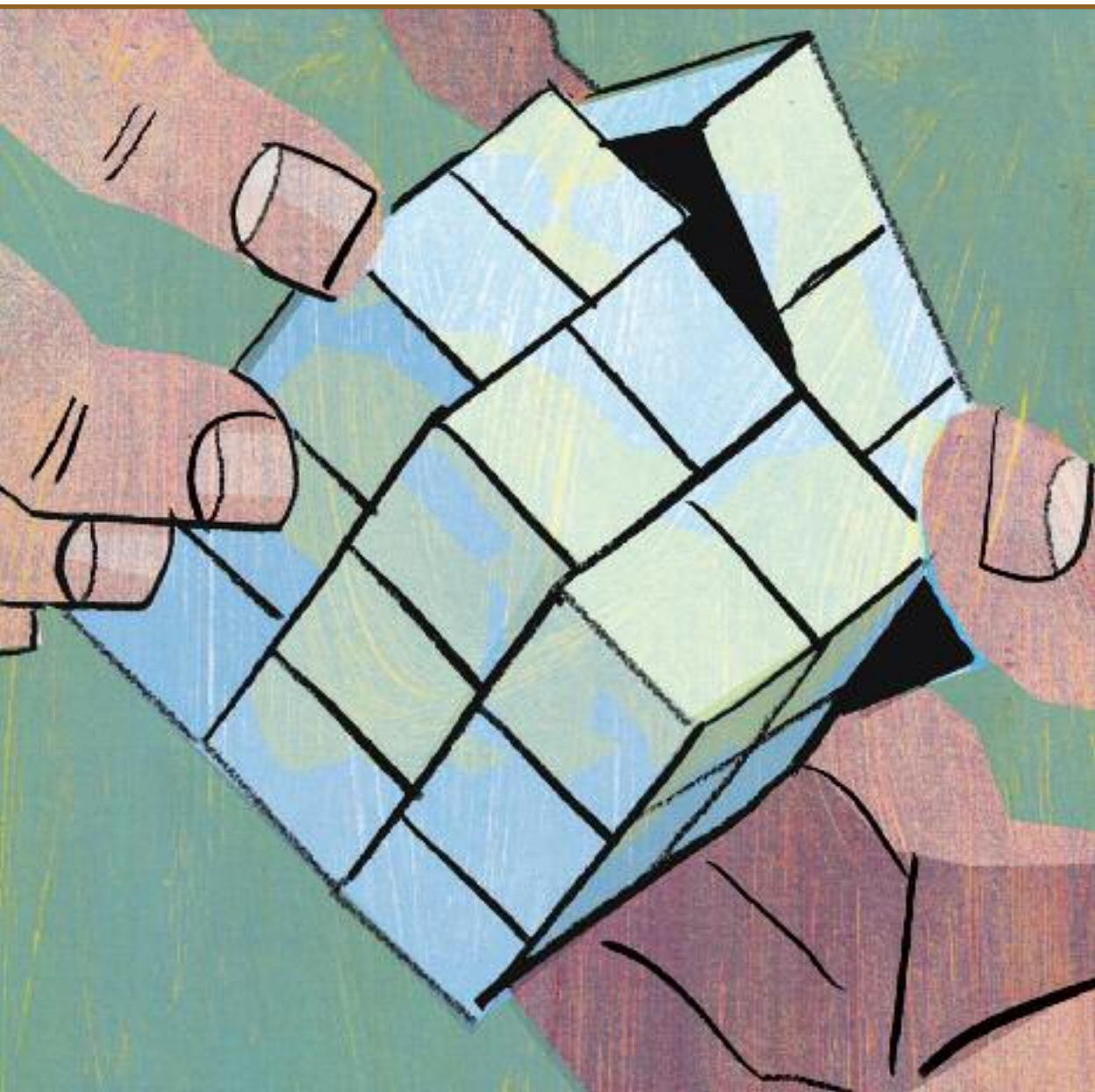


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A new decade, a new primer for growth

Considerations for managing growth in a *Bimodal Global Economy*

J.P.Morgan

Marc Zenner
marc.p.zenner@jpmorgan.com
(212) 834-4330

Akhil Bansal
akhil.bansal@jpmorgan.com
(212) 270-3412

Tomer Berkovitz
tomer.x.berkovitz@jpmorgan.com
(212) 834-2465

Evan Junek
evan.a.junek@jpmorgan.com
(212) 834-5110

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A new decade, a new primer for growth

The global economy is convalescing from one of the most severe recessions in recent memory. Capital markets are cheering this recovery with both credit and equity markets rebounding vigorously from lows in early 2009. Previous recoveries suggest severe recessions are followed by steep rebounds in economic growth. Yet, with high unemployment, excess production capacity, shrinking consumer credit and a rising savings rate, many decision-makers fear that growth rates in developed markets will be anemic in the first years of the new decade. These fears are further reflected in the International Monetary Fund's GDP growth estimates of only 1.5% -2.5% for advanced economies over the next 5 years.

How should decision-makers respond to an environment of anemic growth and significant economic risk? Should firms aggressively increase their exposure to markets with higher growth expectations such as emerging economies? What financial policies should a firm consider when facing a slower growth environment?

