Citi GPS

2016 CORPORATE FINANCE PRIORITIES

Citi GPS: Global Perspectives & Solutions

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About the Financial Strategy and Solutions Group

The Financial Strategy and Solutions Group (FSG) is the corporate finance advisory team in Citi's Corporate and Investment Banking division. We advise corporate and financial institution clients globally on the full spectrum of corporate finance issues, including valuation, capital structure, credit ratings, risk management, liability management, shareholder distributions and acquisition and funding strategies. In partnership with Citi's product and industry experts, we design innovative solutions to assist our clients.

2016 CORPORATE FINANCE PRIORITIES

The global landscape in 2016 remains uncertain with increased divergence in economic prospects around the world. Improving economic fundamentals in the U.S. have provided a catalyst for the first increase in interest rates by the Federal Reserve in nearly a decade, signaling confidence in the continued strength and sustainability of a U.S. recovery.

In contrast, the European Central Bank has extended its quantitative easing program and Japan has slipped into another technical recession. China has acknowledged additional downward revisions in its GDP growth targets, confirming fears of a slowdown in the world's largest growth engine. This reversion in Chinese demand is exacerbating pressures on global commodity markets. All firms will need to plan for the adverse impact of heightened commodity price volatility on corporate revenue growth. These macroeconomic divergences will require companies to rethink how they invest, expand, and continue to create value for their shareholders.

In response to investor demand for top-line growth and evolving activist agendas, companies have turned to M&A and restructuring alternatives more than ever before. Strong U.S. fundamentals, low financing costs, and favorable investor responses to M&A have encouraged growth-challenged firms to strive for larger and more transformative deals in 2015, leading to the highest level of M&A activity in history.

If equity valuations are sustained and market volatility remains in check, the M&A momentum will likely continue in 2016. However, companies will need to exercise discipline in light of high equity valuations and a recent decline in equity investor response to M&A announcements. Moreover, since a third of all companies globally are not earning their cost of capital, corporate executives will need to proactively consider restructuring alternatives in 2016.

Corporates will also need to reevaluate their capital allocation and distribution policies in 2016. Over the past several years, shareholder distributions have represented an important component of shareholder returns. However, as market valuations have risen, the undervaluation signal associated with buybacks has become more muted. Investors are also closely scrutinizing repurchase-driven engineered EPS growth. In 2016, deploying capital organically or through M&A could be a more effective path to value enhancement for those firms with the requisite balance sheet strength.

While investment-grade firms should remain relatively insulated from potential market turbulence given the record amount of liquidity on their balance sheets, these firms are likely to face shareholder pressures to deploy excess capital. Noninvestment-grade corporates, however, could face difficult tradeoffs between investment and the need for capital preservation if credit markets tighten. We are currently observing the widest spread differential between sectors in the top and bottom quartiles of the high-yield universe. Companies in commodity exposed sectors such as energy and mining are likely to require more drastic measures to defend their balance sheets. A closer evaluation of the tradeoff between asset sales, dividend cuts, capital expenditure reductions, and equity issuances – which have varying equity market responses relative to the amount of incremental liquidity generated – will be warranted.

In the emerging markets, particularly in Asia, the strong feedback loop between the corporate and financial sectors – reflected in the simultaneous rising of bank and corporate credit spreads – will necessitate that corporates opportunistically diversify their funding sources and pursue customized structured solution alternatives. A potential increase in risk premia affecting both the cost of debt and equity for bank-reliant corporates will pose an added challenge for these EM firms as they seek investment opportunities that earn a return commensurate with their cost of capital.

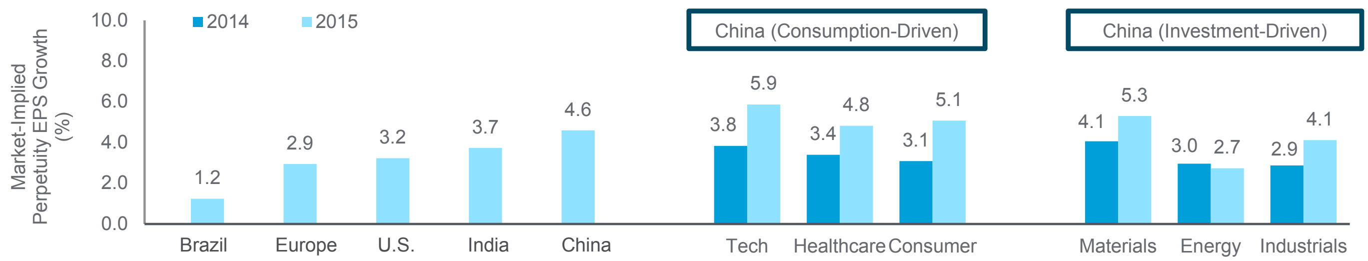
Contents

1. Adapt to Moderating Growth Prospects in China

After accounting for a large share of global economic growth over the past decade, China's economy is in transition and its real GDP growth is expected to decline to 6.4% over the next five years (with 2016 estimates ranging from 5.8 to 6.8%), down from an average of 8.6% during the previous five years. China's slowing pace of economic growth has called into question many companies' growth plans, as well as their EM strategy more broadly. As a consequence, blue-chip companies across the U.S. and Europe, particularly those in commodity driven industries, have experienced meaningful downward revisions in sales and EPS forecasts this past year. Close to a quarter of companies with a greater than 10% downward revision in sales growth estimates cited China as the primary factor resulting in an average industry-adjusted stock price underperformance of 14%.

Figure 1. China Growth Prospects Remain Attractive Especially in Consumption-Driven Sectors

Market-Implied Perpetuity EPS Growth by Country and by Sector for China



Source: FactSet

Despite the projected slowdown, China still offers attractive growth opportunities relative to many other economies as its GDP growth is expected to remain materially above all other countries. China's market-implied perpetuity EPS growth of 4.6%[1] is still the highest across all major world economies. The acceleration of fiscal spending in China (up 26% y-o-y) combined with further renminbi (RMB) depreciation is also likely to help alleviate the underlying growth headwinds.

