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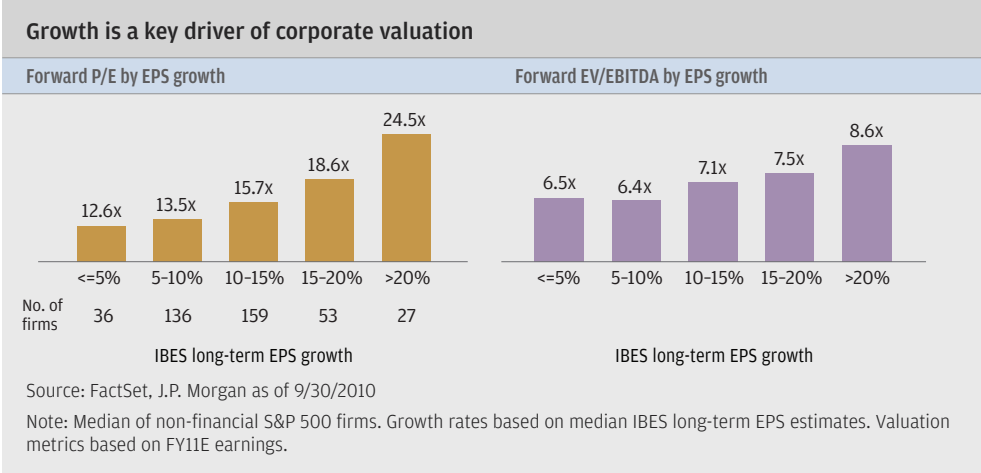
Understanding the new growth paradigm: Opportunities to create value in an anemic growth environment

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1. The new growth paradigm

Expectations of future earnings growth have been a key driver of equity valuations since company shares started trading on stock exchanges in the 16–17th centuries. Pursuing and maintaining a high growth profile has, therefore, been the Holy Grail for many CEOs and board members. Indeed, growth remains a key driver of value. As Figure 1 illustrates, firms with high growth forecasts trade at materially higher valuation multiples than firms with low growth forecasts.

Figure 1



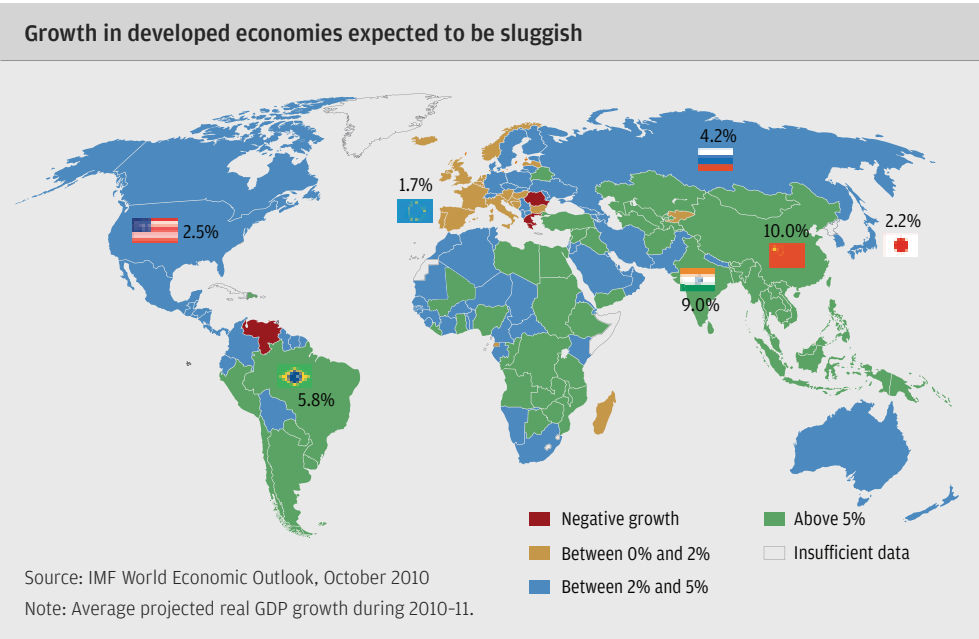
The last eight recessions in the U.S. have been followed by strong economic rebounds, with annualized real GDP growth averaging about 4.6% for each of the two post-recession years. Deep recessions such as the one we just suffered through are typically followed by even steeper rebounds. Instead, we have experienced a meager rebound, and economists forecast next year's growth to remain sluggish in North America, Japan and the European Union, as shown in Figure 2. Does this mean that developed markets have entered a new era of modest growth? Can firms still aspire to achieve double-digit earnings growth? If not, are there other ways to create shareholder value besides growth?