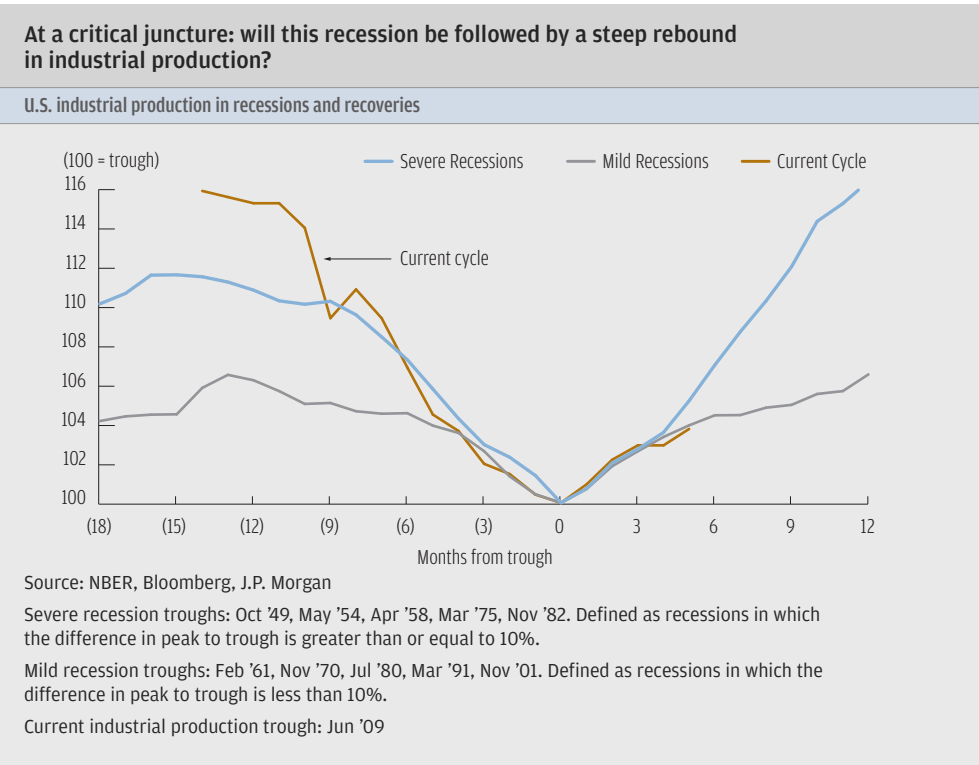
Growth expectations are key drivers of valuation multiples and financial policy decisions. For example, today's S&P 500 forward P/E multiple of 14x would decline to about 11x if expected growth dropped by 2 percentage points. For some firms the best strategy to mitigate a contraction in P/E multiples may be to grow via organic or M&A driven cost cutting, innovation or by entering new and emerging markets. Other firms may be better off implementing financial policies that reduce their perceived risk and provide more predictable total returns.

We believe that there are 4 growth challenges in 2010 and beyond: (1) Growing the bottom line without top line growth; (2) pursuing strategies for top line growth; (3) adapting financial policies to a low growth environment; and (4) coping with strategic risk in a low-growth environment. Decision-makers should adopt a strategy that will succeed in a macro-economic environment split between anemic growth in OECD countries and rapid growth in emerging markets. We call this environment the *Bimodal Global Economy*.

Signposts of the *Bimodal Global Economy*

A significant crossroad: As Figure 1 illustrates, recessions have typically been followed by steep rebounds in industrial production, with the most rapid increases in industrial production succeeding more severe recessions. The economy is now at a significant crossroad that will either soon verify or disprove the notion of a *Bimodal Global Economy*. Will the economy have the expected steep rebound as the initial data suggest, or will growth be anemic as the recent flattening of the industrial production line implies?

Figure 1



The long winding road to full employment: The current high unemployment level is a major concern for corporations and policy makers alike. About 70% of the pre-crisis U.S. economy was consumer driven. Consumers are not likely to return to their pre-crisis spending levels if they are unemployed or fear becoming unemployed. According to “Okun’s law”¹ if peak unemployment reaches 10%, the economy would require 16 quarters of 5% growth to return to a 6% unemployment level. This may be challenging to achieve, considering that the economy has experienced growth of 5% or more in only 10 of the last 80 quarters. In fact, when including part-time workers who are seeking full-time jobs and laid-off workers who have given up looking for work, “underemployment” is over 17%.² These estimates suggest that growth may be challenging for firms reliant on consumer spending in advanced economies over the near term.

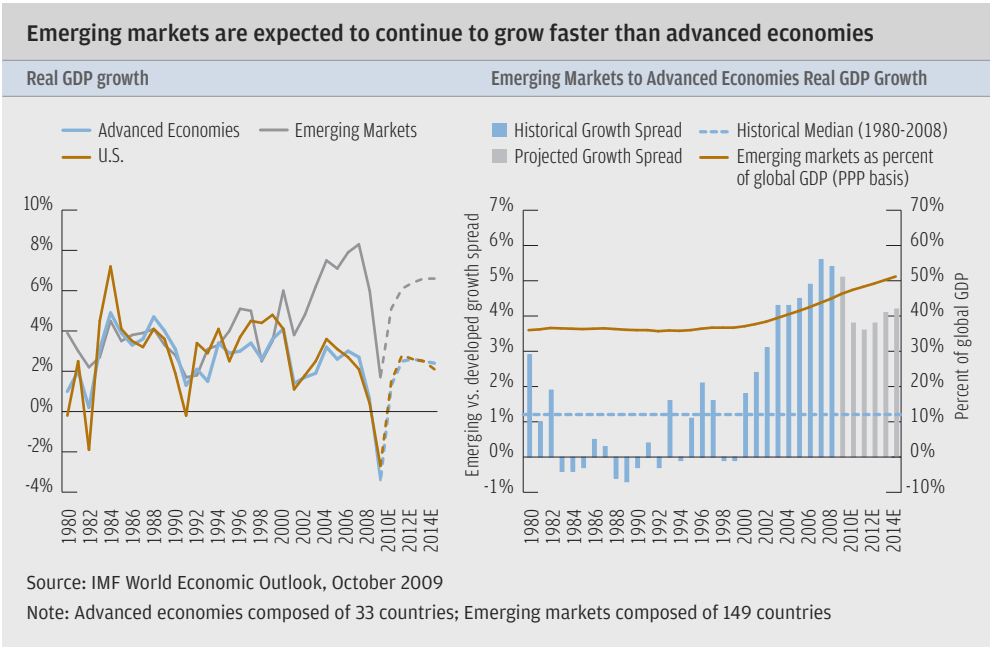
¹ Okun’s law describes an empirical relationship between the change in the unemployment rate and real output growth (GDP). The “difference version” of the law suggests a 1% improvement/decline in GDP (over 2.5% growth rate, which is the required growth rate to maintain the natural unemployment level of 5%) corresponds to 0.4% decrease/increase in unemployment.

