Corporate finance post-Brexit

Financial policies for a lower growth, more uncertain environment

J.P.Morgan

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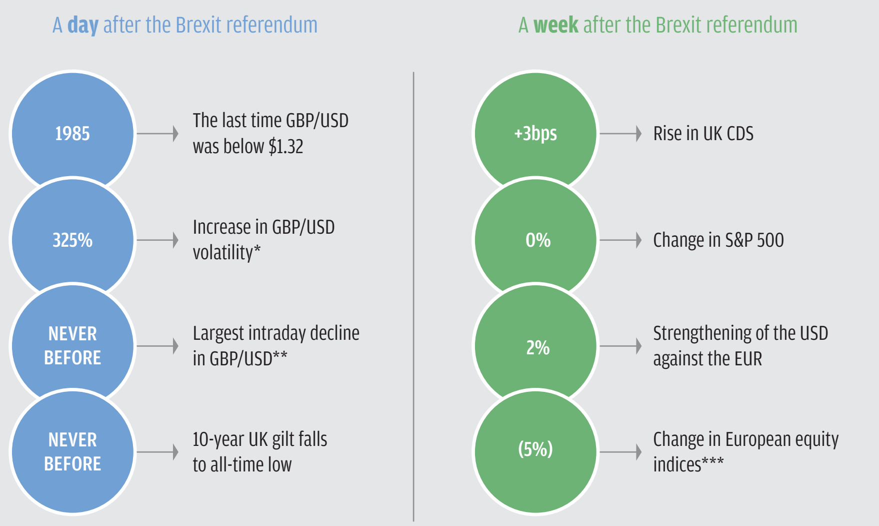
1. Introduction

The Brexit referendum is over, and a whole host of records were set in the financial markets the day the results were announced. Within a few days, however, most global markets were back to near pre-referendum levels (Figure 1). In fact, key measures of volatility were actually down in that time period.

Figure 1

Financial markets post-referendum: "Much ado about nothing"?



Source: J.P. Morgan, Bloomberg as of 07/01/2016
* Calculated as 10-day volatility;
** GBP / USD dropped from 1.4880 to 1.3681;
*** Change in European equities is in local currency

How can markets be so calm in the wake of one of the biggest political surprises in recent memory? This question is vexing everyone from investors to commentators. In this light, market participants appear resigned to a new economic environment of elevated uncertainty coupled with lower growth. This resignation can perhaps best explain the overall limited market reaction to the referendum's results, but it does not mean that Brexit is a non-event. Developments in the post-Brexit world will likely involve a number of legal and operational themes for global firms. Even firms without direct UK or EU exposure should take into account that a Brexit will impact them directly or indirectly through a number of channels. This report describes the corporate finance implications of the post-Brexit-referendum world we find ourselves in.[1]

[1] For further reading on Brexit, please see our June 2016 brief titled *Bumpy road ahead: A Senior Decision-Maker's checklist to prepare for "Brexit" uncertainty... Part II* found at http://www.jpmorgan.com/directdoc/JPMorgan_CorporateFinanceAdvisory_BrexitUncertaintyPartII.pdf and our May 2016 brief titled *Bumpy road ahead: A Board's and Senior Decision-Makers' checklist to prepare for "Brexit" uncertainty* found at http://www.jpmorgan.com/directdoc/JPMorgan_CorporateFinanceAdvisory_BrexitUncertainty.pdf

EXECUTIVE TAKEAWAY

As firms awaken to the reality of a potential Brexit, they may face a double blow of lower growth and greater uncertainty. In such times, we encourage firms to use everything available in their toolkit to limit the destruction of, and potentially even create, shareholder value. Firms may need to adjust their financial policies not only to capitalize on market dislocations but also to create enduring value.

