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From fear to frustration:

A special report for the 2010 J.P. Morgan CFO Forum

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1. From fear to frustration

In late 2008 and early 2009, companies worried about Armageddon scenarios. Fear abounded on whether the banking system would collapse, the economy would enter into a severe depression or if companies would be able to survive. While the environment was scary, most **decision-makers agreed on the immediate course of action**: cut costs, reduce/eliminate shareholder distributions, preserve liquidity, extend debt maturities, hold off on major acquisitions and embrace a fortress balance sheet to ensure survival.

Today, fear has been replaced by frustration. Balance sheets, maturity profiles and liquidity positions have been bolstered and are healthier than they have been in a long time. In addition, capital markets are open and vibrant. Yet despite the financial health of companies and the availability of “cheap” capital, economic, political and regulatory uncertainty are frustrating senior decision-makers. Should firms invest in future potential growth or prepare for a double-dip recession? Should they access capital markets while capital is cheap and build a war chest, or will capital remain cheap for a prolonged period? Should companies increase shareholder distributions now that markets have stabilized or should they wait for more clarity on taxes and the economy? Should decision-makers use today’s low cost of capital to evaluate once-in-a-lifetime acquisition opportunities? **While the questions are obvious, today’s action plan is not.**

Figure 1

A shift in the corporate finance issues facing CFOs

2008 -2009 Themes

- ✓ Surviving the crisis
- ✓ Build fortress balance sheets and liquidity
- ✓ Capital markets access and capacity
- ✓ Maturity extension
- ✓ High cost of capital
- ✓ Survival of banking partners
- ✓ Fear

Raise capital and maximize liquidity

2010 Themes

- ✓ How to generate growth?
- ✓ Managing political, economic and regulatory uncertainty
- ✓ Capital allocation
 - Capex/R&D?
 - M&A?
 - Dividend/buyback?
- ✓ Low cost of capital
- ✓ Impact of banking reform
- ✓ Frustration

Is there a clear action plan?

Source: J.P. Morgan

Despite the uncertainties of the current environment, **inaction is not the best strategy**. We believe that firms should be internally consistent. If decision-makers believe in the prospects of a near-term economic recovery, then they should take advantage of the temporary low cost of capital by raising funds to finance opportunities sure to arise once global growth prospects improve. Alternatively, if the cost of capital is set to remain low for the foreseeable future, then firms should evaluate opportunities at today's low cost of capital to generate growth through mergers and acquisitions and synergies. Firms hesitating at the crossroads may find themselves left behind, irrespective of which growth scenario materializes.