² Source: U.S. Bureau of Labor Statistics. Underemployment is defined as the sum of workers who are unemployed, marginally attached, and part time employed for economic reasons as a percent of the civilian labor force plus all marginally attached workers.

Emerging markets or emerged markets? While many market participants expect anemic growth over the next few years in developed markets, prospects for growth are more favorable in emerging markets. While advanced economies dipped into a recession in 2008-2009, emerging economies avoided a recession by maintaining positive, albeit lower, GDP growth. As illustrated in Figure 2, the past decade has most certainly been the decade of the emerging markets. In the 1990s, growth in emerging markets was comparable to or slightly higher than growth in developed markets. In the first decade of the 21st century, however, emerging market growth has been about 3 to 4 percentage points higher than developed market growth. Further, economists expect this real growth difference of approximately 4 percentage points to continue over the next five years.³

While the expected rapid growth in emerging markets suggests these economies are likely to attract investments from multinational companies, many question whether the purchasing power of consumers in these economies is sufficient to materially affect the growth of firms in advanced economies. Empirical data suggest that the share of global GDP (on a purchasing power basis) generated by emerging economies increased from 36% in 1980 to 45% in 2008 and is expected to grow to 51% by 2014.⁴ However, the scarcity and cost of consumer credit in emerging markets may impact consumer purchasing power in those economies.

Figure 2



EXECUTIVE TAKEAWAY

Growth is expected to be weak in the advanced economies. Emerging markets, however, are projected to generate robust growth in the next five years and could represent over 50% of the world’s purchasing power by 2014.

³ Source: IMF World Economic Outlook, October 2009.

⁴ IMF data; share of emerging markets of the global economy on a nominal basis is 31% and projected to increase to 36% by 2014.

The growth challenges ahead

What are the four growth challenges for 2010 and beyond?

(1) Growing the bottom line without top line growth. Unprecedented cost cutting during the credit crisis has allowed firms to mitigate declines in their operating and net income margins despite sharp declines in their revenue. As companies reach the end of the cost cutting cycle in 2010, incremental cost savings may be realized via mergers where redundant costs and functions can be eliminated. Realization of these savings will be maximized in transactions where companies with significant overlap combine. This quest for acquisition targets will further enhance the competition between cash-rich strategic buyers and cash-rich private equity firms.

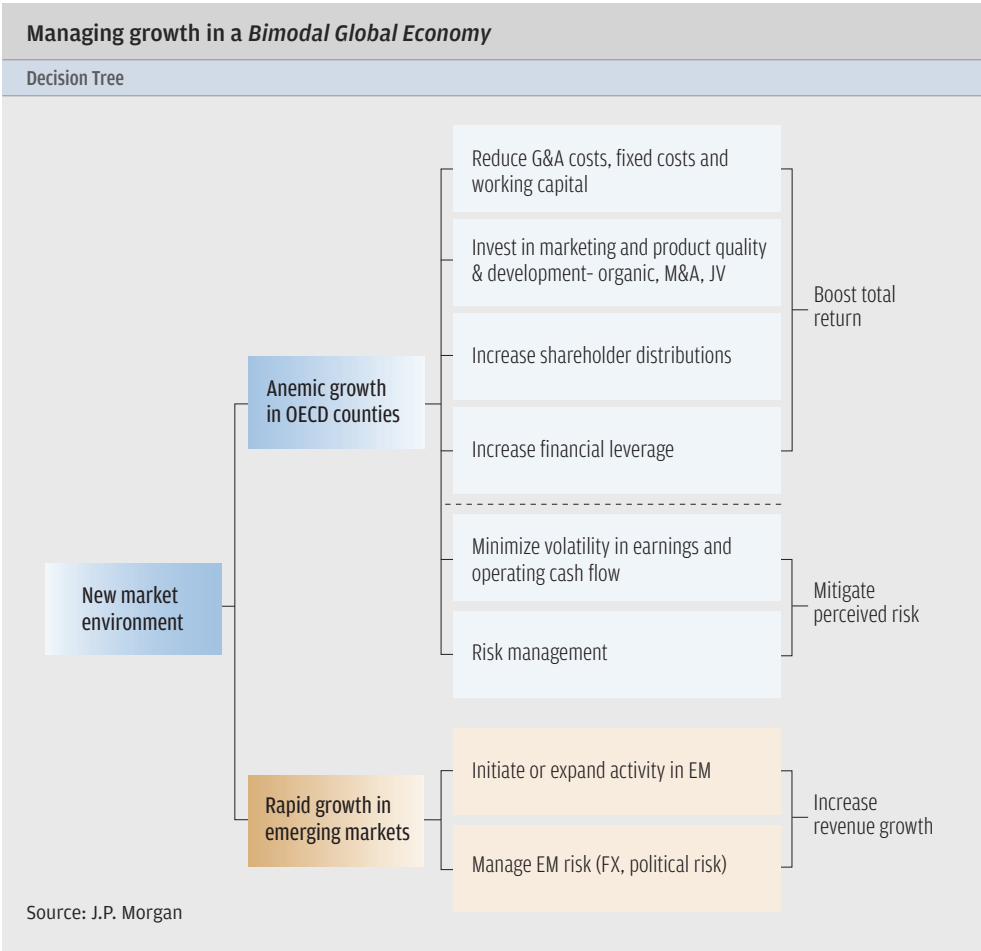
(2) Pursuing strategies for top line growth. If top line growth is anemic in developed markets, firms can either capture market share from weaker competitors, or focus on emerging market growth (via greenfield or acquisitions) where revenue growth expectations are significantly higher. We highlight the main concerns about investing in emerging markets today.