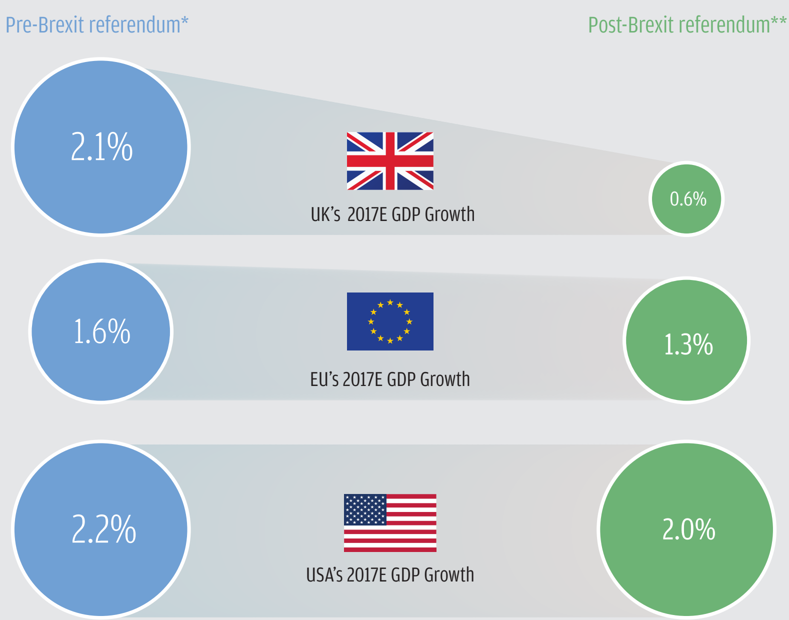
2. Ten focus areas for a slower growth, more uncertain environment

2.1 Growth

Global growth has yet to fully recover since the financial crisis almost ten years ago, and Brexit may further delay a full recovery. **The full impact of Brexit on growth may not be felt for quite some time.** Economists have been swift to revise global growth estimates downward (Figure 2). In the short-run, the uncertainty associated with a Brexit may slow corporate top-line growth by delaying investments, even those expenditures already planned or budgeted. This feedback loop could continue for years while firms await greater clarity on the negotiations between the UK and the EU. In addition, bottom-line growth will be impacted as firms face legal and operational expenses to offset Brexit-related disruptions.

Figure 2

Global growth estimates have declined post-Brexit referendum



Source: J.P. Morgan, Bloomberg
* Displays median of analyst estimates available on Bloomberg up to two weeks prior to Brexit;
** Displays median of analyst estimates available on Bloomberg on 06/24/2016

Firm should be particularly wary of a low-growth environment, since growth is critical to equity valuations. For instance, top performing non-financial firms in the S&P 500 have top-line growth rates three times higher than those of the weakest performers, as measured in the last three years. In this current growth-starved economic backdrop, **firms are encouraged to scour every opportunity, from organic investments to acquisitions, to generate best-in-class growth.**

2.2 Cost of capital

The global flight to quality following the Brexit referendum drove U.S. Treasury yields even further into historic low territory. A lower risk-free rate driven by uncertainty is usually followed by higher risk premia for both equity and debt. **A cost of capital advantage can emerge, however, for higher rated, lower beta firms for which premia increases do not fully offset the risk free rate decline** (Figure 3). Such firms should undoubtedly re-visit investment hurdle rates, which tend to remain at stubbornly high levels that can no longer be justified.[2] Lower hurdle rates may also make sense for lower-rated and/or higher beta firms: rising interest rates will likely be accompanied by decreasing risk premia, mitigating the impact to the overall cost of capital.

Figure 3

Brexit impacts not only future cash flows, but also cost of capital

		Investment grade		High-yield	
		Pre-Brexit	Post-Brexit	Pre-Brexit	Post-Brexit
	UST	1.75%	1.45%	1.75%	1.45%
DEBT	SPREAD	125bps	135bps	640bps	700bps
	COST OF DEBT	3.00%	2.80%	8.15%	8.45%

Source: J.P. Morgan, Bloomberg
Note: Pre-Brexit denotes 06/23/2016 market close, Post-Brexit denotes 06/27/2016 market close; 10Y UST at 1.75% pre- and 1.45% post-; For a hypothetical issuer, assumes IG spread of 125bps pre- and 135bps post-; HY spread of 640 pre- and 700bp post-; Cost of debt shown pre-tax