EXECUTIVE TAKEAWAY

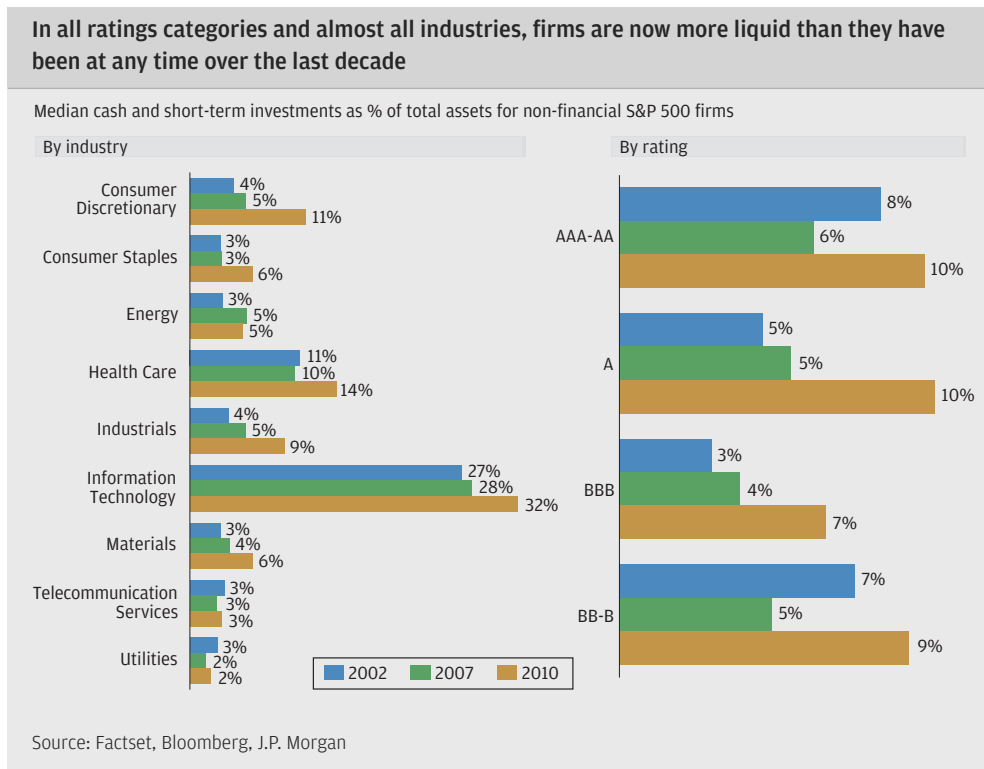
In contrast to the fear that was prevalent in late 2008 and early 2009, today's stabilized market environment has eliminated the specter of cataclysmic outcomes. Unfortunately, today's uncertain environment does not provide a clear-cut action plan. Highly liquid balance sheets and a historic low cost of capital are challenging Corporate America's decision-makers in an uncertain growth environment. We believe that inaction is not the optimal strategy.

2. The delevering and recapitalization of Corporate America

Cash-rich global industries: Non-financial S&P 500 firms have increased their liquidity positions to unprecedented levels over the last few years. Since 2008, non-financial S&P 500 firms have added \$137 billion of cash (and marketable securities) to their balance sheets. More broadly, U.S. firms (financial and non-S&P 500) currently hold about \$3 trillion in cash and liquid assets according to the Federal Reserve.¹ This is a trend that has been well documented in the press and our previous reports. In fact, the cash to total assets ratio is at its highest level since 1963. However, the accumulation of cash varies significantly across industries. In Figure 2, we show that industries with significant international operations, such as information technology, consumer staples and discretionary, and healthcare, experienced larger increases in their cash balances than telecommunication services and utility firms, which have a more domestic focus, or energy firms, which have sizable capital investment needs.

Trapped cash: The amount of **available** liquidity held by U.S. firms with international operations is overstated. A large fraction of their cash is located in offshore low-tax jurisdictions and U.S. firms may need to pay a repatriation tax (typically in the 25%-35% range) to be able to use the cash domestically (hence the term “trapped cash”). Each dollar of offshore cash may therefore only translate into 65-75 cents of cash available to invest in domestic projects and M&A targets, or to service U.S. debt obligations and pay shareholder distributions. In most cases, however, this cash can be fully utilized to finance non-U.S. investments and M&A targets.