(3) Adapting financial policies to a low growth environment. Firms should only pursue growth to the extent it creates shareholder value. In some sectors, the best shareholder strategy may include reducing investment spending and increasing shareholder distributions. Firms can mitigate the negative effect of reduced growth expectations by reducing the perceived risk of their company. Lower volatility in earnings and operating cash flow, accompanied by more predictable total returns, can support a company's valuation when growth is anemic.

(4) Coping with strategic risk. Dealing with weak growth entails a number of risks that need to be monitored closely. Today's low growth environment favors risk mitigation because of the following characteristics: (1) vulnerable bottom lines; (2) seeking growth in new products and in new markets; (3) new financial policies; (4) the low cost of financial insurance; (5) a fragile financial system; and (6) the potential for the next "bubble."

Figure 3 summarizes the framework we believe companies should use when thinking about growth in a *Bimodal Global Economy*.

Figure 3



EXECUTIVE TAKEAWAY

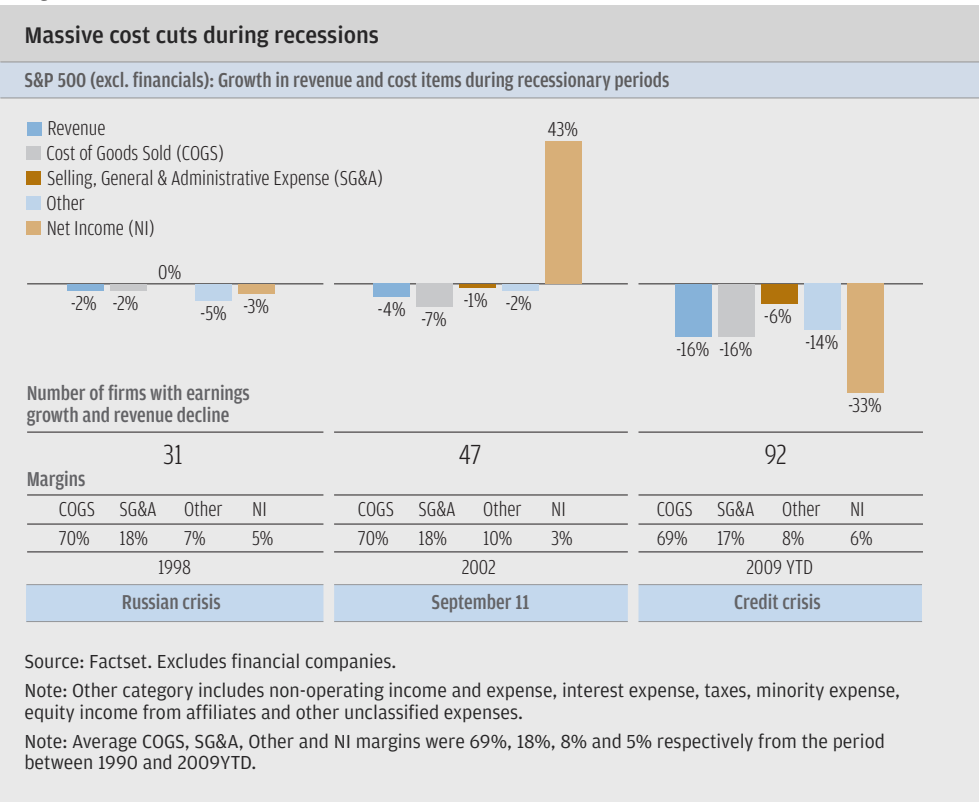
Companies face four growth challenges in the new decade: (1) Growing the bottom line without top line growth; (2) pursuing strategies for top line growth; (3) adapting financial policies to a low growth environment; and (4) coping with strategic risk in a low growth environment.

1. Growing the bottom line without top line growth

When revenue is stagnating, firms often focus on efficiency and productivity gains to generate bottom line growth. For example, meaningful cost cutting helped 92 S&P 500 non-financial firms achieve earnings growth without revenue growth during 2009, as compared to only 31 and 47 firms during the Russian Crisis and following the events of September 11th, respectively. This compares to only 21 firms, on average, that achieved earnings growth without revenue growth during non-recessionary periods since 1990.