		Low beta		High beta	
		Pre-Brexit	Post-Brexit	Pre-Brexit	Post-Brexit
	BETA	0.5	0.5	1.5	1.5
EQUITY	MARKET RISK PREMIUM	7.25%	7.75%	7.25%	7.75%
	COST OF EQUITY	5.40%	5.30%	12.60%	13.10%

Source: J.P. Morgan, Bloomberg
Note: Pre-Brexit denotes 06/23/2016 market close, Post-Brexit denotes 06/27/2016 market close; 10Y UST at 1.75% pre- and 1.45% post-; Market risk premium uses dividend discount model at 7.25% pre- and illustrative 7.75% post-; Illustrative betas shown for low and high beta categories

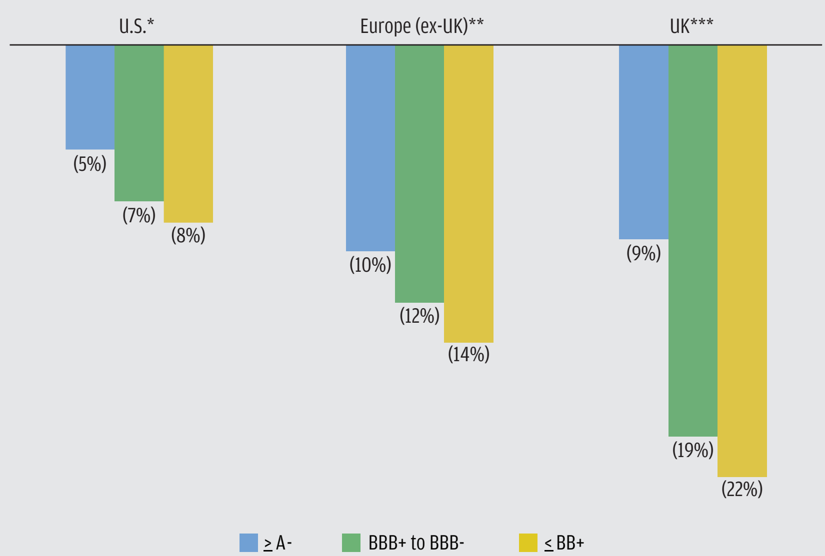
[2] For further reading on hurdle rates, please see our September 2014 report *Bridging the Gap between Interest Rates and Investments: Understanding the weak links between interest rates, cost of capital, hurdle rates, and capital allocation* found at https://www.jpmorgan.com/directdoc/JPMorgan_CorporateFinanceAdvisory_InterestRatesAndInvestments.pdf

2.3 Capital structure

The value of a fortress balance sheet is almost always apparent in times of uncertainty. Significant differentiation between investment grade and non-investment grade firms emerges, as equity and debt investors alike rush to resilient, higher quality assets. **Indeed, equity investors look to balance sheet resiliency given prospects of future stress** (Figure 4).

Figure 4

In the post-referendum turmoil, stronger balance sheets buffered equity returns



Source: J.P. Morgan, Bloomberg, S&P, FactSet
Note: Total shareholder returns calculated from 06/23/2016 to 06/27/2016;
Dataset excludes financials and firms that do not have a rating per S&P as of 06/27/2016
* U.S. dataset consists of S&P 500 firms;
** Europe dataset consists of STOXX 600 firms, excluding all UK firms;
*** UK dataset consists of both FTSE 100 & FTSE 250 firms

Following the Brexit referendum, non-investment grade firms declined on average by 2% to 6% more than investment grade firms, depending on the location. The differential was particularly pronounced in the EU and UK, compared to the differential in the U.S. Firms need to be proactive and reinforce their balance sheet and ratings when such activity appears to be least needed, since shocks to the system traditionally are followed by mounting rating agency pressure. Slow global growth and political uncertainty can easily de-rail status quo corporate credit ratings. A fortress balance sheet can mitigate this risk: well-capitalize firms usually come out ahead during periods of turmoil.