Here is what decision-makers should know about the new growth paradigm:

- Anemic growth in developed markets is having significant repercussions on growth prospects of S&P 500 firms. The percentage of **firms with high growth prospects fell from 32% in 2007 to 19% today**. In contrast, the percentage of low growth firms surged from 23% to 42% over the same period.
- Firms now trade at lower multiples than before the crisis and **dividend yields are higher than 10-year Treasury rates** for the first time since 1958.
- Valuation multiples of emerging-market stocks still appear low relative to their growth prospects.
- **Keys to success in emerging markets.** Large firms with fortress balance sheets have a competitive advantage in bidding for assets in emerging markets. Utilizing local resources to identify potential targets is also a critical factor to grow in these markets.

- **Investors continue to pay up for growth.** High growth firms trade at higher multiples than low growth firms. In some industries, however, investors are less willing to pay for EPS growth that is driven by cost cutting, share repurchases, and tax planning, as opposed to revenue growth.
- **Dividends support the valuation of low growth firms.** Mature firms with low growth expectations can provide a floor to their valuation by paying a higher dividend. Yet, regardless of the dividend payout, firms with a credible growth strategy still trade at higher multiples. Low growth firms should, therefore, adopt the appropriate distribution policy for their growth profile but not abandon the search for new opportunities.
- Low growth firms should and do pursue very different financial policies than high growth firms. This suggests that firms with both high and low growth business segments will be challenged to fully maximize shareholder value.

Figure 2



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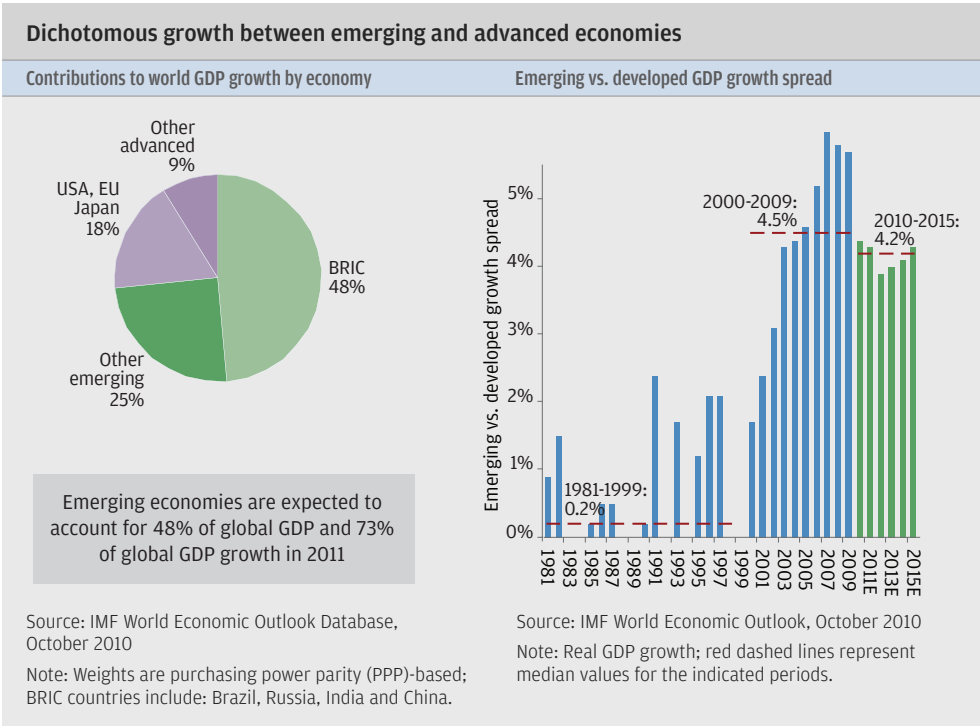
As the growth environment has changed materially over the last few years, senior decision-makers need to assess the realities of this new growth environment. In particular, they should reevaluate whether their business development and financial strategies are still appropriate to maximize shareholder value in a bimodal growth environment.