China's gradual transformation from an investment-led to a consumption-led economy will require firms around the world to recalibrate their China growth strategy. Investors have recognized this paradigm shift. Chinese equity markets are already ascribing a higher perpetuity growth rate to consumption-driven sectors over most investment-driven counterparts. Consequently, firms in sectors more exposed to domestic consumption have experienced larger improvements in their price-to-earnings multiples relative to sectors with more exposure to the business investment component of GDP.

Multinationals in the technology, healthcare, and consumer sectors should recognize that a maturing Chinese economy will not necessarily constrain their growth prospects. In fact, across all three of these industries, the implied perpetuity growth rate saw meaningful improvements from 2014 to 2015 even as China lowered its national growth guidance. Thus, China remains a viable jurisdiction for companies in developed markets looking to close the growth gap between expected sales growth and projected GDP growth of their local economies.

Within sectors more sensitive to the deceleration in China's GDP, companies may need to reevaluate their China growth strategy. However, exiting may not be an option since China's economy is likely to remain essential to supplement low and declining growth in developed markets. For example, long-term implied growth rates for the industrials sector in the U.S. and Europe have declined materially this year. In the short run, those companies in industrial and commodity-based sectors will need to find ways to bolster their balance sheet via proactive equity raises, cost control measures, and corporate restructurings.

2. Evaluate the Growth Impact of Commodity Volatility

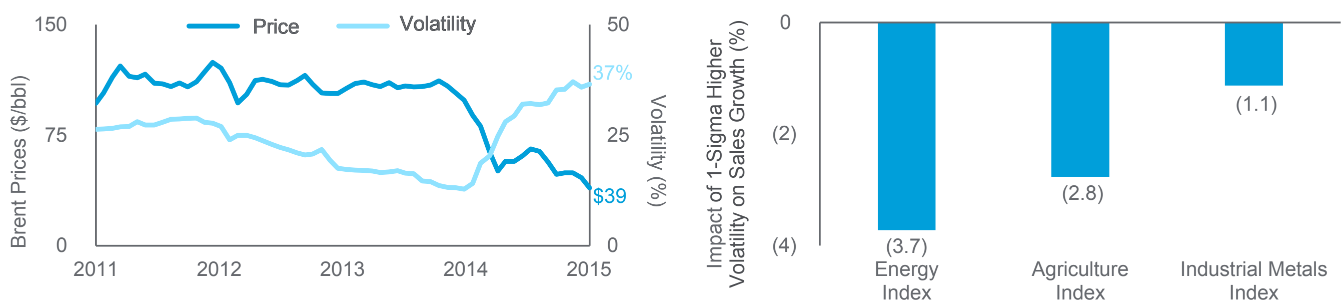
Significant declines in commodity prices have created an imperative for managers to reevaluate their risk management policies for 2016 as aggregate supply and demand dynamics in the last 18 months have led to a simultaneous weakening across many commodities. Correlations between index returns tracking energy, agriculture, and industrial metals have been on the rise, curtailing the benefits of natural diversification and necessitating proactive management of commodity risk exposures.

While conventional wisdom suggests that lower commodity prices benefit commodity consuming firms and constrain commodity producers, the increased commodity price volatility has created an environment where forecasting future cash flows and financial planning becomes a more difficult task for all. Historically, managers often curtail investments during periods of elevated volatility, leading to subsequent declines in revenue growth.

Figure 2. Elevated Commodity Volatilities Pose Headwinds for Revenue Growth

Low Oil Price Coupled with Elevated Volatility[2]

Elevated Commodity Volatility Poses Threat to S&P 500 Sales Growth[3]



Source: Bloomberg and FactSet

Indeed, a closer look at factors driving revenue growth illustrates a negative relation between commodity price volatility and sales growth for S&P 500 firms. Economic environments in which energy price volatility is 10% higher than average correspond to annual revenue growth rates that are 3.7% lower than average. In 2015, we saw Brent volatility skyrocket from 17% to 37%. Near-term option-implied volatilities suggest that uncertainty will remain elevated and revenue growth could be pressured further before oil prices stabilize. Since equity investors have historically exhibited a preference for lower volatility, risk management strategies need to be employed proactively to improve earnings stability and growth.

For producers, the current commodity environment has affected companies across the globe to varying degrees. While the price of Brent is now 65% lower in the U.S. since the beginning of 2014, for companies operating in Australia and Brazil, Brent is only 58% and 43% lower net of currency depreciation relative to the dollar. Such offsetting currency effects have delivered production advantages to overseas producers, while many U.S. producers have been forced to scale back investments and curtail distributions. Although producers may be reluctant to fully hedge at today's prices, option strategies can provide downside protection against certain adverse triggers such as a breach of covenants if commodity prices continue to decline in 2016.

For consumers, as commodity prices remain at the low end of their five-year price distributions, several opportunities exist for companies to strengthen risk management programs as early cycle hedges initiated at higher costs begin to expire. For example, recent oil price declines have made long-horizon hedges particularly appealing. Since 2014, the cost of initiating a one year forward hedge has declined by 32%. Furthermore, layered hedging strategies can allow companies to gradually reduce commodity exposures and diversify timing and execution related risks.

3. Navigate Interest Rate and FX Uncertainty

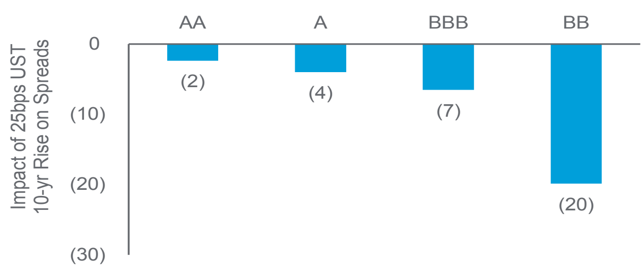
For much of 2015, all eyes were on the Fed as investors and issuers braced for the end of almost seven years of near-zero short-term interest rates. Fed actions certainly matter – especially for corporate funding costs – but we believe corporate executives should adopt a wider lens for two main reasons. First, there are many other forces that could affect corporate funding costs in 2016. Second, the effects of rising rates may extend well beyond just U.S. dollar funding costs.

