolerate more expansive corporate strategies. This is often associated with more equity capital-raising. Examples of this right now might include U.S. housing and shale gas/oil sectors. Elsewhere, premium equity valuations and increased capital-raising suggest the presence of growth-seeking investors in the South East Asian markets.

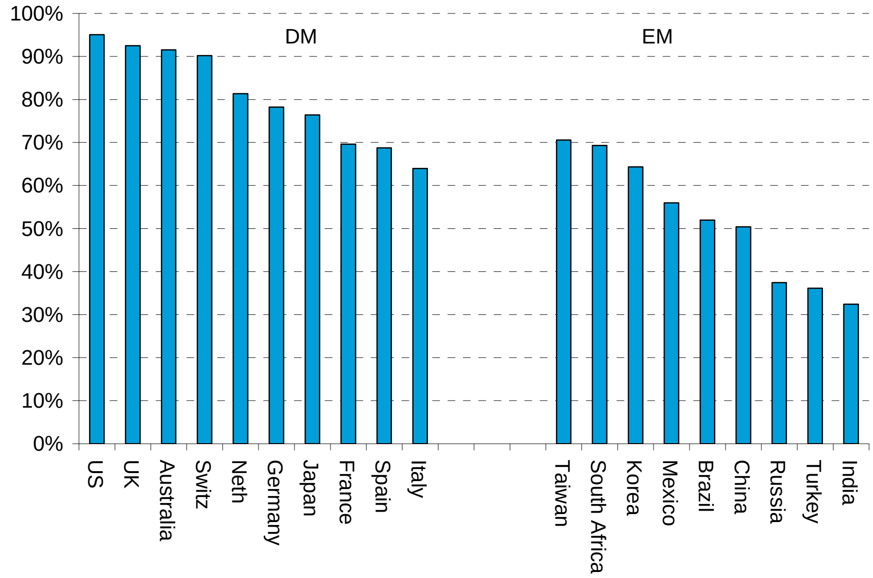
But overall, the message from Figure 16 seems fairly clear. Right now, equity investors value capital return highly. If a CEO ignores that message then they may find themselves subject to a de-rating and therefore unwelcome shareholder attention. Indeed, we would see the rise of activist investors as a logical response to current market conditions. When the equity market is in growth-sponsoring mode, there is much less desire to rein back CEOs' natural expansionary instincts. But now that it is in income-extracting mode, activists have a policing job to do.

Shareholders: An Anglo-Saxon Concept

Our analysis makes the understandable assumption that the corporate sector is subject to similar increasingly activist shareholder influences across the world. On closer examination, this is not really the case.

Shareholder structures are not the same. Figure 17 shows the percentage of each market, as measured by MSCI, which is freely available to private sector investors. This is usually called the "free float". The non-free float shares might be owned by governments, founders or other companies.

Figure 17. MSCI Country Free Floats (%)



Source: Factset, Citi Research, MSCI

There is a wide spread. The U.S. has the highest free float at 95%. The U.K. and Australia are not far behind. Amongst the larger DM markets, Japan, Italy and France have lower free floats although all are above 50%. The lowest free floats are to be found in EM. Russia, Turkey and India all have just 30-40% of their equity tradable, according to MSCI. The rest of the market is owned by other shareholders such as family or government.

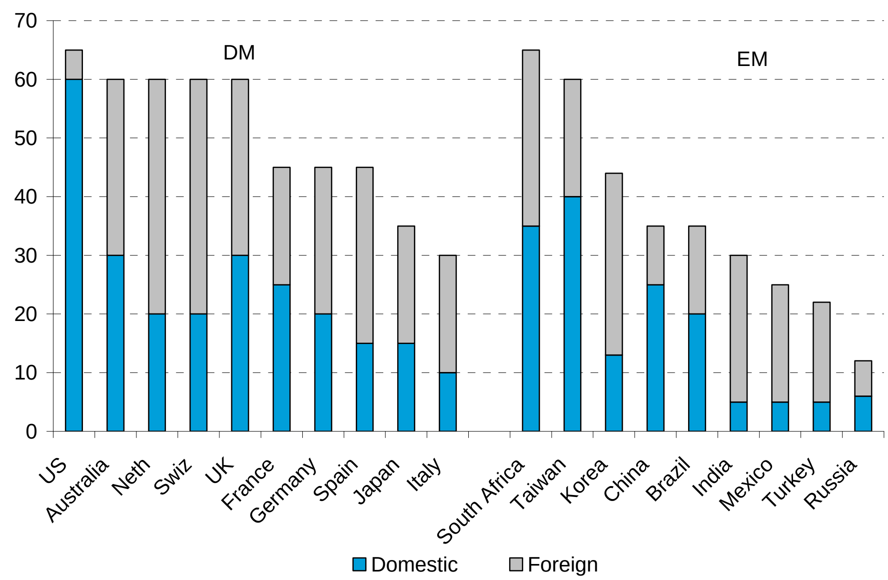
Countries with higher free float are more accountable to shareholders

This has important implications for the ability of markets to shape corporate strategy. While in the U.S. or U.K., we might expect companies to be accountable to the market, elsewhere other stakeholders may call the shots. We would therefore expect companies listed in those markets to show different responses to a given set of macro circumstances.

But institutional shareholder influence differs regionally

To investigate this further, we asked Citi's network of local equity strategists to weight the importance of shareholders in their markets. This is a necessarily qualitative exercise, so the responses should be seen as a guide rather than the definitive answer. Figure 18 ranks markets by the weightings given to the influence of conventional institutional shareholders, domestic or foreign. Unsurprisingly, markets with higher free floats, such as the U.S., U.K. and Australia also tend to be those where our strategists think institutional investors have the most influence. This is where corporate governance is better, although not flawless. They are also the areas where activist shareholders are likely to have the greatest influence upon corporate strategy.

Figure 18. What Weight Do You Give to Conventional Shareholders in Setting Corporate Strategy? (%)



Source: Citi Research

The popularity of index-trackers and ETFs could diminish shareholder effect

But, even here, there are complications. Our strategists highlight increasing market share of cheap equity index-trackers. This will be accentuated by the rising popularity of Exchange Traded Funds (ETFs). So, while high free floats in the U.S. and U.K. make them ideal markets for more aggressive activists, the overall effect may be dampened by the rising market share of more passive index-trackers.

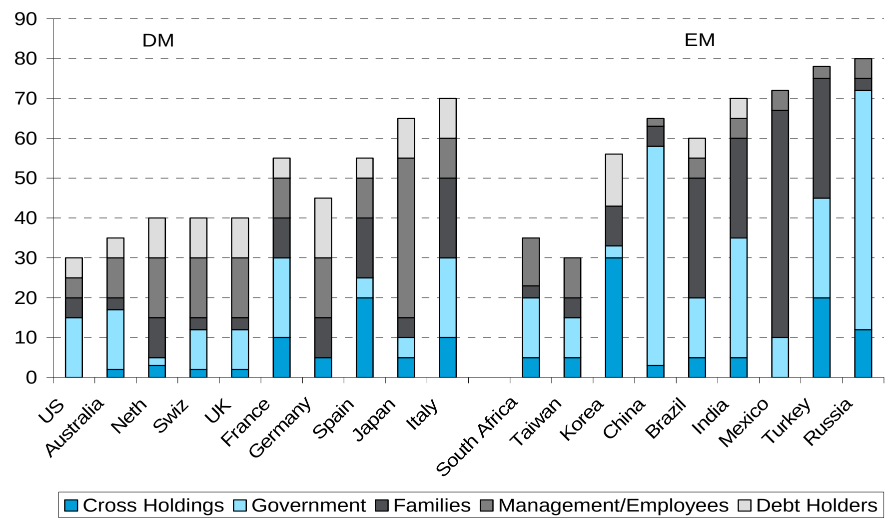
Elsewhere, free float shareholders are less important. Amongst the emerging markets, South Africa is an exception. As some mining CEOs have recently found to their cost, institutional investors in South Africa carry serious weight. In Asia, Citi strategists suggest that conventional investors will have less influence.

There are some signs of change. Overseas holdings of Japanese companies are rising and our strategist notes some greater shareholder sensitivity as a result. Amongst the low free float markets, India is opening up to increased overseas investor participation and the corporate sector increasingly understands that foreign capital demands better standards of corporate governance. Despite this trend in India, we are not seeing this in Russia where there are fewer signs of Russian companies becoming more shareholder-friendly.

Who Else Matters?

It's not just about conventional shareholders. We have also asked Citi's equity strategists to describe the other corporate stakeholders in their respective markets. Who are they? How important are they? And what do they want? Their responses are summarised in Figure 19.

Figure 19. What Weight Do You Give To Other Stakeholders In Setting Corporate Strategy? (%)



Source: Citi Research

Cross-Holdings

Cross-holdings limits investor influence and management change

Cross-holdings might be found between the parent company and subsidiaries. Sometimes these can be cross-border as with the current trend for some developed market companies to list their emerging market subsidiaries. Cross holdings can also be found between companies involved in the same supply chain.

They are not dominant anywhere, but are important in Russia where oligarchs often own meaningful parts of various companies through cross-holdings. This intertwined corporate structure is also to be found in Turkey.