2.4 M&A

Brexit could both lower GDP growth and increase firms' cost of capital, twin levers that will likely impact existing M&A projects. In fact, both factors increase the attractiveness to sellers in already-announced combinations at pre-existing terms. They have the opposite effect, however, on purchasers. This could lead to the renegotiation of "live deals," with some of them potentially falling through.

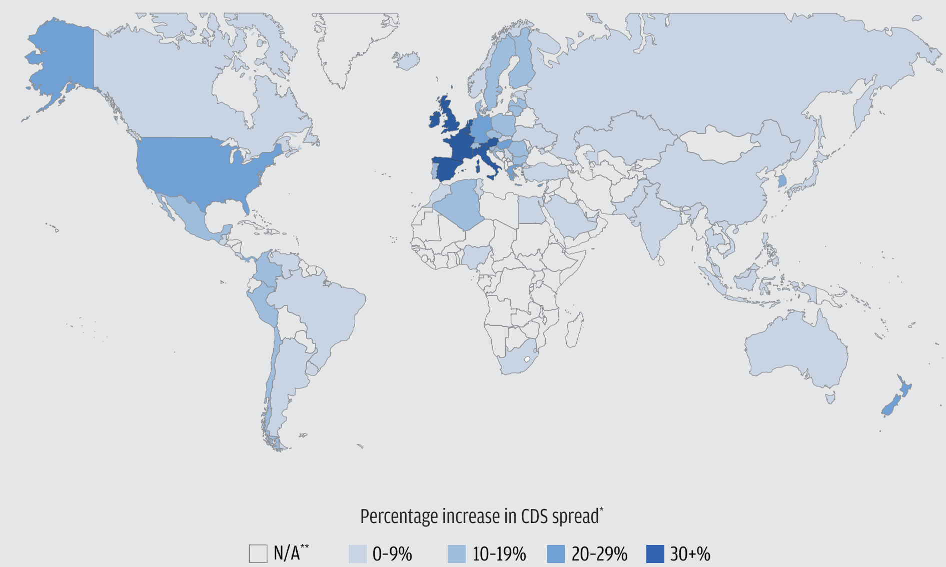
Brexit uncertainty may, however, also have a silver lining for the M&A market. **To the extent the current decline in equity market valuations is in excess of the true reduction in fundamental values, well-capitalized firms will find attractive buying opportunities.** Further, an evolving global landscape should encourage firms to re-assess their global exposure. Geo-political uncertainty, even in developed nations, can provide compelling opportunities for firms to diversify into certain markets, thereby providing an additional impetus to M&A.

2.5 Credit/counterparties

While the Brexit referendum most clearly impacts the UK and EU, it has widespread additional implications, as already illustrated by financial markets. Following the Brexit referendum, the CDS of UK and several European countries spiked the most. However, both developed and emerging economies outside Europe also experienced notable widening of their CDS spreads (Figure 5). **Firms should therefore be mindful of not only UK/EU exposure but also global exposure**, and in particular, high-risk jurisdictions and/or counterparties.

Figure 5

Brexit-induced tremors were felt in markets around the world



Sources: J.P. Morgan, Bloomberg
* Calculated as the percent increase in CDS spreads from 06/23/2016 to 06/27/2016;
** Countries without CDS spreads were excluded from the heat map and not shaded