Despite this cost cutting, the S&P 500 as a whole saw its 2009 YTD earnings drop 33% from the comparable period in 2008 as firms were unable to cut SG&A costs as quickly as revenue was declining. Previous crises suggest, however, that the effect of cost cutting on the bottom line is more pronounced in the years following a recession, as the benefits of operating leverage are realized from higher revenues on a lower fixed cost base. Nonetheless, this unique focus on efficiency has successfully sheltered firms from even larger earnings declines.

Figure 4

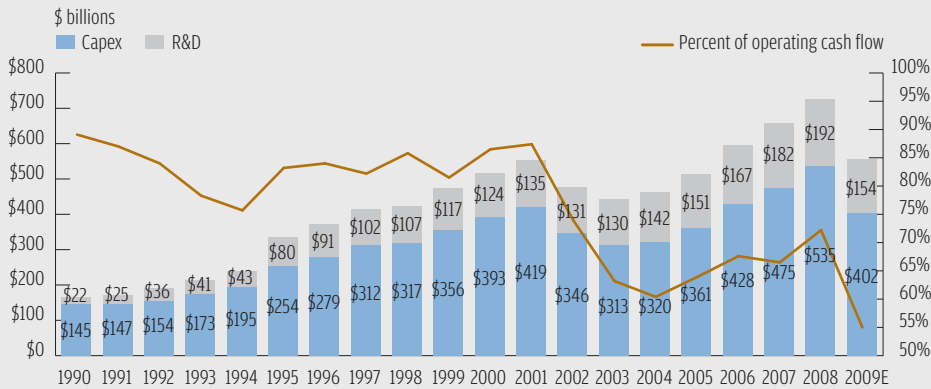


Growing cash balances: S&P 500 firms have cut capex and R&D by unprecedented amounts, from 72% of operating cash flow in 2008 to 55% in 2009. These cuts, together with efficiency gains, improved working capital management, and capital raises, have led to a build-up of cash and short-term investments (henceforth cash) of almost \$1 trillion for non-financial S&P 500 firms alone. Cash grew from 8.6% to 10.3% of assets from early 2007 to September of 2009. In the first three quarters of 2009 alone, cash increased by \$157 billion. The second largest comparable increase was \$106 billion during full-year 2004. A weak dollar has also contributed to high cash balances by boosting overseas profits and leading companies to keep cash offshore for tax reasons.

Figure 5

Capex and R&D at 20-year low relative to cash flow

S&P 500 (excl. financials): Capital expenditures and R&D from 1990



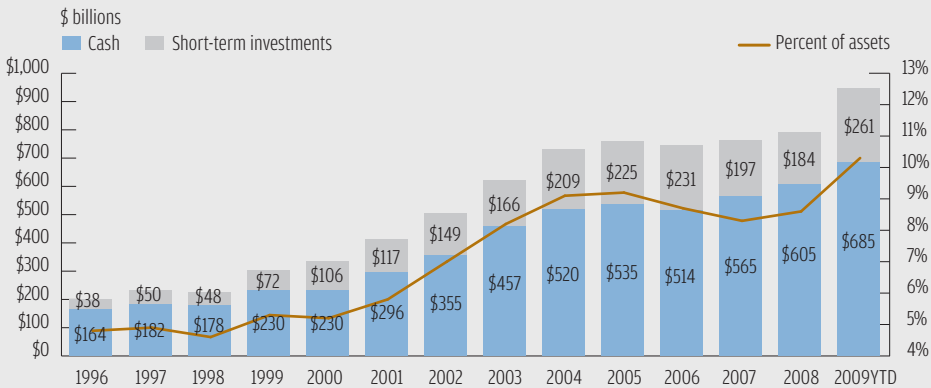
Source: Factset. Excludes financial companies.

Note: Q4'09 Capex, R&D and OCF estimated as a margin of Q4'09 revenue consistent with Q3'09. S&P 500 Q4'09 revenue estimated using IBES consensus medians.

Figure 6

Historic high cash balances for corporate America

S&P 500 (excl. financials): Cash and short-term investments from 1996



Source: Factset. Excludes financial companies.

Acquisitions as a path to bottom line growth: In the absence of organic opportunities to boost growth, mergers often provide a compelling path to bottom line growth through cost synergies. Several factors are likely to fuel the use of mergers as a tool to enhance bottom line growth in 2010: (1) the record-high cash balances we discussed previously; (2) the much improved capital market conditions which reduce financing uncertainty; (3) an environment that will enable mergers and acquisitions to provide top line growth by accelerating access to new (emerging) markets and or products; and (4) a “catch-up period” for transactions postponed over the last two years because of the crisis.