The Fed influences, but does not control, long-term rates. A 2001 study found that, for every 25 basis point increase in the fed funds rate, the ten-year Treasury yield rose by about 8 basis points on average.[4] According to our analysis, this impact was only about 5 basis points in the period since 2000. A more likely catalyst for higher long-term rates is a stronger U.S. economy.

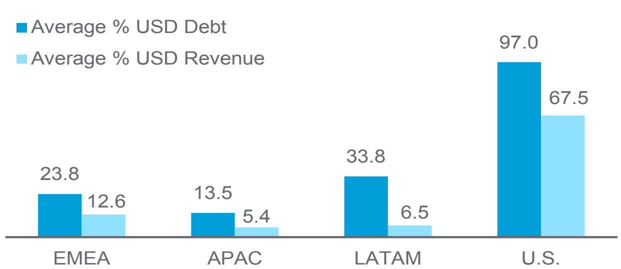
There is significant uncertainty surrounding the trajectory of long-term interest rates: one-quarter of economists project the ten-year Treasury yield ending 2016 below 2.47%; another quarter see it ending above 2.91%.[5] Improving U.S. fundamentals could be offset by global macroeconomic, financial, and regulatory factors, including a slowdown in emerging markets. Continued quantitative easing in the Eurozone or Japan could keep U.S. rates low, given the strong historical rate correlation. Bank liquidity coverage ratio (LCR) requirements could also increase demand for long-term Treasuries, consequently lowering rates and decreasing bank net interest margins. Finally, the changing distribution of Treasury maturities may impact rate dynamics in 2016.

Figure 3. Rising Rates May be Mitigated by Tightening Spreads, but Stronger Dollar can Create Headwinds

Rising Rates Have Historically Resulted in Lower Credit Scores



Wide Variability in Corporate USD Exposures across the Globe



Source: Citi, Bloomberg and FactSet

Higher rates also do not necessarily lead to a one-for-one increase in borrowing costs. Rising rates have on average coincided with tightening spreads, which should moderate the effect on all-in borrowing costs, with the strongest effect for high-yield issuers. Similar to rates, spreads are subject to uncertainty and could widen abruptly as seen in the latter half of 2015.

An equally important effect of higher U.S. rates will likely be in the form of continued strengthening of the dollar. While unwelcome by U.S. multinationals, a strong dollar can benefit many non-U.S. companies with significant sales in the U.S. For example, nearly half of EMEA firms have an average U.S. revenue exposure of 26%, resulting in an average exposure of 12.6% across all EMEA firms. However, a strong dollar can also adversely impact non-U.S. firms with dollar-denominated debt to the extent that this is not offset by operational or financial hedges: 61% of EMEA corporates have USD debt, with an average exposure of 39%.

The prospect of both rising rates and dollar appreciation should spur corporates around the globe to holistically evaluate their approach to risk management. There are opportunities for funding strategies to complement other risk management tools. For U.S. corporates, shifting funding away from dollar-denominated debt could simultaneously blunt the impact of a stronger dollar on revenues and offset higher dollar interest rates. For those pursuing cross-border M&A, proactive hedging strategies to mitigate the impact of FX volatility on deal execution risks may be needed.

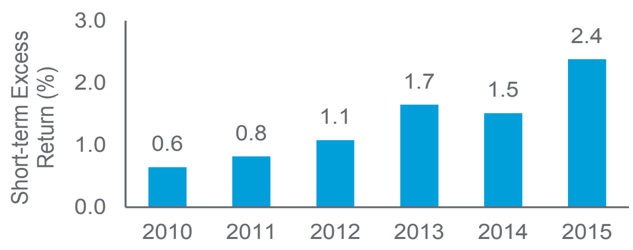
4. Pursue a Disciplined M&A Growth Strategy

Global M&A volume hit a new peak in 2015. Strategic buyers across the globe and across all sectors capitalized on M&A opportunities to transform their businesses as equity valuations and market volatility across developed markets were sustained at attractive levels. The sizeable growth premium, where high-growth companies outperformed their value-oriented counterparts, gave further impetus to M&A as a strategy to drive growth.

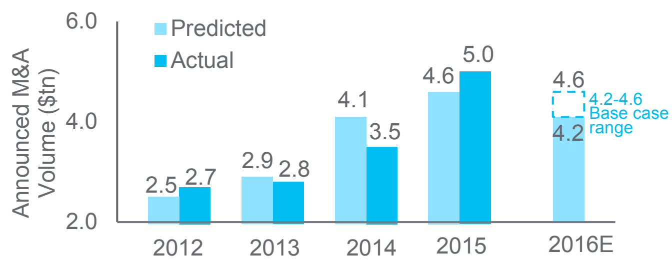
Further fueling momentum, investor receptivity to M&A was the most favorable in recent history. M&A announcements in 2015 were accompanied by a median stock price outperformance around announcement of 2.4% for buyers (-10, +10 day window around announcement), the highest level over the past five years. Cross-border deals were also well-received. Takeovers of U.S. and Western European companies generated a median share price outperformance of 1.5% (-10, +10 day window around announcement) for their international acquirers.

Figure 4. Global Announced M&A in 2016 Expected to Remain Robust

Enthusiastic Investor Receptivity to M&A[6]



Continued Corporate Focus on M&A in 2016[7]



Source: SDC Platinum, Bloomberg, Dealogic and FactSet

Whether this momentum will continue in 2016 will depend on the evolution of equity valuations and market volatility. Assuming these market fundamentals are sustained at the beginning of year levels, 2016 global M&A volume is projected to range from $4.2 to $4.6tn, according to our models. But uncertainty about the market environment implies more downside risk to global M&A volume than upside potential. For example, if the VIX moves to its long-term average of 20%, M&A volume could decelerate to $4.0tn in 2016. Additionally, if the growth premium reverts to its historical average, M&A volume could decline to $3.7tn. In many sectors, the availability of acquisition opportunities will also likely constrain M&A volume.