2. Will emerging markets drive the growth of developed market firms?

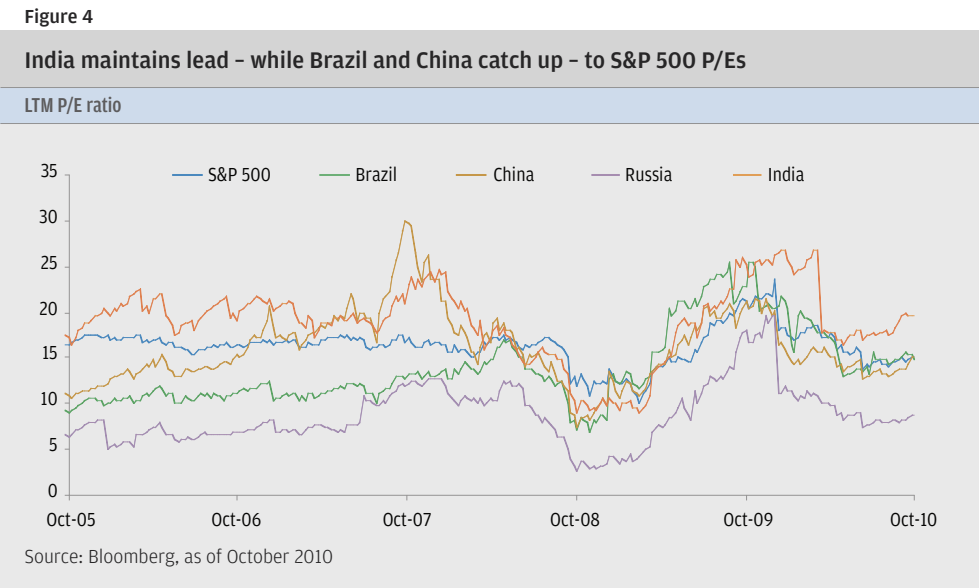
Supercharged economic growth: Emerging markets have long been considered an alternative path to enhance the growth and diversification for developed-market firms. Yet, because of financial crises that have started in these emerging markets, lagging macroeconomic fundamentals, barriers to entry, and higher perceived risk, many developed-market companies have refrained from aggressively expanding their operations in emerging markets. However, following the glowing performance of emerging markets over the last decade (and especially in the aftermath of the credit crisis), most market participants now believe that emerging markets will play a significant role in the global economic recovery and will attract more foreign investments. In fact, the International Monetary Fund (IMF) estimates that **emerging markets will represent 48% of global GDP, but will generate 73% of global GDP growth in 2011.**

Emerging markets grew at a pace similar to developed economies in the 1980s and 1990s, but then outpaced these economies by 4.5 percentage points during the first decade of the 21st century (Figure 3). Even during the peak of the financial turmoil in 2009, emerging markets **grew** at 2.5%, while developed economies bore the brunt of the crisis and **contracted** by 3.2%. Emerging economies are also further ahead on the road to recovery and are expected to grow at 6.6% versus only 2.5% growth in developed economies, which still face significant headwinds.

Figure 3



Improved valuation metrics: How are these growth expectations incorporated in today’s equity prices? While investors still demand a higher risk premium for investing in emerging markets (arising from their higher financial, economic and political risks), Figure 4 shows that some emerging markets trade at a similar or even higher (e.g., India) price-to-earnings ratio relative to the S&P 500. These valuation metrics are consistent with higher growth expectations and/or declining perceived risk in emerging markets.



Trapped cash: The higher expected growth in emerging markets, coupled with record levels of trapped offshore cash (which can often be reinvested offshore without significant tax implications) are driving many U.S. companies to expand their global operations, especially in emerging markets. Figure 5 shows that during the first three quarters of 2010, cross-border M&A activity increased by 83% relative to the same period in 2009. While M&A cycles have tracked the macroeconomic cycles over the last 15 years, the magnitude of the M&A recovery this year (especially given the depth of the financial crisis) has been particularly pronounced. Annual cross-border M&A deal volume for 2010 is expected to be higher than 2006 levels (peak of the credit boom). In addition to M&A, many developed market firms are increasing their emerging-market activity via greenfield expansion or joint ventures.