Cross-holdings have historically been important in Asia. Complicated ownership structures in Japan and Korea may have helped to align corporate interests, but they also reduce accountability to the stock market. Cross-holdings have helped protect underperforming management. The prospect of replacement by disgruntled shareholders or even the threat of hostile M&A is absent. Incumbent management can generally expect their corporate cross-holders to back them in any confrontation with shareholders. This relationship is often mutually beneficial between companies.

Our Japan strategist highlights that cross-holdings are becoming less important in his market. Of course, they help to protect management but they also restrict the ability of Japanese companies to tap foreign capital. Indeed, he suggests that the recent rally in the Japanese equity market may be used as an opportunity to unwind cross-holdings further.

Our Korea strategist also notes that there is pressure to reduce corporate cross-holdings. Popular resentment of the Chaebol (family controlled industrial conglomerates) has led to plans to ban new cross holdings.

Government

Governments are the dominant influence in China and Russia

Another stakeholder in corporate decision-making is the government, often (but not always) through major ownership stakes. This seems to be especially the case in previous control-economies. Citi strategists suggest that the government is the dominant influence upon corporate behaviour in China and Russia. When the interests of the government and international shareholders diverge in these two countries it should not be a surprise that government interests usually win out. This might put off some investors, so pushing up the cost of equity capital for Russian and Chinese companies and leading markets to impose a corporate governance penalty. Currently, China trades at a 30% P/E discount to the global stock market. Russia trades at a 60% discount.

In developed markets, governments tend to have the greatest influence in regulated industries such as Utilities or Financials. Our strategists note that governments are also becoming more interventionist since the recent financial crisis. Significant amounts of state money were used to bail out financial institutions and many governments still own major stakes in their banks. Overall, the level of government influence on companies is still lower than in China or Russia, but confidence in the market-based system has eroded. Greater state influence may be achieved through shareholdings, increased regulation or tax changes. However, they can only go so far. Multinational companies can threaten to move precious jobs elsewhere if governments become too intrusive.

What do governments want from companies? The main priority of a government is to stay in power. In order to achieve this, they may pressurise companies to maximise employment prospects, perhaps at the expense of profitability. They usually impose regulation and consumer protection. Many governments will discourage takeovers by foreign companies, especially in the more politically sensitive industries. This may protect underperforming management. Governments often sponsor national champions and so provide the base for expansion overseas. Our EM strategists highlight that government-controlled companies are at the forefront of securing future access to commodities. These objectives may clash with the interests of profit-motivated investors.

Government influence is not all bad news for shareholders. Dividend income may be one area the state and shareholder is becoming more aligned. For example, the governments of China and Russia wield major influence over their respective corporate sectors. However, Citi strategists note that worsening fiscal positions mean that both are becoming more interested in extracting bigger dividend payments from the companies in which they hold stakes. Even governments are now being swept along in the global search for yield.

Families

Citi strategists suggest that families are most important in driving the behaviour in Mexico, Brazil, India and Turkey. They are more important for smaller companies in China (the larger companies are controlled by the government) and they have an important influence via the Chaebol in Korea.

Amongst developed markets, families are probably most important in Continental Europe. Plenty of companies still have significant family shareholdings. This is often associated with distorted voting structures.

Dividends are more favourable to families so ownership weightings don't get skewed

Markus Rosgen, Citi's Asia strategist, suggests that it is important for investors to align themselves with the desires of family shareholders. He thinks the key priorities for most family-dominated companies are dividend income and continued control,

especially as control is passed down to the next generation. The former is generally desirable for other shareholders. The latter is more questionable. Share buybacks are less favoured by family-owned companies because they can shift ownership weightings in undesirable directions.

Management/ Employees

The agency problem — the conflict of interest inherent in any relationship where one party is expected to act in another's best interest — is a well-known market inefficiency. Shareholders appoint managers to run companies. They are supposed to be accountable but may be tempted to run the company in their own interests, not those of shareholders. The current debate around executive pay partly reflects concerns about this issue.

Of course, management is an important driver of corporate strategy, but Citi strategists do not see them as being especially misaligned with shareholders. One potential exception is Japan. Here Japan strategist Kenji Abe, sees the interests of employees (so a broader definition than just management) as being top of the stakeholder priority list. He thinks that Japanese companies are often run for the benefit of employees, especially to provide job security. Profitability may be sacrificed to achieve that aim.

Others

Bond markets and the court of public opinion can also influence corporates

Citi strategists highlight other stakeholders who can have an important impact upon companies. For instance, debt-holders and banks exerted significant influence everywhere in the financial crisis. Now that balance sheets have been repaired, their influence has waned. Nevertheless, the bond markets remain important for highly leveraged industries such as Utilities, Telecoms and Banks. Bond-holders' interests can conflict with shareholders. For example, they will be resistant to aggressive buybacks that enhance shareholder returns but weaken balance sheets.

Tobias Levkovich also highlights "the court of public opinion" as an increasingly important influence. The financial crisis has put corporate behaviour, especially in the Banking sector, under the spotlight. CEOs can be weakened, or even removed, as a result of media pressure. Corporate strategy usually changes subsequently.

It's a Complicated World

A strong rebound in profits has allowed companies to repair balance sheets. And as the cash continues to pile up, the pressure is on for CEOs to return it to increasingly yield-starved investors.

But other stakeholders often complicate the picture. Sure, institutional investors might want companies to maximise profits and return capital. But governments might want them to preserve jobs or expand overseas. Families might want to maintain control. CEOs might want to use mutually beneficial cross-holdings to protect themselves from predators or activists.

Of course, Western investors complain that they do not have the same influence upon companies elsewhere. Other stakeholders' interests can overwhelm theirs. For each country, our survey of Citi's strategists helps identify who those different stakeholders are and what their influence on corporate behaviour might be. We suspect that there will continue to be a trade-off in EM equity markets — worse corporate governance but better growth prospects. Perhaps investors should favour an "EM in DM" investment strategy, i.e. buy shares in DM-listed companies with significant EM businesses. This offers an attractive combination of EM growth prospects but DM corporate governance.

The Corporate Response

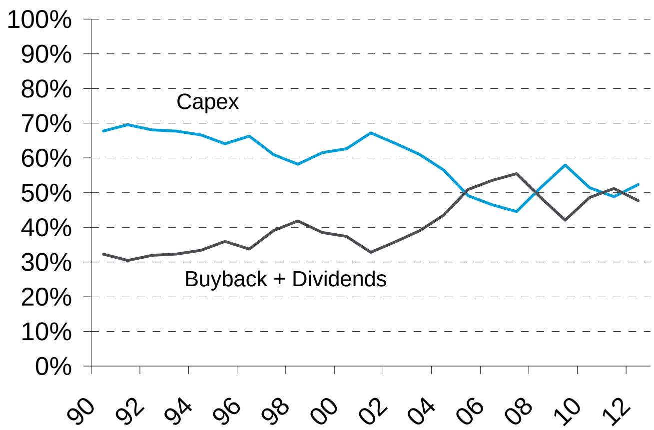
We then bring these global and local drivers together to consider the likely future behaviour of companies. In particular, how are CEOs allocating resources and how is that likely to change?

Overall, there seems to be increasing pressure for listed companies to raise payouts. As new income-obsessed equity investors exert greater influence, so CEOs may increase allocations to capital returns. If capex has to give, then so be it.

Two Different Models: U.S. and Japan

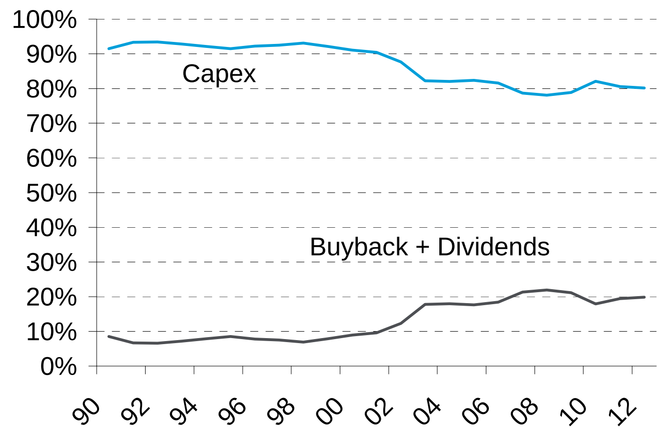
Markets and industries seem to be responding to these pressures in different ways. For example, Figure 20 shows buybacks + dividends and capex as a percentage of cashflow for the U.S. Figure 21 does the same for Japan. In the U.S. there has been a general shift away from capex towards distributions since 1990. Of course, that doesn't mean that capex hasn't grown, but just that buybacks and dividends have grown faster. In effect, U.S. companies now distribute as much capital as they invest. This would have been unthinkable 20 years ago.