Much of the growth in global M&A volume in 2015 came from very large and transformational deals. The number of mega deals (transactions over $10bn in value) surged to 69 globally in 2015, the highest level ever recorded. Furthermore, the volume of mega cross-border transactions doubled since 2014 and represented half of all cross-border deals. However, the outlook for mega and cross-border transactions is uncertain – our analysis shows that $10bn+ in value and cross-border deals are particularly sensitive to increases in equity market volatility. Though economic fundamentals continue to be supportive of M&A in technology and healthcare sectors, activity may shift to sectors impacted by the commodity and energy price environment, as well as geographies such as Western Europe that are positioned for recovery.

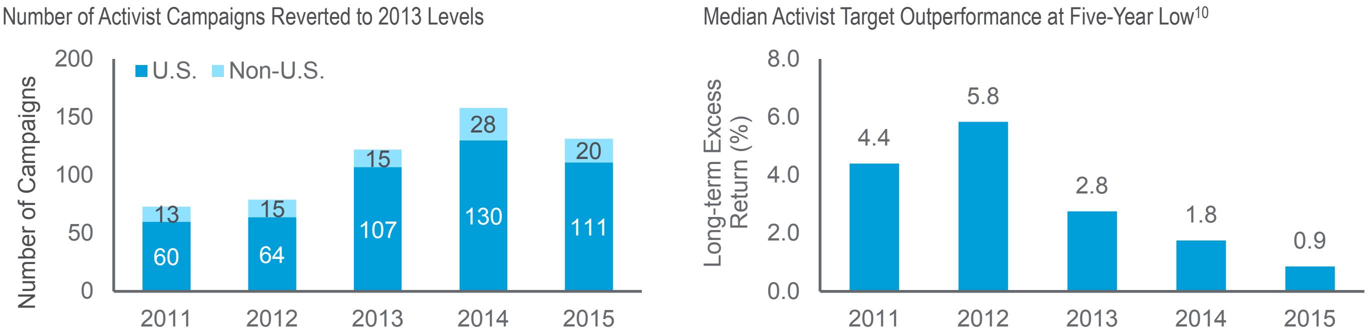
History suggests that the later stages of an M&A cycle yield less favorable returns for buyers. M&A purchase price multiples in 2015 reached prior highs seen in 2007 and there are signs that investor response to M&A announcements might be waning – excess returns for buyers announcing deals in the third quarter of 2015 averaged -0.4%, down from 1.4% in the second quarter and 6.5% in the first quarter (-10, +10 day window). Hence, a key challenge for buyers in 2016 will be the exercise of discipline in the pursuit of M&A.

5. Prepare for Evolving Activist Agendas

After three years of significant growth and outsized returns, shareholder activism leveled off in 2015. The number of campaigns initiated against companies $1bn in market cap and larger reverted to 2013 levels, after more than doubling from 2012 to 2014. Activist hedge funds' assets under management fell in the third quarter for the first time in three years, after growing from $55bn in the second quarter of 2012 to $130bn in the second quarter of 2015.[8] This slowdown notwithstanding, the number of campaigns against megacap targets ($30bn and greater) was still 50% greater in 2015 than in 2013, continuing the trend of increased targeting of megacaps.

Even more striking is the change in how share prices react to the announcement of an activist campaign. In 2012, the median activist target experienced a 5.8% risk-adjusted excess stock return in the 60 days following campaign announcement. Every year since then, however, this number has fallen, and in 2015 the median target only saw a 0.9% long-term excess return.[9] Outside the U.S., excess returns following campaign announcements have been smaller than those in the U.S., playing some role in driving down overall returns.

Figure 5. Campaign Activity has Leveled Off and Target Company Returns have Declined



Source: Citi and FactSet

Declining returns likely reflect the maturing of shareholder activism. Assets under management have grown nearly threefold since 2012 with multiple new funds launched. Activism has also spread globally, with 15% of 2015 campaigns targeting non-U.S. firms. After only three campaigns in 2011-2014, Japan saw four campaigns launched in 2015 alone. In Europe, where most campaigns have focused on restructuring and corporate strategy rather than shareholder distributions, there is still much room for activism to grow.

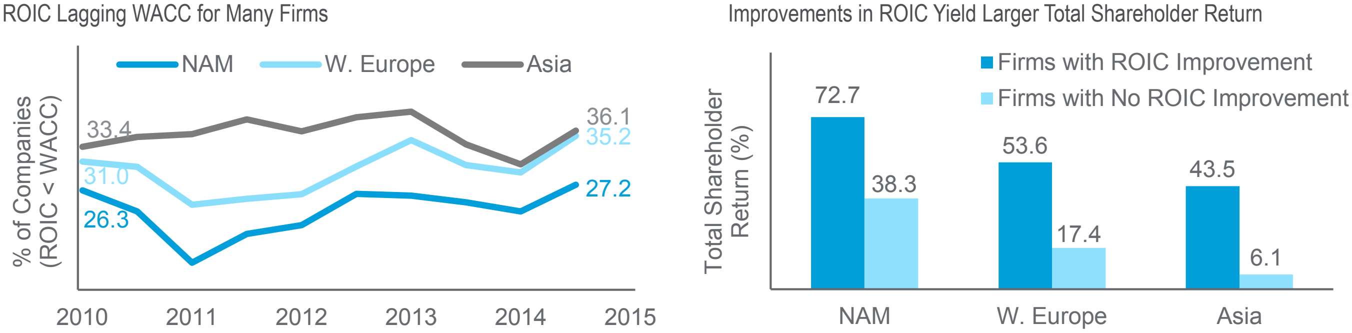
One consequence of a crowded field and lagging returns may be an increased focus by activist investors on aggressive tactics such as seeking board control to directly effect change at target firms. Activists have been more successful in proxy fights, even though their frequency has remained relatively constant. Activists succeeded in just over half of all proxy fights in 2012, but in 2015 they succeeded in nearly two out of every three.[11] Finally, even when an activist is unsuccessful, significant change may follow at the target company. A case in point is Trian's unsuccessful bid for seats on DuPont's board, followed several months later by the CEO stepping down.