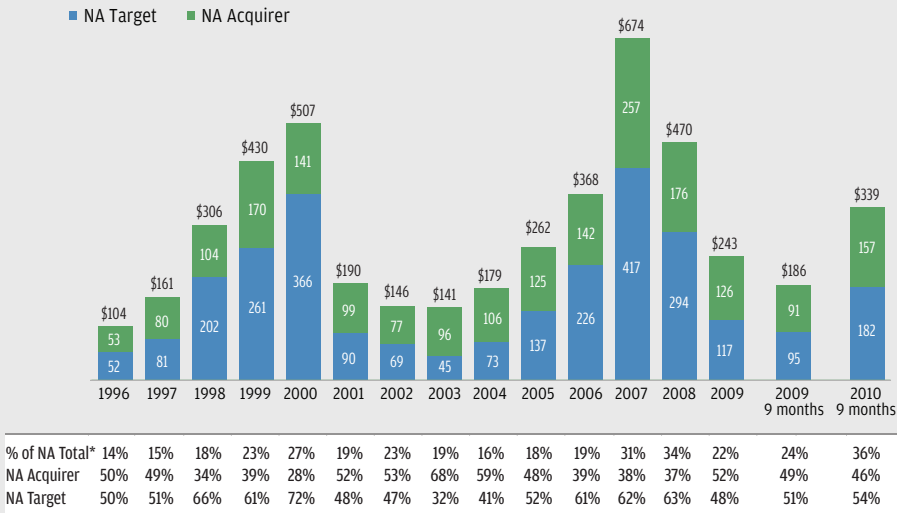
USD weakness: Many U.S. firms are reluctant to acquire offshore assets when the USD is weak. If one has no bias about where the USD is heading in the future, then a weaker USD means paying a higher USD price for cash flows that are also higher in USD. Yet, given the current state of U.S. monetary policy, many firms anticipate that the USD will continue to weaken relative to some emerging-markets currencies, increasing the attractiveness of emerging market investments.

Scarcity of actionable targets: Emerging markets often lack many actionable targets. Many of the more important companies are privately held, or potentially controlled by families or government entities. Firms have approached this challenge by being proactive and patient in searching for actionable targets. In some cases, pursuing other developed-market firms with a deeper emerging-market footprint is a more viable alternative.

Figure 5

Cross-border M&A in North America up 83% compared to 2009 Q1-Q3

North America cross-border volume (target/acquirer), 1996-2010 9 months (\$bn)



Source: Dealogic (M&A Manager) as of September 30, 2010; announced deal volume

Note: Rank eligible deals with value greater than \$10mm.

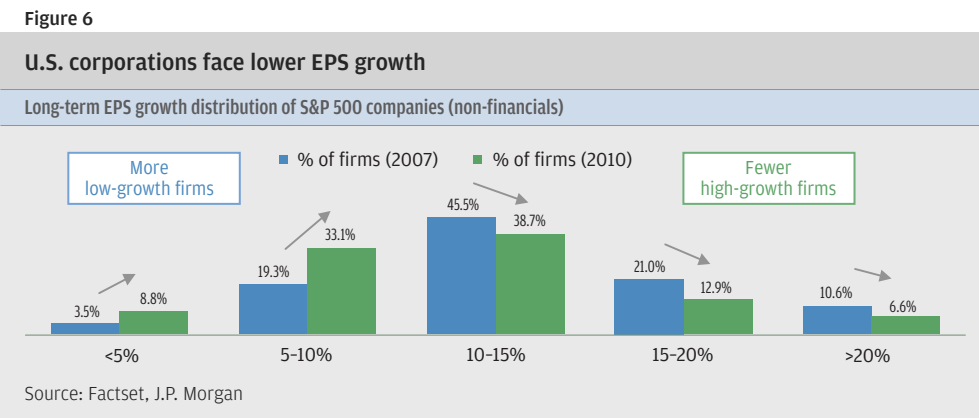
* Percentage of cross-border M&A of overall North America M&A deal volume.