Figure 2



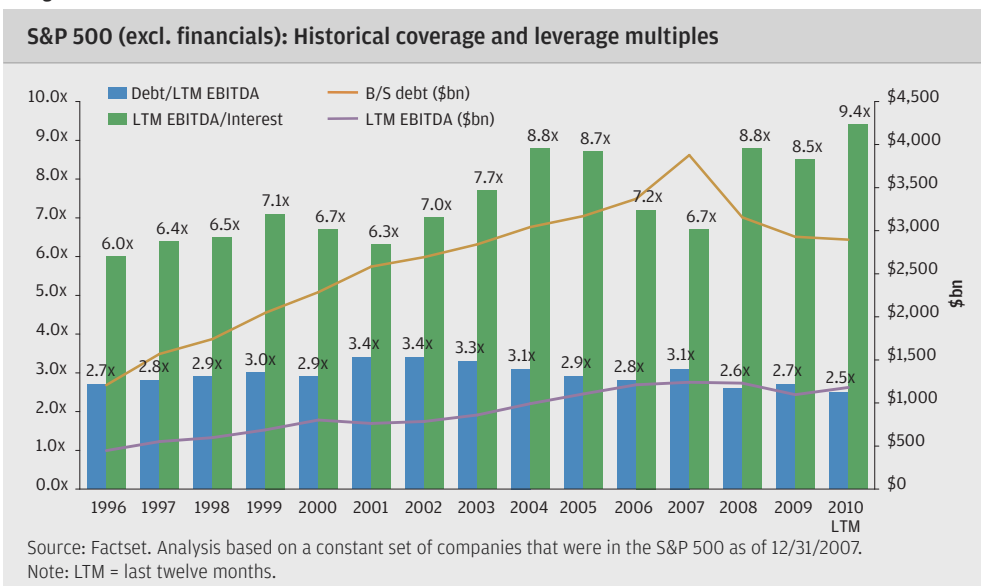
¹ Source: <http://federalreserve.gov>, Flow of Funds Accounts of the United States, June 10, 2010.

Defensive and offensive liquidity: As shown on the right side of Figure 2, liquidity has increased in all credit rating categories. Firms with both strong and weak balance sheets have unusually strong liquidity positions. Highly-rated firms have markedly increased their cash balances to weather the global financial crisis and potentially as an offensive measure in anticipation of future growth and M&A activity. This group includes many successful international companies with significant offshore cash balances, as mentioned previously. Lower-rated firms, on the other hand, have increased their liquidity on the back of significant cost-cutting and record-breaking issuance in the high yield market. Given the perilous environment these firms faced in 2008 and early 2009 (when high yield markets were temporarily closed), they have defensively raised liquidity to address maturity towers on which investors and decision-makers alike were focused. In either case, firms have bolstered their cash reserves to survive capital market shocks or to execute on their strategic priorities.

Liquidity pressures: While the need for incremental liquidity was uniformly recognized two years ago, some firms are currently experiencing external pressures to address their liquid balance sheets. The combination of limited U.S. growth opportunities, vibrant debt capital markets, and the return of hostile transactions and activist shareholders is putting pressure on boards to either use the liquidity for strategic transactions or to return part of it to shareholders hungry for better returns after disappointing years.

Delevering: In addition to boosting cash balances, most firms also pursued the concept of a fortress balance sheet by paying down debt and reducing leverage. In Figure 3, we show that since 2007, non-financial S&P 500 firms have reduced their leverage multiples by a half turn, to 2.5x EBITDA, and reduced their outstanding debt by almost \$1 trillion. Furthermore, the low Treasury rate environment has offset the financing cost of extending debt maturities as evidenced by the increase in interest coverage ratios by almost 3x EBITDA to about 9.4x. Given the current receptivity of the debt markets, these low leverage levels leave many companies with the financial flexibility, debt capacity and liquidity to execute large-scale strategic M&A and achieve scale and growth. Part of this financial flexibility is currently manifesting itself in the recent wave of large-cap unsolicited M&A transactions, a trend that is likely to continue.