Figure 20. US Corporate Uses of Cashflow



Source: Citi Research, Factset, Worldscope

Figure 21. Japan Corporate Uses of Cashflow



Source: Citi Research, Factset, Worldscope

In Japan, job security is more important than returns

Japan looks different. Capex still dominates the uses of cashflow. Dividends and buybacks have been increasing, but from a low base. Arguably, given that interest rates have been derisory for much longer in Japan, investors there should be even more income-obsessed than their U.S. counterparts. But Japanese companies have not changed their behaviour much. This may reflect our local strategist's point that providing job security is more important to Japanese companies. They would prefer to keep reinvesting in the business, even if returns are falling. That maintains capacity and employment, which is good for bond holders (excess capacity is deflationary) but bad for equity investors (profitability suffers). And, of course, it's good for employees. Even after two decades of depressed economic growth, Japanese unemployment is still only 4%. By contrast, in the more shareholder-oriented U.S., unemployment was 4.4% at the peak of the economic boom in 2006, rose rapidly to 10% by 2009, and is still high at 7.5%. Employees share more of the pain in the U.S.

Corporate Japan's behaviour has attracted the attention of activist investors. Cutting back on jobs and capex would surely boost shareholder returns and free up cash to fund shareholder-friendly dividends and buybacks. In effect, these activists want to make Japan look more like the U.S. But they have found that changing Japanese corporate strategy is very different to changing U.S. corporate strategy. As our strategist survey suggests, job security still ranks ahead of shareholder returns in Japan

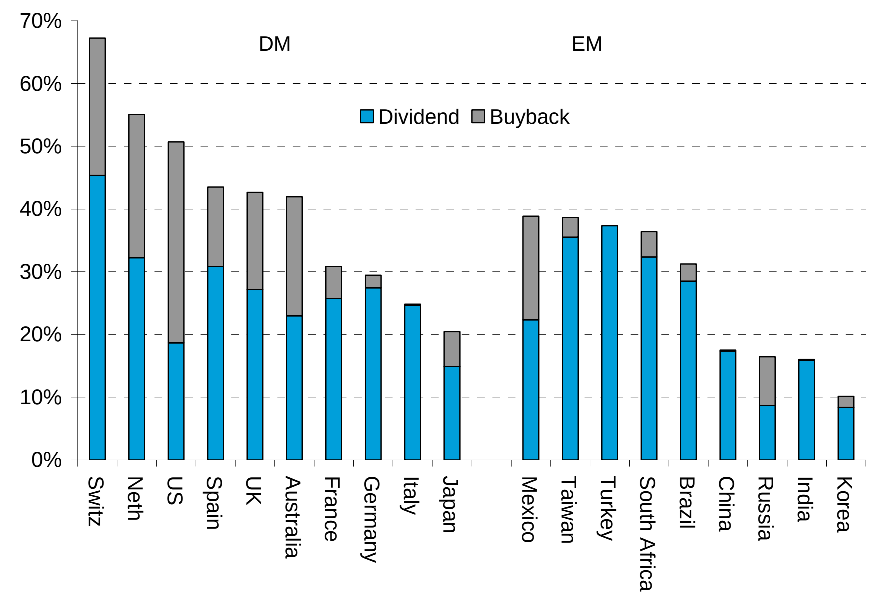
Key drivers of corporate behaviour need to change before activist shareholders gain influence

In this context, it will be interesting to see how the profits windfall of the recent yen depreciation is distributed by corporate Japan. A 65% rise in share prices suggests that shareholders are bullish about their hopes of sharing in the spoils. Indeed, our Japan strategist has highlighted a potential trend of sharp dividend hikes as companies pass on some of the benefits to shareholders. However, there is still a long way to go before Japanese companies prioritise shareholders in the way that U.S. companies do. Maybe that offers an opportunity for activist investors, but the key drivers of corporate behaviour will have to change if that opportunity is to be realised. We will watch current activist involvement in Sony closely.

Different Business Models

Figure 22 ranks the percentage of cashflow paid out as dividends and buybacks across markets. In general, EM companies pay out less of their cashflow than their DM peers. This will partly reflect higher EM growth prospects but may also reflect a lower ability of shareholders to pressurise CEOs to distribute cash. This does not look especially different from the ranking of countries by free float or shareholder influence. We suspect this is not just a coincidence.

Figure 22. % Cashflow Paid Out in Buybacks And Dividends



Source: Factset, Citi Research, Worldscope

Of course, these different ratios may also be the product of different sector exposures. So those markets with greater weightings in higher payout sectors (Consumer Staples, Healthcare) might be expected to rank above those tilted towards more capex-intensive sectors (Materials, Industrials).

Korea pays out the least and our local strategist does not see a particularly great desire to change. The message on India is similar. Payout ratios are low and likely to stay low. In Brazil and Mexico our strategists note greater potential to appease international investors' income obsession. In China and Russia, worsening fiscal positions mean that the government puts companies under greater pressure to pay bigger dividends. In South Africa and Australia, the pressure on Mining companies to increase payouts is intensifying.

The choice is distribution is likely based on tax structure

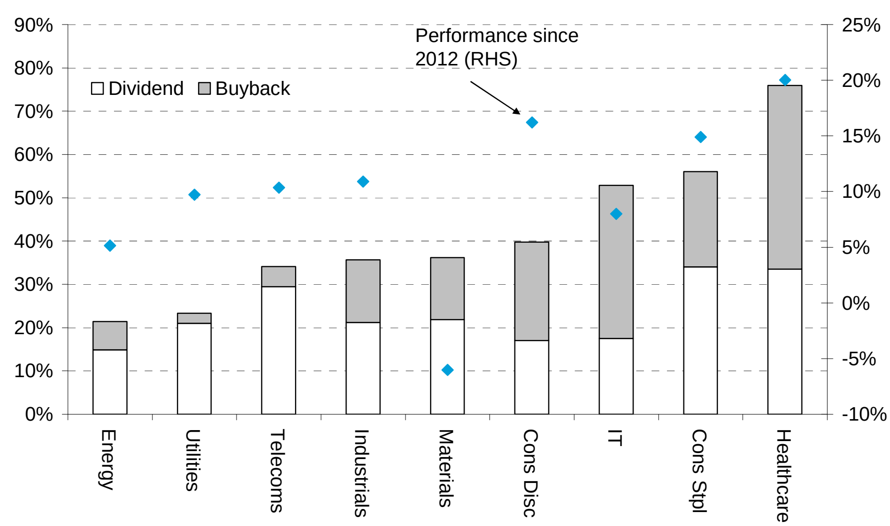
It is worth highlighting the differences in payout methods and the potential influences upon them. U.S. companies show an increasing preference for share buybacks. Our strategist points out that this may reflect preferential treatment of capital gains versus income tax incurred by dividend payments. The accretive impact of buybacks may also result from management incentives to grow EPS or a desire to reduce the impact of dilutive options. More traditional dividends are usually the preferred form of distribution elsewhere in the world. Share buybacks can be disruptive to ownership structures of lower free float companies. They have been discouraged by law in Turkey.

Sector Payouts

Management payout decisions will also be affected by industry economics. Figure 23 ranks the 10 major global sectors by their total buybacks and dividends as a percentage of cashflow. Some are more capex-intensive, which means that less cashflow may be available for distribution to shareholders.

The highest payouts are to be found in Healthcare and Consumer Staples sectors. The lowest are in more capital-intensive Utilities and Energy.

Figure 23. Global Sector Payouts As A % Of Cashflow And Share Price Perf Since Jan 2012



Source: Factset, Citi Research, MSCI, Worldscope

We have added share price performance since the start of 2012 to this ranking. There seems to be a relationship with the payout ratio. Healthcare and Consumer Staples are two of the best-performing sectors in share price terms. Utilities and Energy are two of the worst. The equity market is sending a signal of its preferences. CEOs who want outperforming share prices, and investors who want outperforming portfolios, should take notice.

Capex Can Still Grow

Is an obsession with yield crowding out capex?

Is this shareholder obsession with payouts crowding out capex? Those countries or sectors with the higher payout ratios will be those with the lowest capex ratios, and vice versa. Share prices in higher capex markets and sectors are generally underperforming those with lower capex.

Just because dividends are rising doesn't mean capex is going into a drought

Although payouts may be rising at the expense of capex as a percentage of overall cashflow, there is still scope for companies to fund significant absolute increases in capex. As Tobias Levkovich notes, U.S. companies are so cash-rich now that they can afford to increase buybacks dividends *and* capex. Just because dividends are rising sharply does not mean equity markets are imposing a capex drought.

Nevertheless, our analysis does raise a challenge for policymakers. Ultra-low interest rates are intended to stimulate corporate investment and especially job creation. But this unprecedented monetary policy may actually be having the opposite effect. As income-starved investors are forced out of cash and bonds into higher yielding equity markets, they increase pressure on companies to distribute rather than invest capital. Every day we see new examples of major listed companies announcing job cuts while at the same time raising dividends and share buybacks. QE may be forcing capital into equities but, from a policymaker perspective, it is the wrong kind of capital — income-seeking, not growth-seeking.

Smaller unlisted companies may not face the same decision tree

Our analysis is focused on the listed company universe. Perhaps smaller unlisted companies will be more responsive to low interest rates. They are not answerable to an income-obsessed stock market and may therefore see low interest rates as a chance to finance expansion. Indeed, most of the job creation in the U.S. right now is happening in unlisted small companies. The same is true in Germany, where unlisted *mittelstand* exporters (small and medium-sized enterprises) have been the main drivers of high employment rates.