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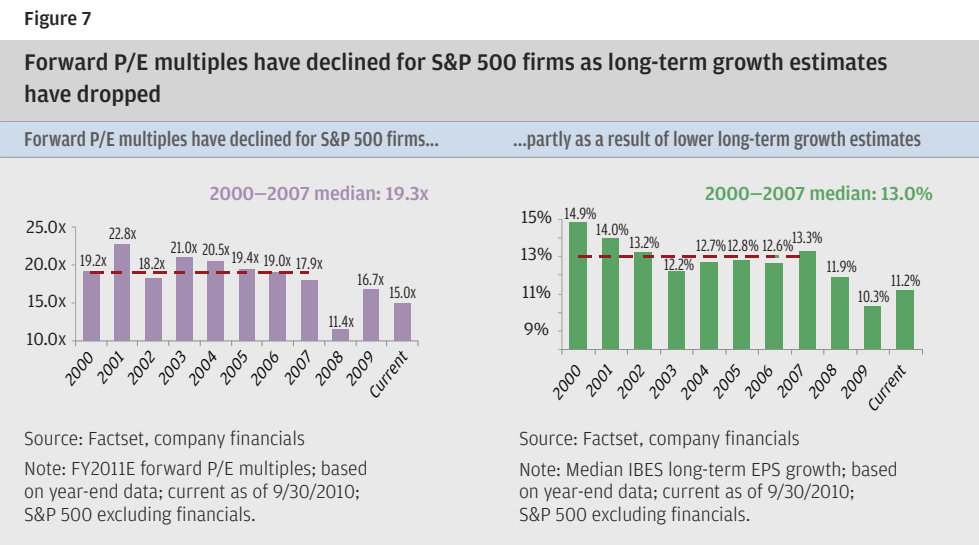
Emerging markets are expected to deliver robust growth over the next five years relative to the anemic growth anticipated in developed economies. In some industries, U.S. companies are already expanding their exposure to emerging markets via mergers, acquisitions and joint ventures.

3. How do investors price the growth?

Lower growth expectations: The financial crisis has led to a sharp reduction in the bottom line of developed market firms worldwide. Given the anemic expectations for future GDP growth, it is now also adversely affecting the growth expectations of equity investors and analysts. Figure 6 shows the expected EPS growth distribution of S&P 500 companies prior to the crisis (end of 2007) and currently (2010 Q3). The bearishness of analysts' expectations is striking. Across all growth buckets, **there are now more firms with low growth expectations and fewer firms with high growth expectations**. For example, 42% of S&P 500 firms are expected to deliver less than 10% annual EPS growth over the next five years vs. only 23% in 2007. Conversely, only 19% of firms are expected to grow their bottom line by more than 15%, as compared to 32% in 2007.



Lower multiples: Lower growth expectations should, inevitably, lead to depressed valuations. Indeed, Figure 7 shows that the median forward price-to-earnings (P/E) ratio of S&P 500 firms dropped from 19.3x in 2000–7 to 15.0x today.

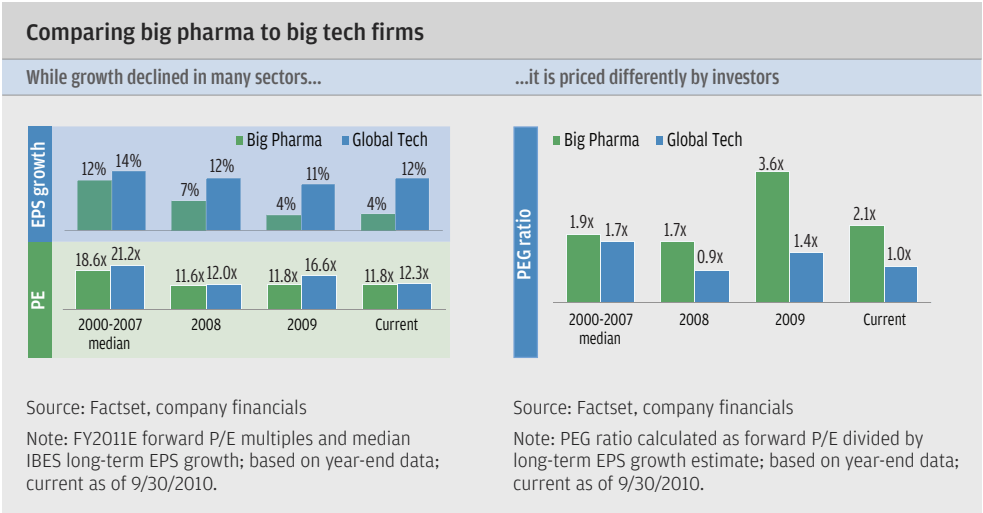


The effect of the crisis on expected growth and equity valuation varies, however, across industries. For example, Figure 8 demonstrates that while both the large pharmaceutical and technology firms have experienced significant declines in their P/E ratios, the determining valuation driver was different.¹ The large **pharmaceutical** firms face significant patent cliffs in 2012–14, which has reduced their expected EPS growth from 12% to 4%. In contrast, the large multinational **technology** companies have experienced only a slight decline in growth (from 14% to 12% long-term EPS growth). As a result, the P/E to growth (PEG) ratio of technology firms has dropped from 1.7x to 1.0x, whereas the PEG ratio of large pharmaceutical firms has remained at a similar level.