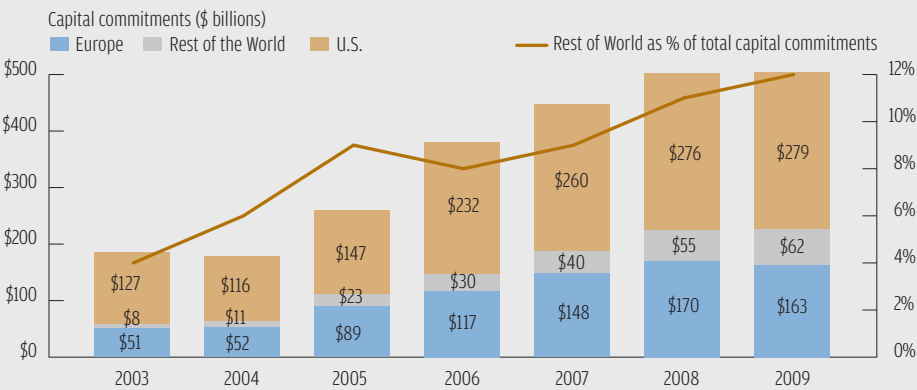
Private equity: As in 2006-2007, we expect that private equity firms will once again be competitive bidders for assets against strategic buyers. Their presence in auctions is likely to increase the price strategic buyers will pay for assets that achieve their growth objectives. Factors which will drive private equity participation include: (1) improved capital markets conditions, particularly in the leverage markets; (2) private equity’s core strength of improving the cash flow generation of slow growing businesses; and (3) record-high equity capital committed to private equity.

Figure 7 indicates that, similar to large public firms, private equity firms have record-high firepower with current capital commitments of about \$500 billion. These balances are at record-high levels on the heels of successful fund raising in 2006-2007 followed by modest acquisition activity starting in the second half of 2007. As shown on the bottom of Figure 7, the \$500 billion of capital commitments currently represents 2.0% of the total U.S. equity market capitalization, versus 1.3% at the peak of the market in 2007 and only 0.7% in 2004. Assuming private equity buyers finance about one third of prospective transactions with equity, private equity firms would have about \$1.5 trillion of total firepower, representing about 6.0% of the total U.S. equity market capitalization versus 2.1% in 2004 (assuming comparable leverage).

Figure 7

Private equity firms with historically high capital commitments

Buyout fund equity capital commitments



Capital commitments as % of geographic market capitalization (excl. of impact of leverage)

	2003	2004	2005	2006	2007	2008	2009
Europe	0.6%	0.5%	0.8%	0.8%	0.9%	2.0%	1.6%
U.S.	0.9%	0.7%	0.8%	1.2%	1.3%	2.4%	2.0%
Rest of World	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%

Source: Preqin Ltd, 2009 and World Federation of Exchanges.

EXECUTIVE TAKEAWAY

Firms have cut costs at an unprecedented rate during the credit crisis, resulting in potentially limited opportunities for organic efficiency gains. M&A allows companies to achieve efficiency gains and bottom line growth via cost synergies. Competition for assets may be healthy because the capital markets environment and significant strategic and private equity firepower supports higher valuations for assets.

2. Pursuing strategies for top line growth

Market share gains: Even when the broader market does not grow, firms can support their top line by capturing market share. Strong balance sheets and liquidity help firms achieve recession-driven market share gains. Indeed, firms with significant leverage or tight liquidity will be captive to financial issues such as upcoming maturities, interest payments, and covenants. These firms will have less time, management focus, and access to funds to develop and execute strategies to gain market share. In particular, gaining market share often involves continuing to aggressively spend on marketing and R&D just at a time when margins are under pressure. Research suggests that firms that increase marketing and/or R&D spending during recessions may have lower profitability during the recession but increase market share and returns afterwards.⁵

Emerging markets: Growth rates are expected to be tepid in developed markets. Emerging markets, though, have continued to grow during the global recession, and more importantly, are expected to continue to generate high growth rates over the next five years. Not surprisingly, many firms will continue to seek top line growth in emerging markets. The challenges that arise as firms consider emerging markets growth include:

(a) Greenfield vs. acquisitions: Greenfield expansion often requires less capital than acquisitions but also requires more time to achieve the desired scale. In some cases, acquisitions constitute the only way to achieve a meaningful presence in a specific geographic market.

(b) Risk factors: Emerging markets are associated with many risk factors, such as volatile currencies, political risk, and repatriation challenges. For firms with limited emerging markets presence, these risks tend to be diversified. As emerging markets become a bigger part of the overall capital base, however, it will become more difficult to diversify these risks. Upcoming elections, increasing budget deficits, and the dichotomy between commodity-rich and commodity-poor may increase political uncertainty.

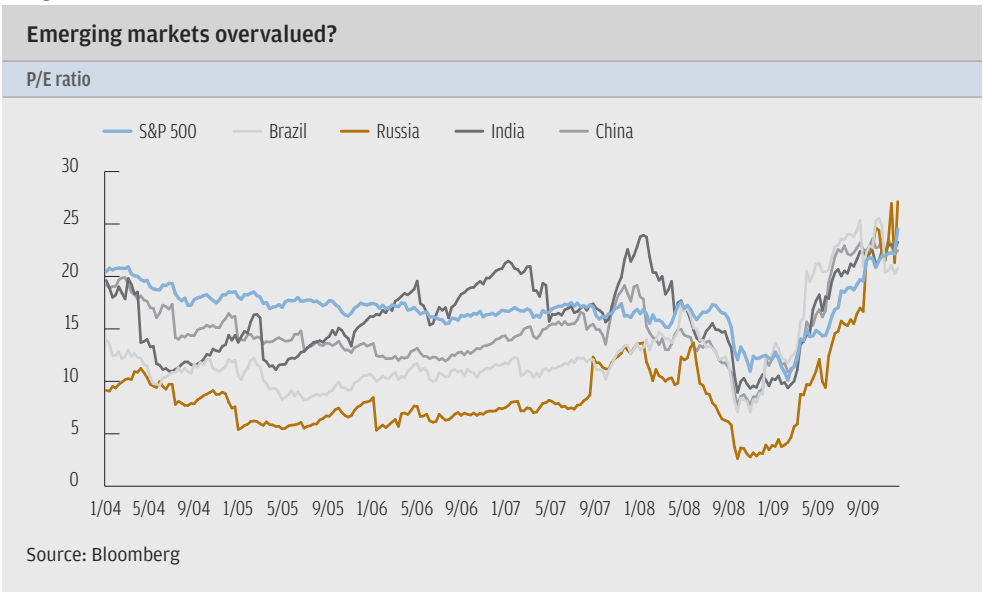
(c) Offshore cash: U.S. firms in particular have sizeable offshore cash balances. It may be practical and tax-efficient to use these cash balances to fund emerging market acquisitions. The tougher question is whether the use of these cash balances warrants a different valuation approach.