Different Markets, Different Corporate Responses

We summarise the inputs from our strategists around the world. We asked them to describe the state of their corporate sector and financing markets. We then asked how these forces would combine with stakeholder interests to drive likely corporate response. The results are shown in Figure 24.

Figure 24. Summary Of Citi Equity Strategists' Responses

Country	State Of Corporate Sector	State Of Financing Markets	Key Stakeholders	Corporate Response
DM				
Australia	Resources coming off peak profits, domestics still sluggish	Average cost of equity, debt is cheap	Institutional investors dominate	Pressure on miners to cut capex, increase payouts. Domestics yet to take up the capex mantle
Europe ex-UK	North Europe good, South Europe bad. Balance sheets look healthy	Debt very cheap in North, still expensive in South. Equity financing expensive	Institutional Investors in NL and Switz. Mixture in Germany France and Spain. Cross-holdings and families key in Italy	More buybacks and dividends, more M&A, limited capex
Japan	Yen depreciation should boost EPS significantly	Debt very cheap, sharp rally means cost of equity falling	Employee interests (job security is important). Foreign investor influence has grown	Some increases in dividends and capex. Rising cash balances
UK	Flat EPS, decent balance sheets	Debt very cheap, equity financing in line with average	Institutional investors	More de-equitisation, less capex, more dividends
US	High profitability, big cash balances	Very cheap debt, quite cheap equity	Institutional investors	More buybacks, more dividends, more capex, probably in that order
EM				
Brazil	Rising leverage	Flooded by yield-seeking capital	Families/government have dominated, big capital requirements mean international shareholders matter more	More releveraging, more dividends, more capex and more acquisitions
China	Slowing but still positive EPS growth, rising leverage	Equity slightly expensive, debt slightly cheap	Government dominates	Higher dividend payouts but from low base. Some consolidation-driven M&A. Infrastructure capex continues
India	Slowing EPS growth, leverage already quite high from last cycle	Cost of debt high but set too fall. Cost of equity reasonable	Families and government	Slowing capex, dividends subdued, M&A limited, leverage being reduced
Korea	EPS reasonable, still wary of leverage	Debt financing cheap, equity financing expensive	Cross-holdings and families important	Little increase in dividends, capex slowing, rising cash balances
Mexico	Healthy EPS, solid balance sheets	Rerating made equity financing attractive	Families are key	Capex and overseas acquisitions
Russia	EPS hit by lower commodity prices	Cost of equity is high. Overseas investors suspicious	Government dominates	Higher dividends, but from a low base
South Africa	Slowing EPS growth, especially for miners	Cheap debt and equity financing	Institutional investors	Less capex, more payouts from miners. Expansion into rest of Africa for other companies
Taiwan	EPS rebound expected	Cost of debt has always been low, cost of equity in line with average	International and domestic shareholders are key. Government also important	Companies always keen to expand
Turkey	Healthy EPS growth	Cost of equity and debt at historic lows	Families and government matter most	More M&A, capex and dividends

Source: Citi Research

Outside Japan, developed market companies are under pressure to increase dividends and buybacks. The U.S. should be more capex-tolerant. Our strategists expect to see a pick-up in M&A in Europe. Different circumstances will dictate different corporate responses in Japan. For now our strategist expects companies to use the yen-depreciation windfall to improve balance sheets. Surplus funds will be added to existing cashpiles. Some of that capital will eventually find its way into dividends, capex and overseas acquisitions but it is likely to be a gradual process.

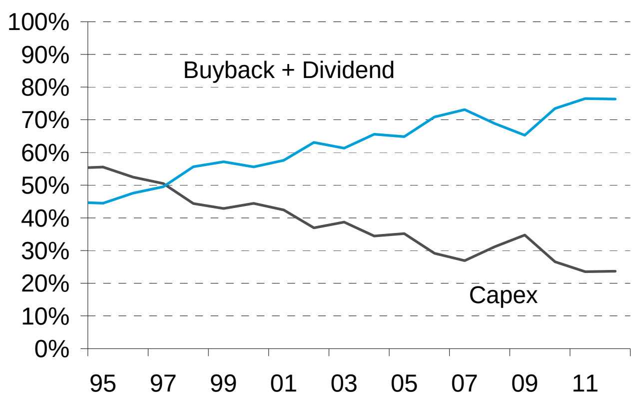
Corporate responses across EM markets are likely to be varied. Animal spirits are evident in Brazil. Our strategist expects to see more leverage, more capex, more dividends and more acquisitions. The Turkish corporate sector looks almost as bullish, with Mexico not too far behind. Asian companies seem more cautious. They are all expected to increase dividends, if from a low base. Leverage is expected to rise in China but fall in Korea and India. Russian companies are expected to increase payouts, but again from a low base. Capex requirements in the Russian commodity stocks remain significant. In South Africa, mining companies are expected to cut back on capex but expansion of the non-resource companies into the rest of Africa is expected to continue.

Reshaping Industries

Industries can change from being capital spenders to capital distributors

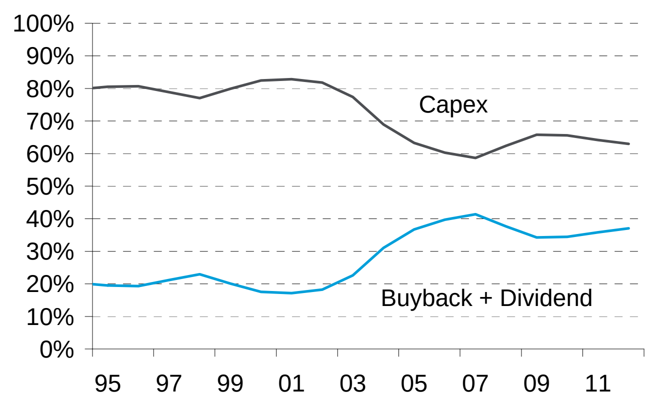
These trends have the potential to reshape whole industries. For example, Figure 25 shows changes in the capex (R&D) versus payout profile of the global Health Care industry (which is dominated by the big Pharmaceutical companies). Back in the glory days, big Pharma invested heavily in R&D. But disappointing returns on that spending led to an aggressive derating of the shares, changes in management and, eventually, R&D cutbacks. This has freed up cashflow to fund dividends and share buybacks. The change in corporate strategy eventually helped to turn around share price performance. Health Care is the best-performing global sector this year. Shareholders have turned the leading companies from being capital spenders to cash distributors. As Citi's Health Care analysts put it, the industry is now looking to "Shrink, Smarten and Spin".

Figure 25. Global Healthcare Use Of Cashflow



Source: Citi Research, Factset, Worldscope

Figure 26. Global Telco Use Of Cashflow



Source: Citi Research, Factset, Worldscope

The global Telecom sector has been on a similar, if less dramatic, journey (Figure 26). Telecom companies spent heavily a decade ago as they purchased licenses and built infrastructure to support new spectrum. However, since then a derating and associated shareholder pressures forced the sector to cut new investment in favour of returning capital. Ongoing capex requirements mean that this has been a very difficult process.

There is a pattern here. Growth opportunities mean that the stock market gives high multiples to industries. These high multiples indicate an investor tolerance for aggressive expansion. They may also indicate the equity market's willingness to finance extra capacity through capital-raising.

Falling growth prospects lead to lower capex and higher payouts which attracts income investors

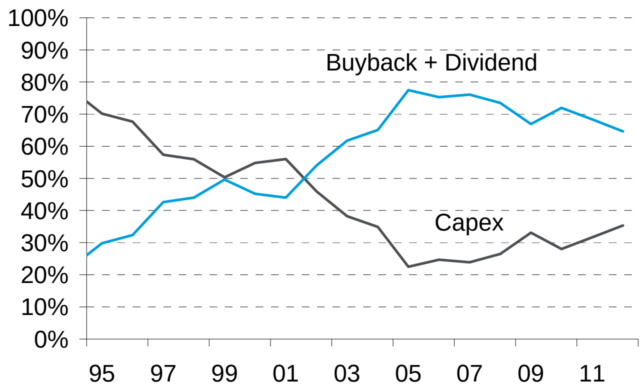
However, there comes a point when growth prospects start to fade. The shares derate, expansionary CEOs are removed, capex falls and payouts rise. Higher dividend yields eventually attract different shareholders to the industry. While more growth-focused investors had provided capital to an industry or region, these yield-hungry investors start to remove it. After all, that is what stock markets are supposed to do — recycle capital away from countries or industries where returns are falling towards those where the prospects look brighter.

That assumes that the signaling mechanisms work, that corporate behaviour adjusts in line with changing investor desires. But we have already shown that is not always the case. For example, despite a similar derating to global Healthcare, Japanese companies did not change their behaviour much. Instead of cutting back, companies maintained capex and headcount. Profitability and distributions to shareholders suffered accordingly. Share prices continued to languish.