This raises several questions:

- What is the best corporate finance policy in a low growth environment (e.g., pharmaceutical firms)?
- Do investors distinguish between different types of growth in today’s environment (e.g., technology firms)?

Figure 8



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Consistent with sluggish economic growth forecasts, analysts and investors have revised their earnings growth expectations downward. Fewer firms are now seen as high growth and more firms are perceived as mature. What is the appropriate business mix and distribution policy in this lower growth, lower P/E and lower PEG ratio environment?

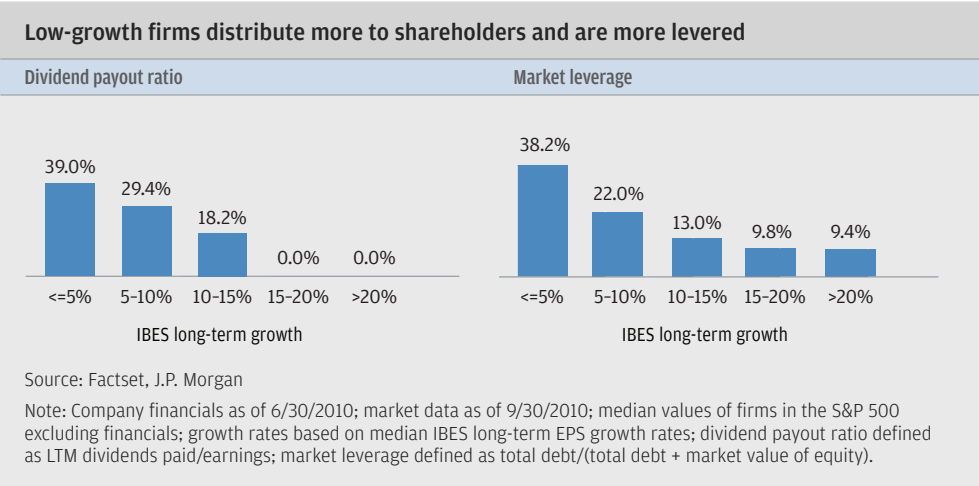
¹ Big pharma firms include: Johnson & Johnson, Bristol-Myers Squibb, Eli Lilly, Merck, Abbott and Pfizer. Multinational tech firms include: Microsoft, Apple, Google, IBM, Cisco, Oracle, Intel and HP.

4. Achieving differential valuation when growth is slowing

Growth is a key driver of corporate valuation. When growth is sluggish, however, two types of firms can achieve a valuation premium. The first set includes firms that are positioned to **credibly achieve growth** through product innovation, disciplined capital allocation and M&A, and/or a presence in growth markets. In contrast, some firms cannot credibly aspire to stay in this high growth bucket because of their size and scale, their market share, and the maturity of their products. This second set of firms includes those that adapt their corporate finance policies to a slower growth profile and **cater to investor demand for predictable cash distributions**. While executing a credible growth strategy is superior, low growth firms in mature industries can provide a valuation support to their stock by adopting a financial strategy that is consistent with their growth profile.

Low growth firms pay out more to shareholders and have more leverage: The most evident changes in the financial policy of firms facing slower growth are higher shareholder distributions and increased leverage. With more stable cash flows and limited investment opportunities, mature firms can take on more leverage and return excess capital to shareholders. Figure 9 shows that firms with greater than 15% expected EPS growth typically do not pay common dividends and maintain leverage that is about a quarter of the leverage of firms in the lowest growth bucket. Conversely, firms with less than 5% expected growth pay out about 40% of their earnings in the form of common dividends.

Figure 9



Firms will catch up post-crisis: As a result of the crisis, many large firms have delevered over the last few years and cut shareholder distributions. Ironically, this is contrary to what one would expect for firms that are likely to grow at a slower pace. Once firms conclude that the growth opportunities continue to be diminished, many firms may materially increase distributions and some may increase leverage.