2.6 Funding

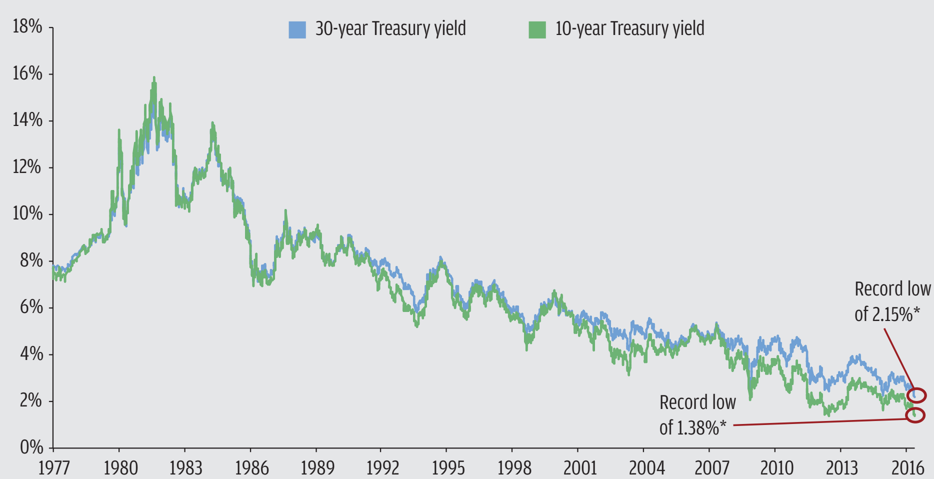
Within days following the Brexit vote, U.S., UK, and European sovereign yields hit new record lows, including both the U.S. 10-year and 30-year Treasuries (Figure 6). This renewed low-rate backdrop provides firms a unique opportunity to lock in "record rates" for long-term debt financing. Firms should use moments like these to re-evaluate their financing strategies:

- **Extend their maturity profile** by issuing longer tenor debt at historically low yields
- **Lock-in record low rates** via derivative contracts such as treasury or swap locks
- **Issue in the Euro debt markets** to both capture lower relative yields and further diversify into maturities unavailable in the U.S. debt markets

Notably, the backdrop may further accelerate the trend of U.S. firms issuing Euro-denominated debt. In addition to cost savings, matched currency funding is a prudent risk management strategy for those U.S. firms who increasingly generate their revenue offshore.

Figure 6

U.S. Treasury yields have reached new record lows



Source: J.P. Morgan, Bloomberg
* As of 07/05/2016

2.7 Strong USD

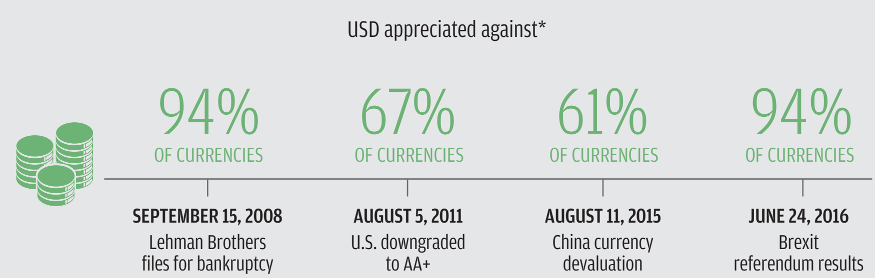
The strength of the U.S. dollar is no new phenomenon; however, unexpectedly sharp appreciation in times of uncertainty can have both direct and indirect implications.[3] Depending on a firm's global composition, its action plan can vary:

- **Firms with significant non-USD exposure** should prioritize currency risk management and asset liability matching, as the value of cash flows translated to USD declines. Such firms should also refine pricing contracts to provide themselves with a buffer to the extent possible
- **Predominantly USD-firms with non-USD competitors** should revisit their supply chain and shift production to lower-cost currencies to remain globally competitive. This may come at a cost as these very jurisdictions – including the UK and EU – may be prone to lower growth and heightened political, tax, and regulatory risk
- **Predominantly USD firms with limited non-USD competition** should be cognizant of a strengthening USD. They may find cheaper sources of capital abroad, and also attractively priced growth opportunities

The USD typically appreciates both significantly and rapidly during periods of market turmoil. Why is this time different from prior examples? On the day the referendum results were announced, the flight to quality was as strong as the day after the Lehman Brothers bankruptcy: **in contrast to recent periods of heightened uncertainty, the USD appreciated against all but one G20 currency** (Figure 7). Many firms immediately disclosed plans to shift strategies following the steep drop in sterling and political upheaval in the UK. This serves as a stark reminder that firms who swiftly re-evaluate their global exposures, along with their risk management practices, are the ones best positioned for global competition.