(d) Local partners: Emerging market investments often require the use of local partners. Local partners can facilitate initial investments, but sharing control may inhibit decision-making and operating efficiency.

⁵ For example, Keith Roberts (2003), "What strategic investments should you make during a recession to gain competitive advantage in the recovery?", *Journal of Strategy & Leadership*.

Valuation risk: As many investors and firms chase the higher growth prospects in emerging markets, valuations have drifted higher. As shown in Figure 8, valuation multiples for Brazil, Russia, India and China are currently at highs as compared to the recent past and comparable to those in the U.S. Considering the inherent risks, one interpretation may be that emerging markets are overvalued due to large investor inflows. However, when the multiples are adjusted for expected earnings growth, the resulting ratios of 1.4x, 2.4x, 1.3x, and 1.7x for Brazil, Russia, India, and China respectively, are all below the U.S. ratio of 2.5x.⁶

Figure 8



EXECUTIVE TAKEAWAY

Companies may realize top line growth through market share gains through continued investment in marketing and R&D, or by participating in faster growing emerging markets. Emerging markets carry their own risks, but when adjusted for economic growth, valuations in emerging markets appear to be similar to those in the U.S.

⁶ Multiples do not reflect pure geographic differences as many U.S. firms have significant exposures to emerging markets and many emerging market firms are equally exposed to slower growing advanced economies.

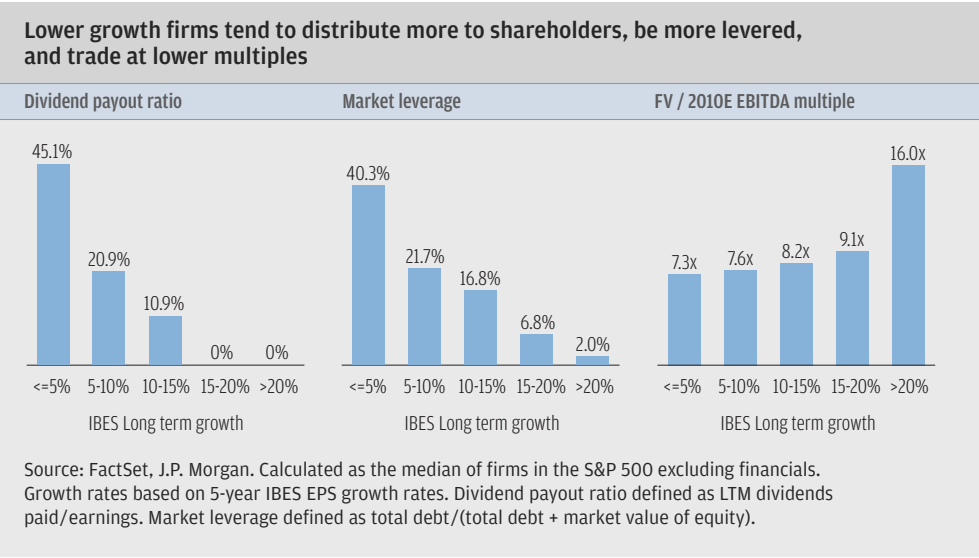
3. Adapting financial policies to a low growth environment

Our discussion so far has focused on strategies to achieve higher growth. In some cases, however, achieving higher growth may not increase shareholder value. We recommend firms only engage in business that **both** grows the firm **and** creates shareholder value. When opportunities for growth and shareholder value creation are exhausted, firms should adapt their financial policies to a new lower growth reality. Many firms have successfully lived through this transition as they inevitably become larger and more mature.

We consider the financial areas that will be principally affected by the lower growth environment: (1) capital allocation, (2) shareholder distributions, (3) leverage, (4) valuation and investor communication, and (5) risk management. We discuss risk management in a separate section.

Capital allocation: In a slower growing economic environment, demand for incremental production capacity declines, leading firms to reduce capital expenditures and defer capital outlays as demonstrated in Figure 5. The impact of reduced investment spending on firm value may be offset by a reduction in the volatility of operating cash flow and earnings and the perceived risk of the company.

Figure 9



Shareholder distributions: With lower capex needs, larger cash balances, and reduced fears about liquidity shortages, firms can now start thinking about increasing shareholder distributions. As Figure 9 demonstrates, firms with EPS growth rates below 5% tend to pay about 45% of their income in the form of dividends. In contrast, S&P 500 firms with growth rates over 15% do not pay dividends.

Lower growth firms can distribute excess cash in the form of *dividends and/or buybacks*. Many firms employ a combination of both distribution methods. The decision of the mix between buybacks and dividends is typically driven, amongst others, by tax considerations, managerial flexibility, predictability of cash flows, and growth expectations. In particular, dividend payments from excess cash flow are not EPS accretive whereas buybacks are. Some firms use buybacks to achieve bottom line growth targets and therefore may achieve higher EPS growth via the use of buybacks instead of dividends to distribute excess cash flow. There is considerable, albeit inconclusive, debate among financial executives about whether buyback-driven growth achieves the same valuation objectives as top line-driven growth.