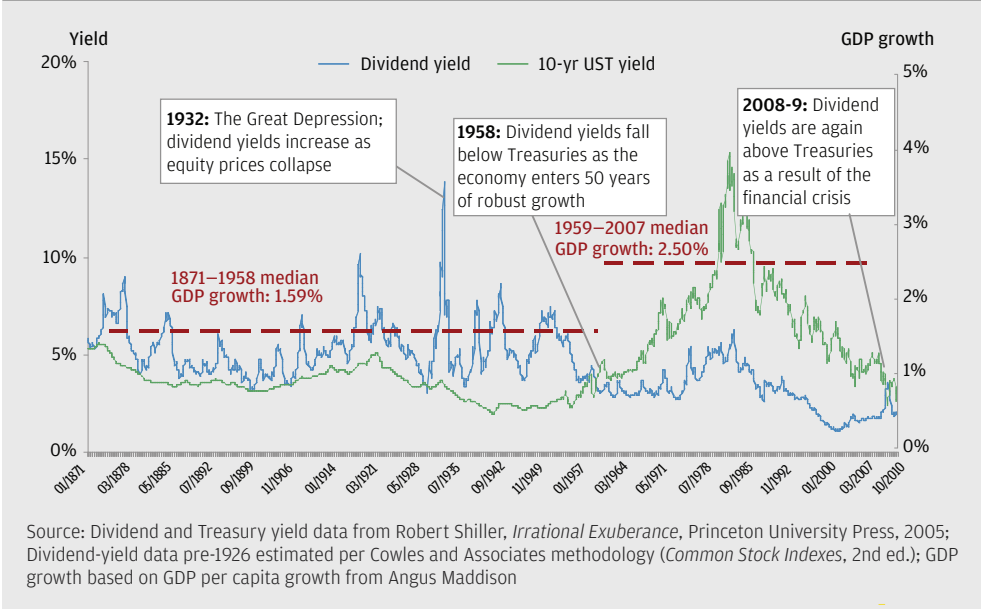
Attractive dividend yields: High demand for U.S. Treasuries and low expected economic growth are driving Treasury yields down to relatively low levels. Simultaneously, most non-financial firms have maintained their dividends through the crisis, and have recently even increased their cash distributions. With equity values still depressed relative to the

pre-crisis days, dividend yields are now approaching long-term Treasury yields. This is a pattern we have not seen in the United States since the beginning of the post-WWII economic boom (Figure 10).

Figure 10

First since 1958: dividend yields approaching 10-year Treasury rates

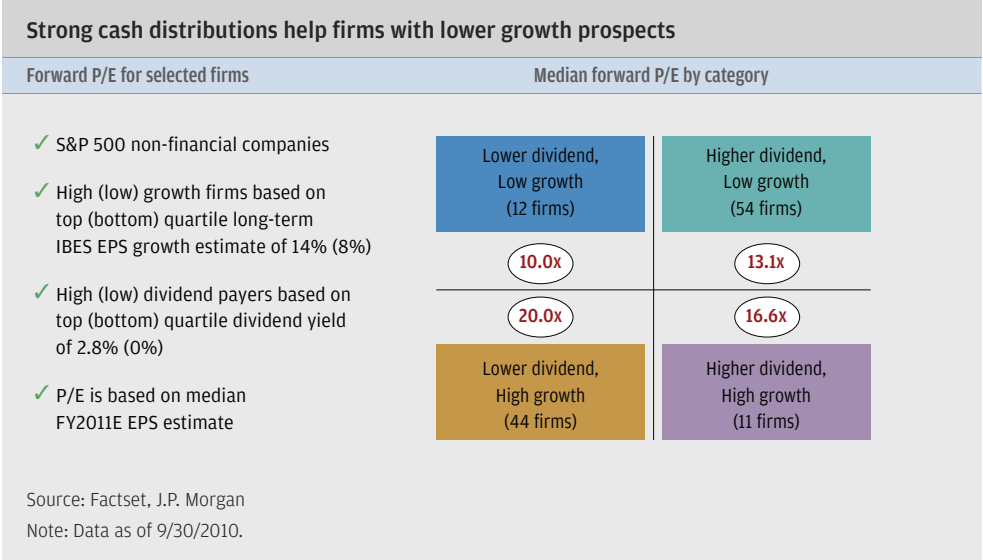
Dividend yield of S&P 500 companies vs. 10-year U.S. Treasury yield since 1871