Figure 7

The aftermath of the referendum saw strong USD appreciation versus prior market dislocations



Source: J.P. Morgan, FactSet
Note: USD appreciation calculated by comparing the exchange rate at market-close on the day prior to the event to the exchange rate at market-close on the day after the event
* As measured against all other G20 currencies

[3] For further reading on FX in the context of corporate finance and risk management, please see our March 2015 report *Who's worrying about FX? Corporate finance strategies for a strong U.S. dollar environment* found at http://www.jpmorgan.com/directdoc/JPMorgan_CorporateFinanceAdvisory_WhosWorryingAboutFX.pdf, our July 2014 report *Lowering risk and saving money? A CFO's roadmap for foreign currency debt issuance* found at http://www.jpmorgan.com/directdoc/JPMorgan_CorporateFinanceAdvisory_LoweringRiskandSavingMoney.pdf, and our July 2013 report *Foreign exchange curveballs: Capitalizing on paradigm currency shifts* found at http://www.jpmorgan.com/directdoc/JPMorgan_CorporateFinanceAdvisory_ForeignExchangeCurveballs.pdf

2.8 Shareholder distributions

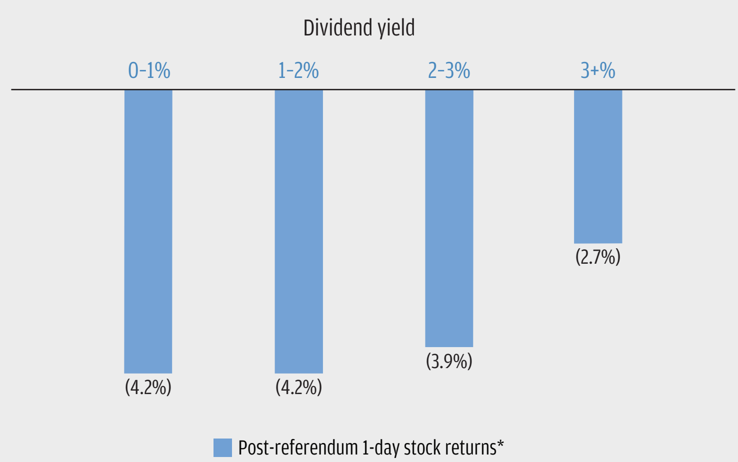
Low interest rates and sluggish growth clearly emphasize the importance of shareholder distributions. Depressed interest rates undoubtedly increase investor thirst for yield, while limited growth opportunities provide firms with an impetus to return capital to shareholders. Elevated market uncertainty also reinforces the benefits of a robust shareholder distribution policy. **Firms that can demonstrate a resilient dividend and buyback policy in the face of uncertainty ultimately (and often immediately) are rewarded by the market**. As a matter of policy, however, firms should reassess sustainability to ensure that future expected distributions can be supported by the business model in a new paradigm such as Brexit.

Dividends

A firm's dividend usually provides long-term signals as to a firm's confidence in its cash flow generation. The benefits of this signaling may be muted in strong markets, but become particularly visible in dislocated markets. **During periods of market turmoil, the stability of a dividend provides comfort to investors.**[4] This was most recently seen the day after the referendum: the larger the dividend yield, the less negative the market reaction (Figure 8).

Figure 8

Strong dividends buffer firms in volatile markets



Source: J.P. Morgan, Bloomberg, FactSet
Note: Dataset consists of S&P 500 firms, excluding financials
* Median of change in stock price from 06/23/2016 to 06/24/2016, dividend yields as of 06/23/2016

Share buybacks

Following rapid stock price declines, firms should reassess their fundamental valuations. Material potential for valuation upside may lead to attractive share repurchase opportunities. Structured share repurchase programs (such as Accelerated Share Repurchases/ASR) can further help firms monetize stock volatility. In such periods, however, firms should be careful to protect the balance sheet: market dislocations may incentivize repurchasing shares, but a sufficiently strong balance sheet is needed to weather the cycle. Additionally, retaining firepower can also help firms capitalize on opportunistic investments as they arise.