Proxy fights have also generated greater returns for the target's shareholders. The median announcement return for proxy fights since 2011 was 8%, nearly two percentage points higher than that of campaigns using other tactics. Our research of shareholder returns over the entire duration of a proxy fight further finds that the median return was greatest when the activist was partially successful (won at least one board seat, but less than half of the seats sought). Interestingly, the median return was negative when the activist won more than half of the seats sought. In light of the above, issues surrounding optimal board composition will likely be important in 2016.

6. Restructure to Improve Capital Efficiency

The slow global growth environment will force corporate executives to be more focused on increasing the efficiency of their capital in an effort to maximize returns. Surprisingly, the gap between median return on invested capital (ROIC) and cost of capital has been on a downward trajectory in Europe, North America and Asia. As a result, one-third of all companies globally did not earn their cost of capital in 2015. Moreover, there is evidence of significant persistence in underperformance with two-thirds of these firms earning returns below their cost of capital in each of the past three years.

Figure 6. Return on Invested Capital Necessitates Many Companies to be Proactive in Restructuring[12]



Source: SDC and FactSet

For companies where ROIC falls below their cost of capital, improving operational performance should be a higher priority than seeking growth. Companies experiencing declining ROIC over the last three years delivered 35% lower shareholder returns than those that managed to improve their ROIC over the same period. In addition, divestitures that led to an improvement in ROIC (i.e. divestment of lower return assets) experienced higher excess returns on announcement.

Although the focus on efficient capital deployment in 2016 is likely to be a global theme, in some sectors and geographies there is a higher level of urgency. Companies in Europe and Asia will need to pay closer attention as both regions lag North America in terms of ROIC trends. Some sectors are in better shape than others. ROIC declines were the smallest in the consumer, industrials and technology sectors, all of which underwent a significant amount of restructuring activity recently. Some sectors such as energy will be forced to restructure in 2016, while high valuations in others make it attractive for companies to monetize their holdings (e.g. infrastructure-type assets that command high valuations).

When returns are declining, the obvious response is an increased focus on improving profitability. However, we find that declines in ROIC are more frequently caused by an expansion of invested capital than a decline in profitability. Hence, at least part of the solution lies in optimizing the levels of invested capital, which can be accomplished by asset divestitures and a reassessment of capital expenditure programs.

Companies will need to be proactive in initiating restructuring programs since the timing of restructuring matters. Companies engaging in divestitures, especially in Europe, tend to do so after a significant compression of the ROIC-WACC spread. Companies that engage in restructuring earlier, in an effort to improve their ROIC, tend to do better. We find that excess returns on the announcement of divestitures are higher when companies do not wait until either the sector's or the company's ROIC is low. In other words, if a company's ROIC is lagging its sector peers, or the sector's ROIC is low relative to prior years, divestiture announcement returns tend to be smaller. In summary, proactive restructuring transactions to optimize and maximize the return on invested capital deployed are likely to be rewarded by equity investors in 2016.

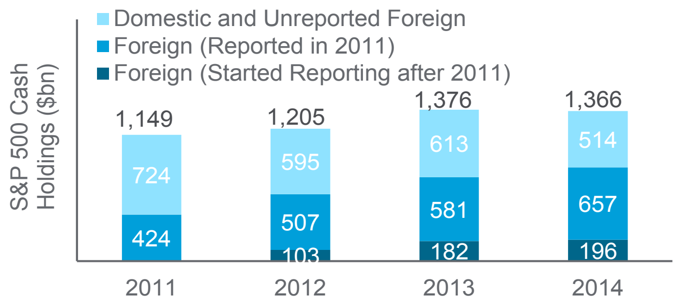
7. Deploy Foreign Cash to Enhance Returns

Foreign cash holdings for U.S. companies have grown at an extraordinary pace. At year-end 2014, S&P 500 companies held an estimated $850bn of their cash in foreign subsidiaries – more than 60% of their total cash holdings. Foreign cash holdings have grown despite the fact that U.S. companies have repatriated a third of their foreign earnings since the 2005 repatriation holiday and reinvested at least half of the remainder according to data from the Bureau of Economic Analysis.

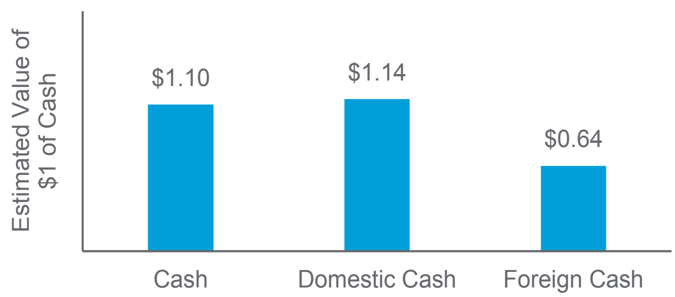
As foreign cash balances grow larger and uncertainty around U.S. tax reform remains, the question of what value investors are ascribing to foreign cash becomes important. Does a dollar of foreign cash translate into a dollar of firm value? Further, with the wave of activist campaigns pressuring companies to distribute excess cash, the question of how and when to optimally deploy foreign cash takes on added importance.