A valuation floor for dividend-payers: Investors appreciate the predictability of common dividends in a low growth environment. While growth is clearly the key driver of equity valuation, we show in Figure 11 that in the absence of growth, a high dividend can lead to a valuation premium. Low growth firms with a high dividend payout trade at earnings multiples that are three turns higher relative to other low growth firms with a low dividend payout. The valuation premium is greater when investors believe that the company's dividend is not only material, but also sustainable given the company's cash flow generation profile. Interestingly, the same valuation benefit cannot be replicated via share repurchases, despite their EPS accretion, relative tax efficiency, and signaling effect.

Not all growth stories are created equal: Equity investors assign a valuation premium to firms that have achieved robust top-line growth over the last few years and are expected to deliver revenue growth in the future. For example, firms with high historical revenue growth achieve a P/E multiple that is two turns higher than firms with similar EPS growth expectations but a poor track record in delivering top-line growth. Equity investors also distinguish between different types of earnings growth and give less valuation credit to firms that plan to deliver EPS growth through cost cutting, tax planning, and share repurchases relative to firms that achieve earnings momentum through strong top-line growth. In fact, firms with high expected EPS growth but low expected revenue growth are traded at a P/E multiple that is four turns lower relative to firms with similar bottom-line growth, but higher top-line growth.

Figure 11



Risk mitigation helps achieve a predictable dividend policy: Firms can also cope with lower expected growth by mitigating the perceived risk of their business. This can be achieved by using a well balanced investor communication strategy with clear and predictable targets. Specifically, what is the firm’s expected return on invested capital (ROIC) and how should it vary through the cycle? Can the firm moderate the volatility of its bottom-line earnings by hedging some of its exposure to market risks (such as exchange rates, interest rates and commodity prices)? For low growth firms operating in a volatile environment, hedging can stabilize cash flows, helping the firm to take on more leverage, and/or adopt a sustainable dividend policy at higher levels.

EXECUTIVE TAKEAWAY

Investors are willing to pay up for firms with a well-defined growth strategy and financial policies that are consistent with these strategies. High growth firms can be focused on realizing their growth plans while low growth firms should return capital in a predictable fashion. Firms caught in the middle or firms with a mix of high and low growth segments may need to reevaluate their business mix strategy.

5. Value creation in the “new normal” world

In a previous report we highlighted how senior decision-makers migrated from fear of the unknown in the middle of the crisis to a sense of frustration today.² They have delevered their balance sheets, cut costs and capex, and now face a historical low cost of debt and record high cash balances without a clear sense of future opportunities. Although it is challenging to create value in an environment of anemic growth, we outline the clear insights that emerge from our analysis in Figure 12 below.

Figure 12

Value creation in the “new normal” environment	
Action plan	
Paying for growth	<ul style="list-style-type: none"> ✓ Investors continue to pay up for growth stories. ✓ U.S. firms should continue to scout new and emerging markets for opportunities.
Not all growth is created equal	<ul style="list-style-type: none"> ✓ Investors do not value all earnings growth equally. ✓ Revenue growth is superior to growth from cost cutting, buybacks and tax planning.
Capital discipline	<ul style="list-style-type: none"> ✓ When value creating investments are limited, investors focus on capital discipline. ✓ Mature firms can signal discipline with strong and growing dividends.
Risk mitigation	<ul style="list-style-type: none"> ✓ In mature industries, risk mitigation supports the sustainability of a strong dividend. ✓ Effective and transparent investor communication is critical.
Asset mix	<ul style="list-style-type: none"> ✓ Optimal corporate finance strategy depends on the firm’s growth profile. ✓ With vibrant capital markets, firms create value by separating high/low growth segments.
Source: J.P. Morgan	

EXECUTIVE TAKEAWAY

The “new normal” world of anemic growth in developed markets presents several opportunities to create value. Foremost on this list are a disciplined approach to seeking out growth in particular in emerging markets, predictable cash distributions for firms operating in mature industries, and the separation of high and low growth businesses.

² “From Fear to Frustration: Financial Strategy Challenges for a Recapitalized Corporate America,” J.P. Morgan, September 2010.

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