Figure 3

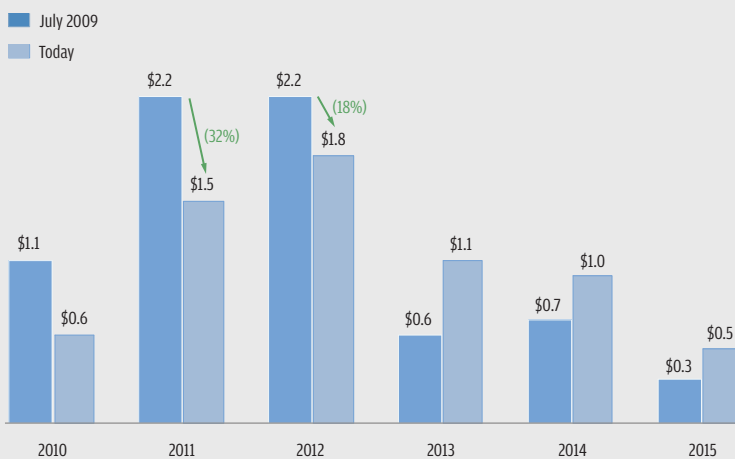


The other face of liquidity – longer maturities: Paying down debt or having large cash balances are not the only ways to create a fortress balance sheet. Many firms refinanced or amended their debt to lengthen their maturity profiles. At the peak of the crisis, many market participants and senior decision-makers were focused on large maturity towers in 2010–2012. This was a particular focus for the high yield market, as during the height of the crisis this market had effectively shut down for new issuance. As one can see in Figure 4, finance teams have diligently chipped away at this issue for 2010–2012. Companies amended, extended and refinanced into longer-term maturities, making near-term towers more manageable relative to the size of each of the markets. Growing maturity towers for 2013–2015, especially in the high yield market, suggest, however, that the problem may have only been postponed rather than resolved.

Figure 4

Maturity tower issues have been pushed back to 2013–2015

High grade and high yield bonds and loans maturity profile (\$tr)

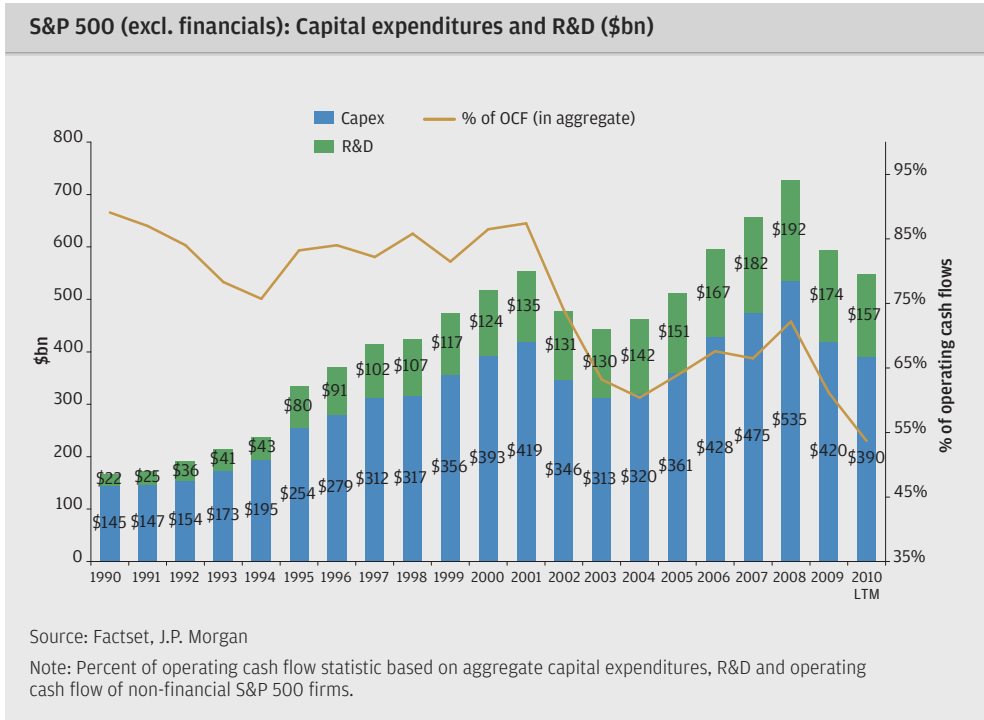


Source: J.P. Morgan Global Credit Research, S&P LCD

Note: Includes high yield bonds, high grade bonds, high grade and leveraged loans.

Abundant liquidity does not drive capital spending: Despite the improvement in the financial health of many firms, capital spending remains depressed. As shown in Figure 5, firms continue to cut back on their capital expenditures and R&D outlays. Together they now represent less than 55% of operating cash flow, down from a high of more than 85% in 2001.