The same sector in different regions may use cashflow differently

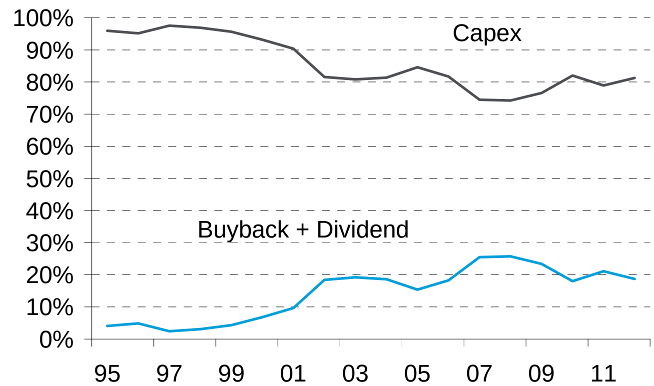
Another example of different outcomes can be seen in the U.S. and Asian tech stocks. After the bubble burst, U.S. companies shifted their corporate strategy to return large amounts of cash to shareholders via buybacks. The pressure is on for them to return more. By contrast, the Asian tech sector seems to be maintaining a more capital-intensive Japan-style business model. This may be good for job creation but has been less good for profitability and shareholder returns.

Figure 27. U.S. Tech Use Of Cashflow



Source: Citi Research, Factset, Worldscope

Figure 28. EM Asia Tech Use Of Cashflow

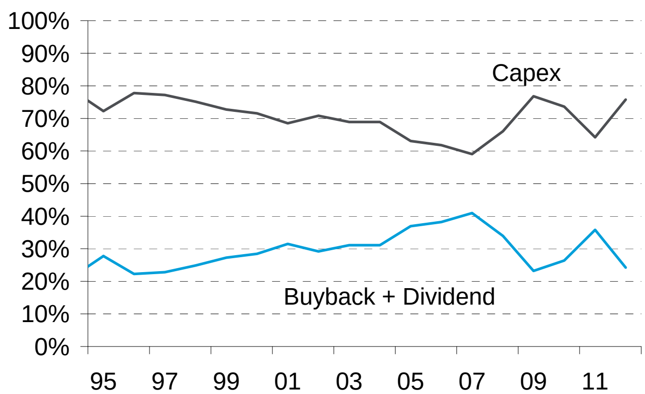


Source: Citi Research, Factset, Worldscope

The Healthcare sector may highlight upcoming changes in the Materials sector

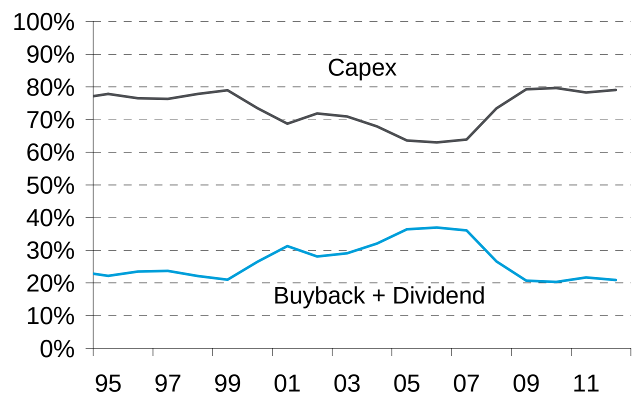
The Healthcare sector may offer an interesting precedent for the big mining stocks, which drive the Materials sector shown in Figure 29. Recent evidence that the commodity supercycle is waning has led to a derating. Accordingly, the pressure is now building on management to cut back on capex and increase distributions. This might be tough to swallow for those CEOs who built up these behemoths. If changes in previous capex-hungry sectors are good examples, expansionary management will be moved aside in favour of more cash-distributive candidates. That is exactly what is happening. We would expect the two lines in Figure 30 to converge further in coming years. Maybe it's now time for the Miners to shrink, smarten and spin as well.

Figure 29. Global Materials Use Of Cashflow



Source: Citi Research, Factset, Worldscope

Figure 30. Global Energy Use Of Cashflow



Source: Citi Research, Factset, Worldscope

The Energy sector (Figure 30), which is dominated by the Oils majors, looks slightly different. With the oil price staying high, stock markets seem to be more tolerant of capital-raising and investment by corporates, most notably in U.S. shale oil/gas.

Global equity investors have not become totally income-obsessed. They are still willing to finance ambitious capex in pockets of the world economy, but those pockets seem to be getting smaller.

Higher equity valuations tend to be associated with higher tolerance of corporate empire-building. But a subsequent de-rating often means that the market wants the opposite — capital constraint and increased focus. As large company share prices fall to trade at a discount to asset value, the stock market increases pressure on them to realise that value. Spin-offs and even break-ups are logical consequences. Given weak share prices and low valuations, these are being openly discussed in the global Mining and Telecom sectors right now. There is also talk of break-ups in the Banks, but this is also about regulatory pressures, not just depressed valuations.

De-rating by the market leads to corporate governance questions

High equity valuations tend to create corporate expansion anywhere. After all, very few CEOs can resist a shareholder-provided acquisition currency. But corporate governance differences become apparent once a de-rating occurs. In more shareholder-friendly markets, the pressure comes on to realise value. If a change in strategy requires a change in management then so be it. It can be a slow process but the market eventually gets what it wants. However, in less shareholder-friendly markets, companies are able to carry on as is, even with share prices trading well below asset value. Spin-offs and break-ups are rarer. It is no coincidence that the conglomerate business model is more common in those markets where shareholders have less influence.

Overall, the global stock market may be heading on the journey already travelled by the Health Care sector. Growth opportunities are limited and equity valuations have fallen to reflect that. Investors are suspicious of capex but hungry for income. At the same time, profitability is high and cash is piling up on balance sheets. But there is a final complication. Investors' ability to get their hands on the cash is often constrained by other, more localised, stakeholder interests. Not all companies can be forced to shrink, smarten or spin.

Shrinking Markets

One potential side-effect of these trends is a return to de-equitisation, especially in developed markets. A stock market de-equitises when the retirement of old equity (through buybacks, cash/debt financed M&A) exceeds the issuance of new equity (through IPOs, secondary issues, equity financed M&A). The stock market starts to shrink.

Cash on corporate balance sheets is dilutive due to low interest rates

Low interest rates make corporate cashpiles highly dilutive to EPS. Low equity valuations make share buybacks highly accretive to EPS. So Citi strategists expect to see more buybacks. For similar reasons, they expect to see a pick-up in M&A, with cheap debt providing the financing and cheap stock markets providing the targets. CEOs should choose to buy, not build. Both buybacks and debt-financed M&A have the effect of shrinking the stock of listed equity.

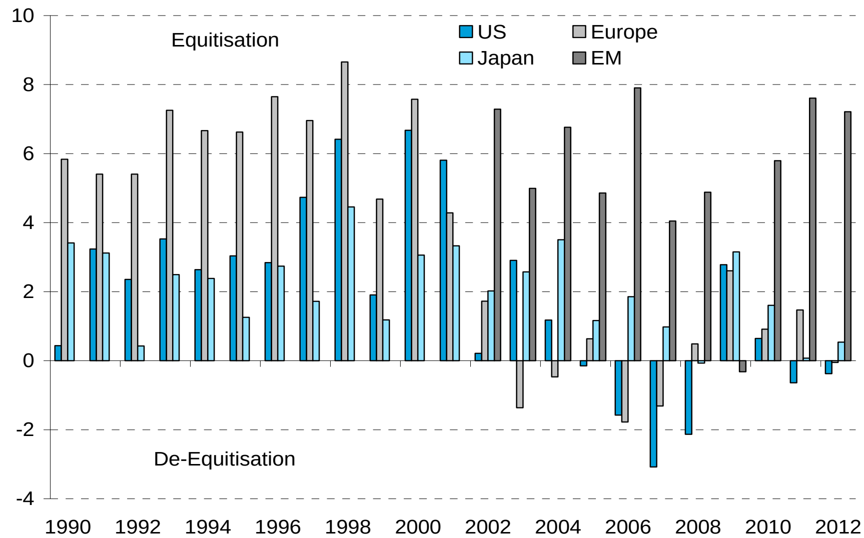
If CEOs do want to expand, either through acquisitions or capex, they should use cheap debt financing not expensive equity. Also, selling to the stock market looks less attractive when alternative buyers financed by cheap debt can pay a higher price. This will limit the listings of new companies on public markets. All these factors will tend to reduce the issuance of new equity on public markets market.

Higher rates of equity retirement will continue to de-equitisation trend

Of course, this doesn't mean that there will be no more equity raisings or IPOs. But overall, we expect to see more equity retirement than issuance over the next few years, especially in developed markets. This would represent a return to the de-equitisation trend of the 2003-07 period. Figure 31 shows how we track this. It

shows annual growth/contraction in stock markets not attributable to moves in shares prices. It is a crude measure of net share issuance**.**

Figure 31. Equitisation*: Annual Change In Stock Market Not Attributable Price Change (%)



Source: Datastream, Citi Research, * EM data since 2002

De-equitisation is most likely to return to more shareholder-friendly markets

Over the long run we would expect equity markets to grow in line with nominal GDP, but the journey can be volatile. Equity markets, especially in Europe, equitised aggressively in the 1990s as companies raised capital and governments privatised assets. But the 2000-03 bear market brought that to a halt. The U.S. and European equity markets both shrank in the 2003-07 cycle. For the first time on record, more equity was retired than issued. Japan and Emerging Markets continued to be net issuers of equity. Most markets equitised again in 2009-10, largely as a result of recapitalisations of the Financials, but that is now largely done. De-equitisation is most likely to return in the more shareholder-friendly developed markets. This is where shareholders have the best hope of preventing dilutive equity issuance. They can also put pressure on CEOs to spend capital on share buybacks rather than capex. An increasingly vibrant M&A market means that they can also sell out underperforming companies to debt-financed bidders.