Figure 7. Growing Foreign Cash Balances Highlight the Need for an Optimal Deployment Strategy

U.S. Corporate Cash Holdings Abroad Keep Rising[13]



Equity Investors Ascribe a Lower Value to Foreign Cash Holdings[14]



Source: FactSet and company filings

Our statistical analysis suggests that an incremental dollar of total cash translates into an incremental $1.10 of firm value. Further, according to our estimates, an incremental dollar of domestic cash translates into an incremental $1.14 of firm value. For foreign cash, the estimate is only $0.64, suggesting that investors do, on average, value foreign cash less than they value domestic cash. For some companies, the $0.64 estimate of the value of foreign cash is very close to that implied by the tax cost they would face when repatriating their foreign cash. Investors appear to be valuing foreign cash at close to its (tax-adjusted) value. For example, in their most recent annual filings, Apple and Microsoft estimate that they would owe about a third in U.S. taxes if they were to repatriate their indefinitely reinvested foreign earnings. However, the average S&P 500 company, taxed at 21% on its foreign earnings, could boost its value via some repatriation.

Since the accumulation of excess foreign cash may adversely affect value, companies need to proactively consider reinvestment in foreign operating assets or strategic opportunities that can be value-enhancing. Due to the tax deferral, foreign earnings can be an inexpensive source of funding for foreign investments. In fact, the appropriate hurdle rate for a foreign investment is often significantly lower when funding with foreign earnings than using domestic funding sources due to the lower opportunity cost of foreign cash. For example, a U.S. firm with a cost of capital (hurdle rate) of 8% and foreign tax rate of 10% will need to meet a lower hurdle rate of 5.8% when funding a foreign investment with foreign cash.

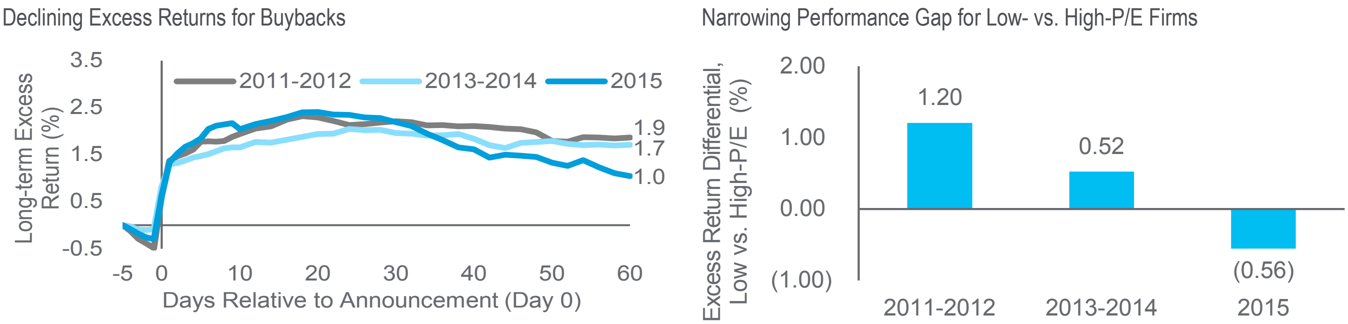
Our analysis of the recent market response to announcements of cross-border M&A transactions shows that, on average, U.S. firms with large foreign cash balances experienced higher share price appreciation when acquiring a foreign target relative to a domestic acquisition. These findings are illustrative of the hurdle rate advantages U.S. firms with foreign cash may enjoy when pursuing overseas growth opportunities.

8. Recalibrate Shareholder Distribution Strategy

Shareholder distributions continued their upward trajectory in 2015 throughout all major geographies, reaching $820bn for the S&P 500, $423bn for the STOXX 600, and $283bn for the MSCI APAC (ex-Japan) in 2015. In the U.S., buyback authorizations rose to $887bn in 2015, up 32% from 2014. Large cash balances and pressure by activist investors continued to drive the growth in distributions. This growth also reflects the tendency of firms to increase payouts when overall valuations are robust.

Share buybacks may serve as a signal that management views the company's stock to be potentially undervalued. But when repurchase activity rises in concert with overall market valuations, the undervaluation signal weakens. Our analysis suggests that this was the case in the U.S. – for each of the past five years, the share price outperformance following a buyback announcement has declined steadily. In 2015, long-term excess returns following buybacks averaged 1.0%, down from 1.9% in 2011-2012.

Figure 8. Declining Share Price Outperformance following Share Repurchase Authorizations in the U.S.[15]



Source: FactSet

Furthermore, conventional wisdom suggests that buybacks are a more meaningful signal when valuation multiples are low. However, in 2015, the buyback return differential for low-P/E firms has essentially disappeared, continuing the declining trend observed in recent years. However, share repurchases in the U.S. continued to be viewed positively in the context of excess capital deployment – repurchasing firms with high cash balances outperformed those with lower cash balances. Outside the U.S., particularly in Western Europe, buybacks may remain a valuable tool for both signaling valuation and deployment of excess cash.

In 2015, dividends accounted for a sizeable portion of the total capital distributions to investors in the U.S. and Europe – 41% for S&P 500 firms and 85% for STOXX 600 firms. Dividend increases were viewed positively by the markets with an average long-term excess return of 0.4% in the U.S. and 3.1% in Europe in 2015. Historically, yield-oriented investors tend to find higher dividend payouts attractive especially in a low-rate environment. Reflecting this, excess returns around dividend increase announcements in the U.S. have been higher for low P/E firms in the past three years (characterized by low rates), but the gap narrowed significantly in 2015. During episodes of heightened market volatility, similar to what we experienced in 2015, dividend increases tend to lead to similar levels of price appreciation for both value and growth-oriented firms.

These trends suggest that in 2016, deploying capital to grow earnings organically or through M&A will be a more effective path to valuation enhancement than repurchases for many firms, unless the undervaluation story is highly credible or the firm has substantial excess cash. For firms with excess liquidity and cash flows which are relatively immune from severe shocks, increasing dividends is likely to be rewarded by markets, particularly if market volatility resurfaces in 2016. In such an environment, even high-growth firms may benefit from considering dividend payouts to promote stability of investor returns.