Leverage: We continue to embrace the view that conservative balance sheets add value in this environment. All else equal, however, firms with lower growth prospects need to maintain less financial flexibility to exercise their growth options, as they have fewer growth opportunities. As we can see in Figure 9, firms with EPS growth rates below 5% have market leverage of about 40% whereas firms with over 15% EPS growth rates have market leverage of less than 10%.

Valuation and investor communications: It is widely accepted that firms with higher growth prospects will trade at a higher valuation multiple. Figure 9 shows that firms in the lowest growth bucket trade at multiples of around 7x EBITDA whereas the firms in the higher growth buckets trade at premium multiples, as expected. There are examples, however, where firms have cut back their capex, recalibrated growth expectations, increased shareholder distributions, and not suffered a valuation multiple contraction. The quality of a firm's investments should guide value creation. Nonetheless, we believe that a well balanced investor communication strategy with clear and predictable targets helps to achieve desirable valuation outcomes.

EXECUTIVE TAKEAWAY

Firms with limited growth opportunities should consider adapting their financial policies to a new low growth environment by potentially: (1) reducing capital spending; (2) increasing shareholder distributions; (3) increasing leverage; and (4) communicating a clear strategy with predictable targets to investors.

4. Coping with strategic risk

One of the paramount lessons of the current crisis is that firms should adopt financial policies that allow them to execute their business strategies even during financial crises. Over the last two years, many firms had to cut back on investments or had to sell strategically important assets to survive. The following characteristics of the current environment increase the importance and ability of firms to engage in risk mitigation:

(1) Vulnerable bottom line: When economic growth is anemic and firms are challenged to grow the top line, margins and earnings are more vulnerable to external shocks.

(2) Expected growth in new products and in new markets: New products and markets are inherently riskier than established ones. While emerging markets have become more liquid and more transparent, there is still significant political and economic risk associated with investments in these markets. For example, emerging market currencies may be appreciating against developed market currencies over the next decade, but in the short-term there may still be significant downside shocks firms should be protected against.

(3) New financial policies: Low growth financial policies may include more leverage and increased shareholder distributions. Such policies leave less room for cash flow shocks. In addition, firms can offset the multiple contraction, which is invariably associated with lower growth prospects, by reducing their risk profile and enhancing the predictability of returns.

(4) Low cost of financial insurance: While decision-makers recognize the inherent risks in today's fragile economy, the costs of insuring against shocks have dropped significantly from their highs. While cost alone should not drive firms' risk management decisions, when coupled with the other factors described herein, the relatively lower cost of insurance allows firms to engage more easily in risk management. Figure 10 shows how both stock volatility and CDS prices have dropped back to pre-crisis levels. Stock volatility is a key input in pricing stock options, which provide a form of equity insurance, and CDS can be viewed as the price of credit insurance.

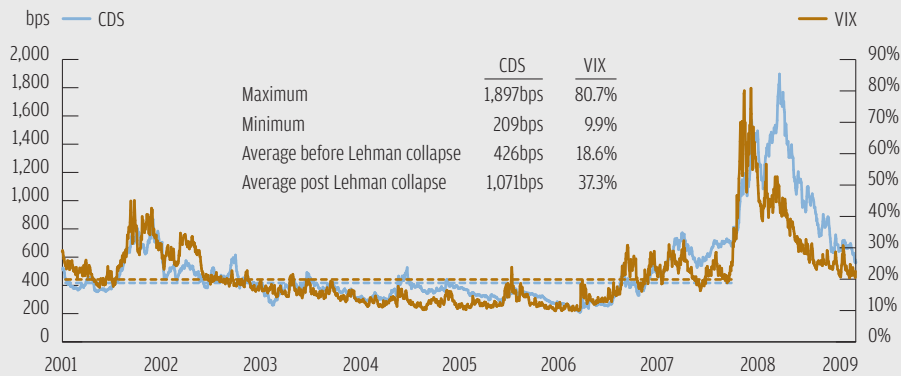
(5) Fragile financial system: While financial market conditions have improved significantly, the financial system remains susceptible to shocks. Hence, firms should take advantage of today's strong equity and credit markets to "insure" against these risks. For firms that face significant upcoming maturities this may include terming out part of their liabilities. Other firms may want to consider equitizing their balance sheet to provide insurance in downside scenarios.

(6) Potential for the next "bubble": The unprecedented infusion of liquidity in the global financial system is raising the prospect of another "bubble." It is difficult to identify "bubbles" before they occur. However, firms should consider the current low cost of insurance and buy protection against extreme price movements that occur when "bubbles" are created or when they collapse.

Figure 10

The price of insurance now back to pre-crisis levels

Price of equity and credit insurance



Source: Bloomberg. CDS spread based on North America High Yield 5-year CDX spread.

EXECUTIVE TAKEAWAY

The current environment favors risk mitigation because (1) margins and earnings are more susceptible to external shocks; (2) investments in R&D and emerging markets are inherently riskier; (3) financial policies of a low growth firm reduce financial flexibility; (4) the cost of insurance is well below historic highs; (5) the financial environment continues to be fragile with weakened financial institutions and large refinancing needs; and (6) the current liquidity glut may be creating the next “bubble.”

NOTES:

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