M&A and share buybacks create de-equitisation…

Recent examples of de-equitisation abound. Proposed bids for Heinz and Dell would take major companies off the US listed market and return large amounts of capital to shareholders. Apple's share buyback is another example of activist-driven de-equitisation. Just these three deals would pay for all the U.S. equity issuance (IPOs and follow-ons) likely this year. The potential bid for Vodafone's stake in Verizon Communications could do the same for the UK equity market. It is harder to find such big examples elsewhere in the world. Japan equitisation has fallen more because of a collapse in issuance than a rise in redemptions. Indeed, the recent sharp rise in the market could prompt a return to issuance.

…but spin-offs are also an important form of de-equitisation

Spin-offs can be an important driver of de-equitisation. For example, a company may sell an asset and return the funds through a share buy-back. As long as the buyer doesn't finance the purchase through equity issuance then there will be a subsequent decrease in listed equity. Spin-offs can also shift equitisation between markets. Recent partial listings by Spanish Banks of their LatAm subsidiaries will equitise the Mexico or Brazil stock markets but avoid the requirement to list new Spanish shares at depressed valuations.

De-equitisation reflects many of the forces that we have already highlighted in this report. A reduction in listed equity is the logical corporate response to strong balance sheets, cheap debt and expensive equity financing. It helps to mop up investor selling and should eventually allow equity markets to re-rate. And as equities become more expensive, so they become a less attractive source of yield and de-equitisation becomes less compelling. But with interest rates so low, that still seems some way off.

De-equitisation represents pure capitalism at work. Messages from the financial markets eventually produce a corresponding response from CEOs. In response to lower share valuations, less equity is issued and more equity retired. Therefore, it is not surprising to us that de-equitisation is less evident in those parts of the world where the market's signaling mechanisms are dampened by other stakeholder interests.

What Could Change?

We have attempted to predict how the current market conditions could shape future corporate behaviour. In particular, we see yield-starved investors imposing more pressure on CEOs to raise payouts, with activists ready to pounce on those who do not comply, at least in those countries where shareholders matter. But how could market conditions change? What would be follow-on implications for corporate strategy?

Bonds for Income, Equities for Growth

Equities could stop being treated as an income asset if bond yields move back to normalised levels

Perhaps equities stop being treated as an income asset. This might happen because the withdrawal of ultra-aggressive monetary policy pushes bond yields back to normalised levels. An old rule of thumb suggests that an equilibrium level of bond yields is nominal GDP. That would mean benchmark 10-Year U.S. Treasury yields nearer 4% (currently 2%), back above the dividend yield on global equities (3%). While the transition would probably be painful for financial markets, such a move would restore bonds to their rightful place as the income asset class of choice. Yield-driven investors could return to the fixed income markets and so relieve the pressure on CEOs to pay out more cash. The need for activists to police corporate behaviour might be reduced.

Investors could become more tolerant of corporate expansion

If this withdrawal of cheap money was associated with a healthy recovery in the world economy, equity investors could become more tolerant of corporate expansion. The obsession with dividends and buybacks would diminish. A meaningful re-rating of the global equity markets would mean that IPOs and equity-financed M&A would make more sense. Issuance could overtake redemptions. Developed markets could start to equitise again.

If higher yields push income-hungry investors back into the bond markets, we might expect them to sell their income-oriented equities. As these stocks lose their premium to more capex-focused companies, so the signals to the corporate sector would change. Who knows? Maybe activist shareholders start pressuring CEOs to reduce dividends and buybacks in order to fund increased expansion. That would be interesting to see.

Perhaps the recent rally in share prices turns into a full-scale multi-year bull market as investors flood back to the asset class. Tobias Levkovich's "Raging Bull" thesis suggests that the cult of equity could be set to make a comeback given improving house prices, U.S. energy self-sufficiency and a belief that the demographic bear argument for equities is overdone. Tobias also thinks rising share prices could bring the performance-chasers back to the asset class. In Europe, Jonathan Stubbs thinks that a new breed of capital allocators is poised to shift large amounts back from bonds into equities. A liquidity-fuelled bull run could re-rate global equities by enough to make buybacks and bids less attractive. Funds could be diverted towards corporate expansion instead.

Better Governance

Activist shareholders could turn their attention to opportunities elsewhere

Alternatively, market conditions could stay as they are. Having pushed many Western companies to higher payouts, maybe activist shareholders could turn their attention to opportunities elsewhere. Japan looks like an obvious target. Many stocks still trade below book value and dilutive cash is piling up on balance sheets. The recent rally offers an ideal opportunity for overly-diversified Japanese companies to sell off assets and return capital to shareholders. If Japanese companies could be persuaded to prioritise employee job security less, then margins could rise towards the global norm. The impact upon profits would be significant.

Maybe the classic EM equity trade-off between strong economic growth and weak corporate governance could change. If EM companies need to improve governance to attract foreign capital, then this could help to reduce the disappointing gap between EM economic growth and EM profits growth.

But such shifts in corporate cultures tend to be slow. Perhaps the best opportunity is in a crisis. Few of the weaker governance countries are now in crisis. If anything, the current yen depreciation takes the pressure off Japanese companies to tighten up their corporate governance. On this argument (crisis breeds change), maybe the Eurozone periphery countries offer a better chance for improvement in shareholder control mechanisms.

Industry Reshaping

Global growth could lead markets to reward capex vs. distribution

The market's current preference for higher distributions has led to a rerating of the lower capex sectors against their higher capex peers. Consumer Staples stocks have outperformed commodity stocks. But if that preference were to change, perhaps as a result of an acceleration in global growth, then we might expect some of the current market signals to change. If a better world economy were associated with a reincarnation of the commodity super-cycle, then we would expect the market to stop trying to change the big mining stocks into Pharma-style cash cows — less need to shrink, smarten and spin.

Higher interest rates would reduce the EPS dilution from corporate cash piles. This would reduce activist pressure on the U.S. IT stocks to raise dividends or buy back stock. Alternatively, increased shareholder discipline could wean the Asian Tech companies off their sales and employment-maximising business models. That seems pretty unlikely for now.

Policymakers Discourage Payouts

Policymakers could remove tax credits on dividends to discourage payouts

Ultra-low interest rates were intended to encourage companies to create jobs, but they may be creating a dividend and buyback boom instead. Maybe frustrated policymakers could seek to discourage payouts by removing tax credits on dividends. This happened in the UK back in 1997. "Investors are forcing companies to over-distribute and under-invest" was the justification used at the time.

They might also choose to discourage share buybacks and give increased tax breaks for capex. All of these moves would have implications for the strategic direction of companies. We might expect payouts to fall and capex to rise as a result.

Regional / Country In-Depth

Spotlight on Russian Corporates (Maria Gratsova)

Russia has historically been viewed as a risky high-beta equity investment proposition, but that is not the only reason the market is trading at a wide discount to peers. Foreign investor sentiment appears to have recently hit a new low, mainly on concerns with poor corporate governance but also exacerbated by a slowdown in growth.

Most of the largest Russian companies are controlled by the government or at least linked to it (controlling shareholders are often oligarchs with government connections), and minority shareholder interests appear to be merely an afterthought in the corporate decision-making process.

The government kicked off this year by announcing a broader drive to improve the attractiveness of Russia as an investment destination for foreign investors; however the impact of this is yet to be felt. They also have an ambitious privatisation plan, so improving Russia's attractions to foreign investors is of very much interest. Some signs of more investor-friendly policies from recent years include a meaningful increase in dividend payments by major Russian energy companies. However, a big reason for the increase is to help fill government coffers, rather than please minority shareholders (even if they do benefit).

Capital Distribution

Russian companies have not historically been good at distributing cash to their shareholders through dividend payments. However there have been signs of change in recent years.

Some of the largest government-controlled companies, including Gazprom and Rosneft, have increased their dividend payouts over the course of the last 1-2 years. This is not entirely surprising given the government needs to increase its budget inflows. Other plans to do this include mineral extraction tax (MET) hikes and further privatisations.

The current policy for state-owned companies is to pay out 25% of Russian Accounting Standard (RAS) net income as dividends. Recent newsflow suggests that subsidiaries of these companies are also likely to start passing 25% of their RAS net income to the parent company; and the requirement at the parent company level may rise to 25% of IFRS net income.

Some non-state-controlled companies are also raising dividends e.g. telecom operator MTS has announced its intention to increase dividends by 30% in 2013-15. Diversified Miner Norilsk Nickel has been known for poor corporate governance in the past, but it has recently promised to focus on returning cash to shareholders, as well as optimising capex. Others in a position to potentially increase dividends include several industrials companies. In addition to higher dividends, Russian companies have also recently used more cash for buybacks, for the first time in several years.