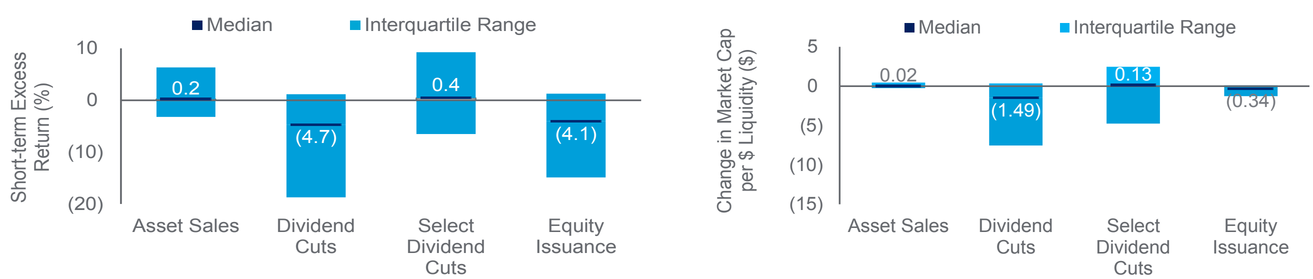
9. Defend the Balance Sheet

There were signs of weakening corporate balance sheets in 2015. Globally, net debt-to-EBITDA rose by 50% above 2010 year-end levels. In North America, high-yield bond covenant quality deteriorated.[16] At Standard & Poor's, global downgrades outnumbered upgrades nearly two-to-one. Moreover, there is increasing divergence within the high-yield universe. The spread differential between the top and bottom quartile sector stands at 4.1% today versus the 1.7% post-crisis median.[17] Heightened regulatory capital requirements and illiquid capital markets are also likely to affect high yield issuers that rely on bank credit.

The energy and materials sectors were particularly challenged. The financial policy decisions of firms in these sectors in response to market dislocations provide key lessons for other corporates.

Figure 9. Asset Sales are a More Attractive Way to Bolster Liquidity than Other Alternatives[18]

Equity Market Reaction to Capital Preservation Alternatives | Significant Variation Per Dollar Cost of Incremental Liquidity[19]



Source: FactSet

Asset sales can boost liquidity and enhance value. Although management may be wary about selling assets at fire-sale prices, in practice these transactions experienced a 0.2% (2.3%) median (average) stock price outperformance around announcement. Accordingly, asset sales – at least sales of non-core assets – can be an important source of liquidity. And, as we highlight in the section on restructuring, an asset sale early in a down cycle will likely be received more favorably.

The market response to dividend cuts varies widely. A few energy and materials companies cut their dividends in 2014-2015, resulting in a 4.7% median underperformance around announcement. For the vast majority of these companies, however, these cuts were announced concurrently with other corporate news (usually earnings). Our analysis of a broader sample of dividend cuts announced in isolation from other announcements finds a negligible median stock price reaction. The signaling effect surrounding these announcements can vary depending upon the strategic rationale and other available capital-raising alternatives. A dividend cut may be the right solution when other alternatives are less attractive.

While equity raises can be expensive, timely issuance can mitigate overall costs. A number of energy and materials companies issued equity to shore up their balance sheets in 2014-2015, representing 11.1% of market capitalization for the median firm. These efforts were costly: around announcement, the median firm's stock price underperformed by 4.1%. For every dollar raised, this underperformance translates to a $0.34 reduction in market value. However, E&P companies that historically accessed the market early in a sector downturn outperformed those who issued later by 5%. In some situations other alternatives such as corporate hybrids and mandatory convertibles may also be cost-effective.

Cutting capital expenditures and share repurchases is rarely sufficient to counter a decline in cash flows. In some cases, there may even be a compelling case for maintaining capital expenditures. Regardless, dividend cuts, equity issuances, and asset sales take on increased importance.

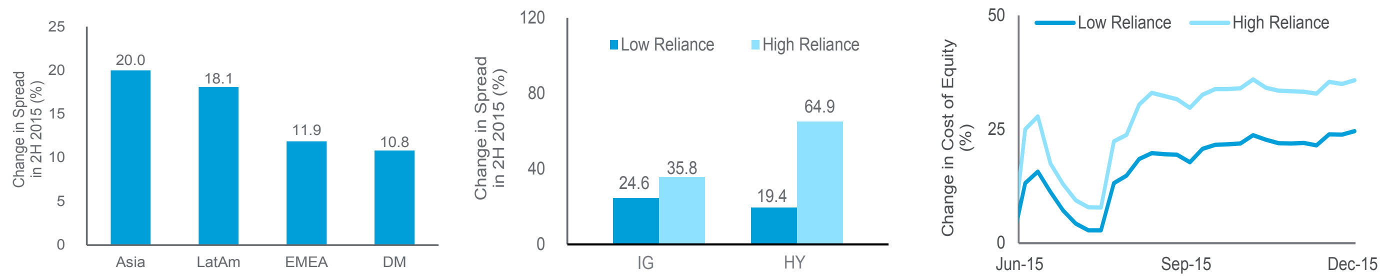
10. Navigate the Pressures on EM Banks

Amid continued macroeconomic uncertainty, the aggregate asset quality of the banking system in the EM has deteriorated over the past twelve months. The ratio of nonperforming loans for EM banks has increased by over half a percentage point in 2015 to 2.6%. In contrast, over the same time period, DM banks have been improving the credit quality of their balance sheets with non-performing loans declining to 1.1% in Q3 2015.

Reflecting this trend, credit spreads for EM banks have widened considerably, particularly in Asia and Latin America. At the same time, corporate credit spreads have increased meaningfully, a manifestation of the feedback loop between the corporate and the financial sectors. In particular, EM corporates with high reliance on bank credit have experienced much greater increases in credit spreads in 2H 2015, with IG and HY corporate spreads increasing by36% and 65%.