Figure 5

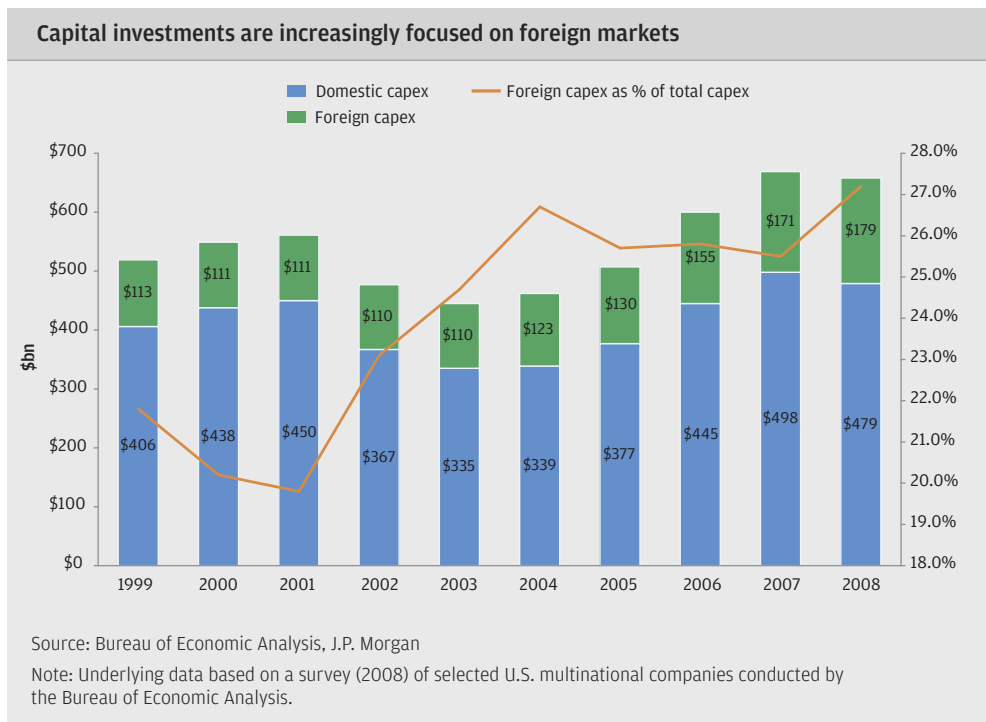


Aggregate nominal capex and R&D dollars are in line with levels we experienced in the late 1990s. Part of this continued reduction in capital investment may be due to decision-makers’ lack of confidence in future growth and their concerns about the changing regulatory environment. It may also be tied to static capital allocation policies, whereby firms continue to employ hurdle rates associated with periods of higher growth and more expensive capital. In turn, it is this low level of capital spending that is leading to the buildup of significant corporate liquidity that we discussed above. In the action plan of this report, we discuss whether firms should lower their hurdle rates, provided their own risk profiles have not increased, to reflect today’s anemic growth and low inflation environment.

In the end, this data suggests that increased liquidity and financial strength alone are not sufficient to jump-start capital investment.

Investment dollars following overseas growth: With growth opportunities prevalent in emerging markets and cash trapped overseas, an increasing share of capital investment dollars by U.S. firms is being invested outside the U.S. As shown in Figure 6, the proportion of total capex being spent abroad has increased from about 18% in 2001 to 27% in 2008. It remains unclear though whether recent proposals to provide accelerated tax write-offs for U.S.-based capital investment will shift the marginal capex dollar towards domestic investment.