Capital Expenditures

For a long time, capex in Russia has been running at well above the level of depreciation, despite stagnation or very limited growth in the largest sectors. Understated depreciation is particularly an issue in the Energy, Metals & Mining and Utility sectors, and is one of the factors that makes the market look 'cheap'. Raising depreciation to the level of replacement capex would result in a more realistic picture of earnings in Russia, which are currently overstated.

Capex is expected to rise further in Russia's high-spending Energy sector. For example, Rosneft has an extensive undeveloped portfolio (particularly offshore and in East Siberia) and is conducting an ambitious $25bn refinery modernisation programme. Peer Lukoil recently acquired Samara-Nafta for $2bn, and is planning to spend a further $1bn on increasing production at the unit. Gasprom is spending heavily in order to bring new fields on stream to replace declining production at its core West Siberian fields. Outside the Energy sector, capex is rising in Russian Retail: e.g. market leader Magnit has an aggressive store roll-out plan and peers are also following suit. But there are also sectors where capex is being cut, including in Mining and Real Estate.

Spotlight on European Corporates (Jonathan Stubbs)

The current state of the European ex-UK corporate sector is mixed. Some companies/ industries appear to be in rude health, others do not. This reflects the clear distinction between winners and losers in the post-financial crisis world. The “haves” have access to growth and strong balance sheets. They also get rating (higher equity valuations) and funding (lower cost of debt) advantages. The “have-nots” do not.

Overall, there have been more headwinds than tailwinds for European corporate profits in the last year. We have now seen over 50 weeks of consecutive net downgrades for Europe ex-UK company earnings, according to the Citi Earnings Revisions Index (ERI). Top down, we expect 2013E earnings growth to be modestly positive, around +5% versus a fall of 3.3% in 2012, and to pick up closer to 10% in 2014E. The recovery in profits from Europe ex-UK Financials is a key driver to this turnaround.

More impressive than the profit backdrop is the balance sheet strengthening that has happened since the financial crisis. Helped by recovering EBITDA, de-leveraging, capital raises and retained earnings, balance sheets in the region appear robust once again. This represents a re-leveraging opportunity. We have seen a mild version of this over recent years with ongoing increases in total shareholder distribution (dividends and buybacks).

Capital Distribution

Comparing the cost of equity and debt in Europe shows a wide funding gap between the two. This suggests that various de-equitisation and capital return strategies look compelling. In fact, companies who follow such strategies are likely to enjoy a lower cost of equity as shareholders attribute a higher valuation. Similar to the U.S., European companies have been raising total distributions to shareholders over the past few years. Total levels of dividends and buybacks have increased from €150 billion in 2009 to €220 billion last year. We expect this trend to continue as companies attempt to boost growth through buybacks and boost total returns through dividends.

European corporates have built up significant cash piles of around €700 billion, up about 50% since 2005. For most companies, this cash is highly dilutive, given how low interest rates are. We would expect growing pressure from both outside and inside these companies for this cash to be “put to work”.

The financial logic for corporate action is compelling with the debt-equity funding gap at record levels. The economic logic is also compelling given a low/modest global growth backdrop and near-record corporate margins, however, CEO confidence or animal spirits are missing. Here, the U.S. is leading following a retreat in U.S. economic and political risks, leaving CEO’s and private equity firms freer to exploit the debt/equity funding gap. With this handbrake released, we expect European companies to eventually join the global M&A party.

Capital Expenditures

Total non-financial capex has moved broadly sideways compared to sales over the past couple of years and remains low compared to 10 years ago. There is little incentive from demand or from equity valuations to encourage a significant pick-up in capex domestically, or internationally. Instead, the equity market continues to reward asset/capex light business models with premium valuations. The recent reduction in capex in the UK Mining sector is an example of company management reversing previous trends and adapting to a softer demand environment.

Spotlight on Brazilian Corporates (Stephen Graham)

Since the 2008 crisis, Brazilian companies have taken advantage of record low costs of capital and a strong Brazilian currency to expand, through both organic capex and acquisitions. Capex as a percent of sales reached 15.8% in 2012, up from 10.7% in 2008 and just 5.7% in 2005. Brazilian corporates — from meatpackers to makers of auto parts, home furnishings, and steel — have become multinationals. Mergers and acquisitions have created fewer, larger domestic firms in retailing, homebuilding, banking, telecoms, credit cards, toll roads, and food.

The debt that helped fund the consolidation has tripled aggregate net debt/EBITDA of companies in the Ibovespa index to 2.4x since 2007. This has been affordable so far because the average corporate cost of debt has fallen from 15.5% to 8.7% per year in nominal terms. With inflation now around 6.5% vs. 4.5% in 2007, the real cost of debt has fallen 80%, from 10.5% to 2.1%.

The drop in the cost of debt is partly the result of extremely low global rates since 2008, partly of Brazil's reaching investment grade as a sovereign credit in 2007 and partly of the ongoing decline in domestic interest rates since the hyperinflation of the 1990s. Another factor has been a surge in long-term, below market-cost lending from Brazil's biggest corporate lender, the national development bank BNDES, in a policy to stimulate investment. A truck today can be bought in Brazil with 90% of funding from the BNDES at 3%, more than three percentage points below inflation.

As long as the global and Brazilian liquidity glut continues, we believe that corporate borrowing to simultaneously fund capex, dividends and cash will continue. The 2.4x net debt/EBITDA level, however, is an indication that the dynamic may be approaching the point of hazard. That level of debt is a complete psychological reversal for Brazilian corporates. In the mid-2000s, the management generation that survived the 1980s/90s debt crisis thought of 1.0x as an appropriate limit.

The new generation believes it has built in safeguards via fixed rates, long lending terms, hedges in foreign assets and cash positions. The thinking is that when the dust of the global financial crisis finally settles, Brazilian companies will emerge larger, stronger, more global and more diversified. They are then supposed to produce enough cash flow to pay down debt as rates rise. But if current conditions continue much longer, the risk of something more bubbly arises.

Capital Distribution

The actions of the BNDES to stimulate investment at low rates helps explain why Brazilian corporates are not only investing more, but paying more dividends and hoarding cash, all at once. The median dividend payout was 34% in 2012, up from 25% in 2004 and the cash position averaged 10.5% of market cap in 2011/12 vs. 7.6% in the previous seven years. This also highlights the limits of state policy of stimulating investment via cheap credit. Some of the money borrowed indirectly from the government at 3% to buy capital equipment ends up lent back to the government at 7.5% in corporate bank accounts, or in shareholders' hands via dividends.

Corporate Governance

With the notable exceptions of Petrobras and Electrobras — the only companies in Brazil's Ibovespa index controlled by the federal government — investors in the last few years have noticed fewer episodes than before of conflict of interest between controlling shareholders and portfolio investors. The consolidation of the "Novo Mercado" segment of the exchange (a listing segment of the Bovespa for the trading shares of companies that commit themselves voluntarily to adopt corporate governance practices), where only a single class of share is allowed, has helped. So has the sheer size of the companies that emerged from 1990s privatisations and subsequent rearrangements: too large to capitalise without institutional involvement, with attendant rights.

The relative power of families over listed corporates is substantial but has declined. Specific families still directly control some large firms (i.e., Gerdau, Klabin, Cyrela, and Cosan), but even they share influence with outside providers of capital. Most companies have controlling groups that include multiple players and institutional money. Even without full compensation linkage to the share price, most corporate managements have more than one master and so focus on the creation of financial value broadly.

Spotlight on Australia Corporates (Tony Brennan)

The cost of equity in Australia is in-line with the historical average, but the cost of debt is now below average. The reason for this low cost of finance is that, since the deferment of prospective resource projects last year and the resulting approach of the peak of the resource investment boom, interest rates have come down to encourage more spending by households and businesses in other industries. And, as in other countries, the willingness of these groups to spend is being tempered by caution towards debt and a desire to contain leverage. Hence the cost of finance needs to be lower than average to stimulate spending. Nonetheless, interest rates aren't as low as in many other developed economies, because the intensity of de-leveraging isn't as great as has been seen abroad, particularly for the Australian government and financial institutions.

Corporate earnings growth has been poor since the financial crisis hit in 2008, with EPS flat or declining in five of the past six years. This compares to sustained double-digit earnings growth during the commodity boom in the half decade leading up to the financial crisis, and longer-term average earnings growth of around 6%. The recently weaker performance is not dissimilar to that in some of the other developed economies, but the reasons have been different. In the initial stages of the financial crisis, Australian companies recapitalised their balance sheets by issuing a lot of new equity at low share prices, and this was significantly dilutive to EPS. In the subsequent years, the resource investment boom has required growth of other industries to be constrained, while long lead times on project completion and recently lower commodity prices have limited resource earnings growth itself.

In the years leading up to the financial crisis, corporate gearing rose, particularly in the commercial property, infrastructure and financial services sectors — not dissimilar to some of the trends globally. But with the onset of the financial crisis, the recapitalisation undertaken lowered gearing substantially, and caution since then has kept corporate gearing around its lowest level in a number of decades.