[4] For further reading on the dividend premium, please see our September 2015 report *2015 Distribution Policy: A trillion reasons to discuss dividends and buybacks* found at http://www.jpmorgan.com/directdoc/JPMorgan_CorporateFinanceAdvisory_2015DistributionPolicy.pdf

2.9 Pensions

Low asset returns and low discounts rates naturally lead to greater underfunding for defined benefit pension plans. We have had several pension storms in recent years, and some feel that recent market movements could mean that another storm is brewing.[5] Others, however, are of the view that the prolonged low rate could lead to a state of perpetual pension underfunding. **As a rule of thumb, a 50 basis point decrease in interest rates may increase total outstanding U.S. pension liabilities by up to $200bn or 10%**. Either way, absent implementing a pension de-risking strategy, firms with significant pension underfunding will face increased balance sheet pressure and be more susceptible to market volatility.

2.10 Shareholder activism

The sluggish growth environment of the post-financial crisis has led to muted returns for investors across many asset classes. This backdrop has fueled the rise in activism, **as investors look to broader asset classes to boost returns. Defensive corporate financial policies have also bolstered the case for shareholder activism**. Firms rationally hunker down and preserve liquidity during crisis.

It is critical, however, for firms not to adopt defensive tactics for extended periods of time, lest they become easy targets for shareholder activists. This is especially true **in periods of temporary market dislocations, when firms with valuations that are depressed beyond what fundamentals would suggest make for particularly attractive value propositions for activists to develop footholds**. In this low growth and low rate environment, therefore, firms are encouraged to proactively monitor and refine their financial policies to avoid complacency and, more importantly, avoid appearing on activist target lists.

[5] For further reading on pension funding, please see our September 2012 report *Time for a Pension Paradigm Shift? Catalysts and strategic considerations* found at https://www.jpmorgan.com/directdoc/JPMorgan_CorporateFinanceAdvisory_Pension_Paradigm_Shift.pdf and August 2011 report *Navigating Through another "Pension Storm": Prudent Pension Management in an Uncertain Market Environment* found at https://www.jpmorgan.com/directdoc/JPMorgan_CorporateFinanceAdvisory_Pensions.pdf

3. The corporate finance checklist post-Brexit

Global economic dynamics indicate that we are entering, or perhaps are already in, an environment marked by sluggish growth and high uncertainty. Investors appear to have reconciled themselves to this phenomenon, as demonstrated by the reaction of financial markets post the Brexit referendum. **While markets did initially react in record-breaking fashion the day and day after the results were announced, the next week found most markets rebounding to near pre-referendum levels**. Of course, markets can be complacent, which might suggest that this rebound could be short-lived. Either way, we urge firms to constantly evaluate and refine their corporate finance and risk management strategies for the current environment.

Figure 9

The corporate finance checklist post-Brexit

- ✓ Political and regulatory uncertainty suggest caution towards M&A and investments, but lower valuations can and should provide unique acquisition opportunities
- ✓ Even firms without direct UK or EU exposure should take into account that Brexit is likely to impede global growth prospects
- ✓ It is always better to be late than never: firms should continue to evaluate existing and potential hedges, along with other risk management tools
- ✓ Lower-rated companies in particular should be wary of potential market-access disruptions
- ✓ Firms should carefully evaluate all forms of counterparty risk with an eye towards elevated risk in traditionally low-risk jurisdictions
- ✓ Firms should revisit relationships with UK and EU-based counterparties, and plan for potential supply-chain and market-related disruptions
- ✓ Companies should continuously monitor the UK's engagement with the EU, while carefully assessing existing legal entity structures
- ✓ Firms should assess all scenarios and go beyond the historically observable

Source: J.P. Morgan

EXECUTIVE TAKEAWAY

Is the new normal a low growth environment marked by high uncertainty? Investors clearly appear to think so: while markets reacted strongly the day after the Brexit referendum, they quickly regained normalcy and most of the change was reversed. Today's economic environment requires firms to constantly re-evaluate themselves and think beyond traditional boundaries.

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