Figure 6



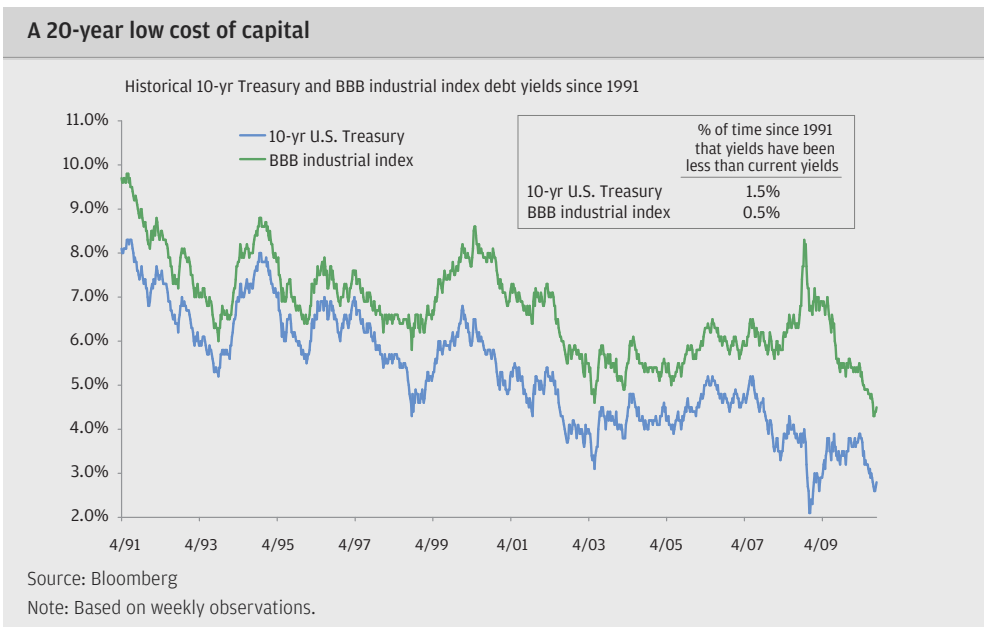
EXECUTIVE TAKEAWAY

Preparing for the worst, U.S. firms have bolstered liquidity, delevered their balance sheets and lengthened their maturity profiles. Companies now have the debt capacity, liquidity and firepower to execute on strategic priorities. Data suggests, however, firms are not ramping up capital investments yet. Whether such investment will occur is a function of growth opportunities, the economic and regulatory uncertainty, and the hurdle rates companies are using to allocate new capital.

3. A low cost of capital: temporary or long-term phenomenon?

Record-breaking “low” yields? In the summer of 2007 the cost of debt was increasing as the first tremors of the global financial crisis were felt in the credit markets. Many welcomed this “repricing” of risk following the relaxed credit markets in the fall of 2006 and the spring of 2007. Ironically, three years and a global financial crisis later, firms can raise debt at similar and in many cases lower cost, thanks to tightening credit spreads from elevated crisis levels and low Treasury rates. As one can see in Figure 7 below, the 10-year Treasury rates and the cost of debt financing are at, or close to, 20-year low levels. In fact, yields for BBB industrial firms have only been lower 0.5% of the time since 1991.

Figure 7



Factors keeping cost of debt at today’s low level: (1) low Treasury rates associated with anemic growth and low inflation; (2) liquid corporate balance sheets and limited growth, which lead to reduced need for new debt issuances; (3) strong fixed income demand from pension and other managers reallocating their portfolios away from equity and toward fixed income.

Factors likely to lead to a higher cost of debt: (1) high public deficit and public financing needs likely leading to a high supply of new Treasury bonds; (2) a pickup in economic growth and inflation; (3) economic, regulatory or political uncertainty unnerving credit markets and widening credit spreads; (4) cost of debt is mean-reverting and currently at historic lows.

EXECUTIVE TAKEAWAY

While the current cost of capital is approaching historical lows, various economic factors may increase it in the near term. At this juncture, firms should be consistent with their view and either raise cheap liquidity or start allocating capital based on a revised, lower hurdle rate.