Capital Distribution

Until fairly recently, companies in the resource and related sectors have been behaving differently to those in other sectors. The resource companies have been undertaking massive capex, largely internally funded, and keeping dividend payout ratios low, while doing buybacks from time to time with surplus cash. Companies in other sectors have for some time been constrained and "crowded out" by the relatively high interest rates and exchange rate needed to manage the resource investment boom. They have been reducing capex, and increasing dividend payout rates instead.

However, more recently there has been a shift. As commodity prices have declined, further projects have been deferred, and resource companies have emphasised sustaining and increasing dividends. Meanwhile, as the cost of financing has come down to encourage a lift in investment by companies in other sectors, so far there has been only a tentative response. Capex remains subdued, M&A activity is quiet, and companies are still maintaining high payout ratios.

Over time, capex outside of the resource sector should pick up. But for the overall equity market, balance sheet expansion seems likely to remain cautious, despite the low cost of finance and low gearing. Payout ratios should remain relatively high, in part a response to investor preferences.

Corporate Governance

Institutional investors, including superannuation funds (government-supported funds reserved to pay workers' pensions when they retire from service) and their managers, are generally active and fairly forthright with management about their expectations. They exert pressure for specific outcomes, including management changes, capital returns, growth and business strategies. Foreign investors are big enough to matter in Australia and can exert similar pressure as domestic investors. Recently, foreign investors have been more interested in income vs. growth as perceived returns on new investment in resources in particular have declined.

Analyst Biographies

Robert Buckland is a Managing Director and Head of Global Equity Strategy at Citi Research. Prior to his current role, he was the European Equity Strategist at Citi when the team was ranked first in all the major investor polls. Before joining the firm in 1998, he was an equity strategist at HSBC for four years. Prior to that, Robert was a sector analyst, economist and strategist at NatWest Securities, starting in 1989.

Kenji Abe, PhD is the Japan Equity Strategist at Citi Research. He joined Citi Research in 2010. Mr. Abe began his career at the Ministry of Finance in 1998 and was involved in foreign exchange policy at the ministry's international bureau. He then worked at Lehman Brothers and Nomura Securities after earnings a PhD in economics from Johns Hopkins University in 2007. Mr. Abe received his undergraduate degree in economics from the University of Tokyo.

Tony Brennan is a Managing Director and Head of Investment Strategy for Citi Research Australia & New Zealand. Tony joined the firm in 2010 from Deutsche Bank where he held a similar role for the past six years and is one of Australia's most respected Equity Strategists (e.g. rating #2 in the 2009 Peter Lee Australia survey, and #3 for Peter Lee in Asia). Prior to Deutsche, Tony was Chief Equity Strategist for Merrill Lynch in Australia; Senior Global Equity Strategist, UBS (New York and London); Chief Equity Strategist, UBS (Australia); Senior Economist, UBS Australia; and Research Economist, Reserve Bank of Australia (14 years). Tony holds a Master of Science (Economics) degree from the London School of Economics, and a Bachelor of Commerce (Economics) degree with First Class Honours, from the University of New South Wales.

Michael Chung is a Managing Director and Head of Korea Country Research, based in Seoul. Michael joined Citi Research in March 2006 from Morgan Stanley. While at Morgan Stanley, the Korean team was ranked #3 in the 2004 and 2005 Institutional Investor surveys. He was also part of the regional banks team that was ranked #1 in the Institutional Investor surveys between 2002 and 2004 and #2 in 2005. Michael holds an MBA degree and a BSc degree in Applied Mathematics from the University of California, Berkeley.

Maria Gratsova has worked on the CEEMEA and Frontier Markets Strategy team since 2008. In addition to Strategy, she is heavily involved in the CEEMEA and Frontier Markets Research Marketing effort. Maria's previous experience includes research on Sub-Saharan Africa and Russia at various institutions, including the BBC World Service Trust. She has a degree in International Relations from the London School of Economics, is a native speaker of Russian and fluent in English, French and Finnish.

Stephen Graham is a Managing Director, Head of Latin America Equity Research and Strategist for Brazil, based in São Paulo. Stephen joined Citi Research in 2012 after more than 25 years analyzing Latin America for investors, including #1 Institutional Investor survey rankings in three different sectors. Stephen was Director of LatAm Research at Goldman Sachs from 2007 to 2011. He was LatAm Telecom/Media/Tech and Special Situations analyst at UBS from 2000 to 2007, and Utilities and then Tech analyst at Credit Suisse and DLJ from 1994 to 1999. He began his career at Business International, consulting for multinationals in LatAm. Stephen holds an MBA in Finance from New York University, completed a graduate Economics fellowship at the Universidade de São Paulo, and was granted a BA with honors in History from Occidental College, Los Angeles.

Peter Kurz is a Managing Director and Head of Taiwan Country Research, based in Taipei. Peter joined Citi Research in June 2006 with 18 years of experience in the Taiwan market, having started as Head of Research with Baring Securities in 1988, before moving to Merrill Lynch in the same position in 1997. While at both Barings and Merrill, Peter and his team were consistently ranked #1 in the market in terms of external rankings (Greenwich and Institutional Investor) as well as broking market share. From 2000 to 2004, Peter established and ran Insight Pacific, his own investment advisory and corporate finance boutique before moving to BNP Paribas in 2004 as Head of Corporate Finance in Taiwan. Peter completed his Bachelor's degree at Dartmouth College and moved to Taiwan to study Mandarin at Tunghai University in 1980. He has a Master's degree in International Affairs, specialising in International Finance and East Asian Studies at the Columbia University.

Tobias M Levkovich is the Chief US Equity Strategist for Citi Research. He is also a member of the firm's Investment Strategy Committee. In this role he is responsible for assessing the direction of the market, setting the firm’s investment sector allocations, and compiling its Recommended List, a list of specific investment that he expects to appreciate in value. Tobias assumed his current role in 2001. He is a member of Institutional Investor’s (2009) All-America Research Team, a recognition that he has received previously. SmartMoney magazine has also recognized Tobias as one of its “Power 30 Thinkers” (November 2004), its “Best Market Seer” (December 2003) and its “30 Smartest People in Investing” (December 2002). Prior to assuming his current role, Tobias spent 13 years analyzing the engineering, construction, and machinery industries and was recognized for his accurate investment recommendations and analysis by Institutional Investor, The Wall Street Journal, and Reuters. He holds a Bachelor’s degree in commerce from Concordia University in Montreal and attended Boston University’s Graduate School of Management.

Aditya Narain, CFA is a Managing Director with Citi India Research, covering Strategy and Banks & Financial Services. He joined Citi Research in August 2000 from UBS Warburg, where he covered the banking sector since 1994. Aditya has also worked at Bank of America and ICICI Bank. He holds a Bachelor's degree in Economics and an MBA degree in Finance and Marketing from Delhi University. Aditya is also a CFA Charterholder.

Markus Rösgen is a Managing Director and Head of Regional Strategy, based in Hong Kong. Markus joined Citi Research in 2004 from Asia ING Financial Markets, where he was the Chief Strategist covering Asia and Japan. Before that, he worked as a Strategist at Morgan Stanley in Hong Kong and London, and Warburg Securities in London. Markus has been consistently ranked as one of the Best 5 Regional Strategists by Asiamoney since 2003. In 2007, Markus and his team were a runner-up in Equity Strategy in the Institutional Investor Magazine (All-Asia Research Team survey) and also ranked #3 by Alpha Magazine surveys. Markus holds a BA (Hons) degree in Western European Politics & French from the University of Essex, UK, and an MBA degree in Banking and Finance from the University of Birmingham Business School in the UK.

Richard Schellbach is an Analyst in the Equity Strategy Team at Citi Research. Prior to joining the firm in 2003, he worked for two years in Asset Allocation at BT Funds Management. He has an Honours Degree in Finance and a Bachelor of Science degree.

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NOW / NEXT

Key Insights Regarding the Relationship between Markets and Corporates

SHIFTING WEALTH/ SPENDING POWER

The Pharmaceutical industry in the glory days invested heavily in R&D but disappointing returns on that spending led to an aggressive derating of the shares, changes in management and eventually R&D cutbacks. This freed up cashflow to fund dividends and share buybacks and eventually helped to turn around share price performance. / With the commodity supercycle waning, pressure is on the Mining sector to cut back on capex and increase distributions, moving Mining from capital spenders to capital distributors.

LABOR MARKET

In Japan, despite interest rates being derisory for a long time, capital expenditure is still the dominant use for cash flow. Providing job security is more important to Japanese companies than shareholder returns therefore they would prefer to keep reinvesting in the business, even if returns are falling. / Shareholder activists are starting to take notice of Japan but key drivers of corporate behavior would have to change before Japanese corporates prioritize distributions over job security.

GLOBAL REACH

A recovery in listed companies earnings per share and a recovery in return on equity from the lows reached during the financial crisis has been a global phenomenon. In addition, with profit recovering faster than capital expenditure, subsequent surplus cash generation has allowed companies globally to repair balance sheets. / Although global in nature, regional differences in shareholder influence due to different market structures and values mean corporate strategy for the deployment of balance sheet cash is very different.