Figure 10. Banking Pressures in EM Happening Concurrently with Rising Credit Spreads and Cost of Equity for EM Corporates

Rising Spreads for Asian & LatAm Banks[20] Increasing Spreads for Bank-Reliant EM Firms[21] Increase in COE for Bank-Related EM Firms



Source: Dealogic, Bloomberg and FactSet

A key implication of this divergence in credit spreads is the need for EM corporates that are highly reliant on bank credit to pay close attention to members of their bank group and consider alternatives to traditional bank lending, including capital market alternatives and structured solutions. Such solutions, which include tradable collateral (e.g. bonds, equities, or commodities) or securitization, can provide funding at lower rates via conversion of credit risk to market risk, as well as hedging possibilities against commodity or local currency risks. Currently elevated EM currency basis swap levels may make local funding particularly attractive when borrowing in local currency from off-shore banks.

Widening financing costs are not limited to the debt markets; in the second half of 2015, equity betas for highly bank-reliant corporates have increased by 55%, leading to a 36% increase in their cost of equity. Greater debt and equity financing costs are increasing the hurdle rate differentials of high versus low bank-reliant corporates, consequently impacting their relative competitive positioning in their sectors.

Ongoing pressures on many banks to bolster capital levels, generate returns over their cost of capital, and shrink balance sheets require corporates to remain vigilant and prepare for the possibility of bank liquidity suddenly drying up. A closer look at the credit spread dynamics highlights the urgency of funding diversification, especially if we expect to see continued pressure on EM economies and the banking system.

Given that bond issuance is much more challenging during periods of market stress and heightened leverage, it is imperative that corporates proactively manage their capital structure through the cycle and diversify their funding sources in anticipation of tail events. Evaluating the cost-benefit trade-off of other defensive measures to bolster the balance sheet – ranging from raising equity early in the cycle to asset divestitures – also needs to be carefully considered. Please see Defend the Balance Sheet section for additional information.

Endnotes

[1] Market-implied perpetuity EPS growth calculated based on forward P/E multiples and firms' cost of equity.

[2] Historical Brent prices are monthly averages of daily prices. Historical annualized volatility is calculated using weekly returns of Brent over rolling 52 week period.

[3] Analysis based on the impact of a one standard deviation increase in annualized weekly volatility of the respective commodity on subsequent quarter's S&P 500 revenue growth, controlling for index levels. Annualized volatility calculated using weekly index returns obtained from Bloomberg.

[4] Kenneth N. Kuttner (2001), "Monetary policy surprises and interest rates: Evidence from the Fed funds futures market," Journal of Monetary Economics.

[5] Federal Reserve Bank of Philadelphia (November 13, 2015), Survey of Professional Forecasters, Fourth Quarter 2015. Forecast is for average during fourth quarter of 2016.

[6] Excess return calculated as the median risk-adjusted return of the acquirer over the respective local index around announcement (-10 to +10 days) of all global M&A transactions over $500mm from 2010 to 2015.

[7] Predicted volume as per Citi's proprietary M&A prediction model, based on a statistical relation between M&A volume, equity market performance, market volatility, and returns to growth versus value stocks. Predicted range based upon median and end of year VIX in 2015.

[8] Data is from Hedge Fund Research.

[9] Long-term excess return calculated as the median risk-adjusted return of the target around announcement (-5 to +60 days) of all global activist campaigns that targeted companies of market cap greater than $1bn.

[10] Long-term excess return calculated as the median risk-adjusted return of the target around announcement (-5 to +60 days) of all global activist campaigns that targeted companies of market cap greater than $1bn.

[11] Success rate defined as the number of outright victories, partial victories, or settlements as a percentage of all proxy fights where an outcome has been reached.

[12] Analysis based on MSCI World Index. Return on invested capital is calculated as [EBIT-tax expense-tax rate%*(EBIT-pretax income)]/(average invested capital-average cash).

[13] Analysis based on 385 S&P 500 non-financial non-utility constituents as of Dec 31, 2014. Among them, 138 companies have reported foreign cash since 2011.

[14] Analysis based on the methodology in Lee Pinkowitz and Rohan Williamson, "What is the Market Value of a Dollar of Corporate Cash?" Journal of Applied Corporate Finance, Summer 2007.

[15] Cumulative excess return measured as average market-adjusted return over the (-5, +60) day window. High and low P/E firms correspond to above and below median P/E ratio prior to announcement. Low vs. High P/E buyback premium calculated as the excess returns gap between low and high P/E firms.

[16] Moody's Investors Service (October 13, 2015), North American Covenant Quality Index.

[17] Interquartile range based on the yield to worst of the 39 high yield sector/subsector indices tracked by Citi. Post crisis period is defined as 2010-2015.

[18] Citi analysis of global asset sales greater than $500 million, U.S. dollar follow-on equity issuances not related to M&A with all proceeds going to the company, and S&P 500 dividend cuts, all by energy and materials companies during 2014-2015. Select dividend cuts are those of all S&P 500 companies in 2006-2015, excluding those announced concurrently with other significant corporate news (mostly earnings).

[19] The cost of raising liquidity is calculated by dividing the implied change in a company's market value based on its cumulative excess return over the (-10, +10) day window around announcement by the amount of liquidity raised via an asset sale, annual dividend savings from a dividend cut, or an equity issuance.

[20] EM sample includes MSCI Emerging Markets countries. DM sample includes the U.S. and W. Europe. EM bank sample includes the five largest banks in each country and region; DM bank sample includes the ten largest banks in each region. Credit spreads for banks include all USD-denominated bonds with around five years of remaining maturity.

[21] Reliance on bank credit categorized based on whether a given corporate's ratio of bank loans to total debt was greater than or less than the median ratio for the country. Credit spread sample includes all USD-denominated bonds issued by EM corporates since 2005, with around ten years of remaining maturity.

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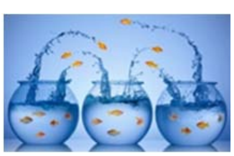

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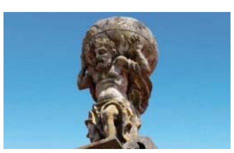

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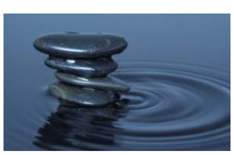

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