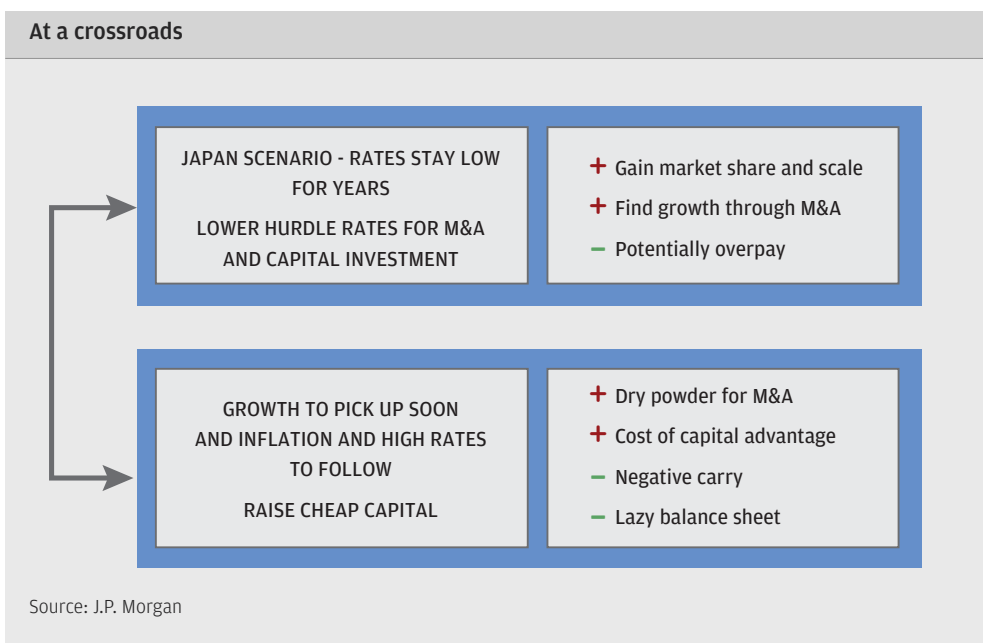
4. At a crossroads

In an environment where firms have the financial wherewithal and access to cheap sources of capital to finance growth and strategic priorities, inaction may destroy shareholder value. The ultimate prescription depends on one's view of the economic future.

Growth and inflation are around the corner – raise cheap capital: If the current state of anemic growth and low cost of capital is a brief pause before continued economic expansion, then firms are well served by raising cheap capital today to build a war chest for tomorrow's growth. Signs of growth will be quickly followed by higher inflation and rising Treasury yields and costs of capital. Recent investment-grade transactions suggest the trend has already started, with many firms building cash reserves in anticipation of future M&A or organic growth opportunities. Strategic priorities must be identified in advance of building cash reserves, however, as lazy balance sheets offer attractive bait for activist campaigns and negative carry costs may eventually erode shareholder value.

Anemic growth is here to stay – lower your hurdle rate: A period of prolonged anemic growth with little to no inflation calls for a different approach to financial policy and capital allocation. In this environment, one can expect that capital will continue to be available at a low "nominal" cost. Companies should therefore not hurry to raise cheap capital, but instead reconcile their hurdle rates to the new environment. In a world where the cost of capital is expected to remain depressed for a prolonged period, investments that generate lower returns may still create shareholder value. Companies must avoid penalizing projects by assuming low economic growth in their cash flow projections but still benchmarking returns against high hurdle rates. Firms that continue to use high hurdle rates will lose market share to competitors who use lower hurdle rates and hence reduce prices or bid higher for strategic assets. The risk of "overpaying" remains when one lowers hurdle rates. If, however, growth and higher capital costs were to materialize, the positive impact on value from accelerated cash flow growth itself should offset the value-loss from using too low a hurdle rate.

Figure 8



EXECUTIVE TAKEAWAY

Companies that believe the current state of anemic growth and low cost of capital is temporary should lock in today's low cost of capital. Those who believe there will be anemic growth for a prolonged period should consider lowering their hurdle rates to find growth through scale and synergies. Companies not proactively responding to this situation may find themselves losing market share and/or cost of capital advantage to competitors.

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