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From conformity to creativity

Creating shareholder value by breaking away from the herd

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1. Breaking from the herd

Conforming to peer best practices is common in strategic and financial decisions, particularly during crisis times. During the 2008 to 2009 crisis, most firms were justifiably focused on preserving liquidity and building fortress balance sheets. A year later, frustration with political and regulatory uncertainty replaced fear, but most firms remained hesitant and defensive. In 2011, decision-makers shifted gears towards prudent offense, including more aggressive return of capital to shareholders and synergistic acquisitions. Though strategies changed from one year to the next during this time period, most firms took similar actions and continued to watch their valuation multiples hover near record lows.

This year, however, an increasing number of senior decision-makers are embracing divergent thinking. Whether through creative M&A or financial policy paradigm shifts, no tool has gone unused to create shareholder value. Investors have applauded announcements that create stronger and more focused industry leaders, unlock hidden value, deliver more cash to shareholders and cater to specific investor bases.

We first describe the broader market factors that have driven the current low equity valuation multiples, thereby increasing attention to how individual firms should respond to the current environment. We explore the various innovative M&A and financial policy decisions firms have embraced to decouple themselves from the overall market to generate increased earnings growth and/or expand their valuation multiples. Creative M&A includes the use of offshore cash, spin-offs of various types and corporate inversions. On the financial policy side, we discuss capital structure arbitrage, paradigm shift dividend increases, real estate optimization, creative liability management and pension restructurings. We debate whether firms should wait for their peers to announce innovative strategies and then follow suit, or whether they should capture the advantage.

The combination of positive investor response to first movers and the rise of increasingly strident shareholder activists, leads us to expect the pace of creative M&A and financial policy to both accelerate and touch a broader swath of value-focused firms.

Figure 1

Corporations take creative actions this year to deliver shareholder value

Source: J.P. Morgan

EXECUTIVE TAKEAWAY

Despite years of prudent balance sheet management, record-low cost of debt, increasing distributions to shareholders and robust earnings growth outpacing anemic economic growth, equity valuation multiples remain stubbornly depressed. With this backdrop, senior decision-makers have made every effort in 2012 to uncover ways to create shareholder value. Increasingly, this effort has included implementing innovative approaches to break from the herd.

2. Management decisions have a bigger impact today

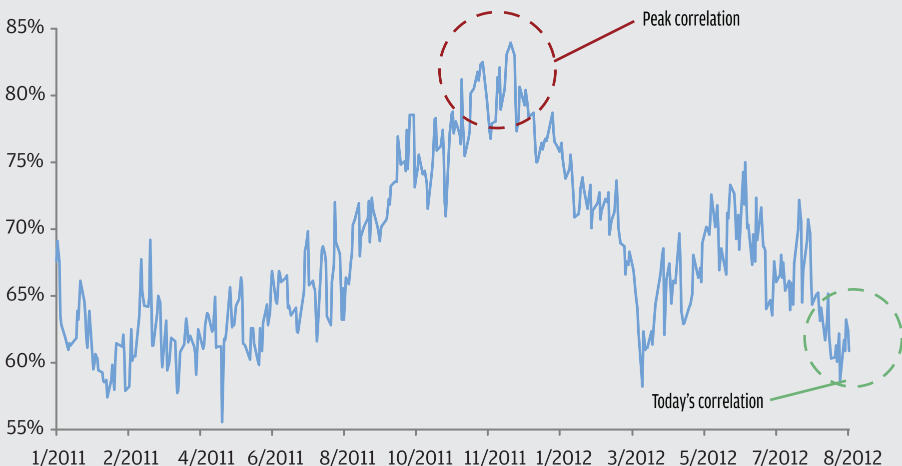
Investors focus again on corporate actions

In the fall of 2011, as markets focused their attention on the European credit crisis, many senior executives felt a growing frustration. Their stock traded in line with the broader market almost regardless of either their underlying performance or their corporate-finance decisions. Indeed, the average correlation among S&P 500 firms peaked around November 2011. Around that time almost 85% of individual stock returns could have been attributed to market movement and CFOs started to wonder: "*Does anything one does matter?*" (see Figure 2). Over the last few months, however, this correlation has dropped significantly and investors are increasingly rewarding firms for their own actions. In particular, investors focus on unique financial decisions that distinguish firms from the rest of the pack.

Figure 2

Investors focus more on specific company actions

CBOE S&P Implied Correlation Index[1]



Source: Bloomberg as of 8/31/2012

[1] CBOE index is an estimate of expected correlation of price returns of the stocks that comprise the S&P 500 with the index itself. The index uses prices (implied volatilities) of options on the stocks in a S&P 500 "tracking basket" against the price (implied volatility) of the S&P 500 itself

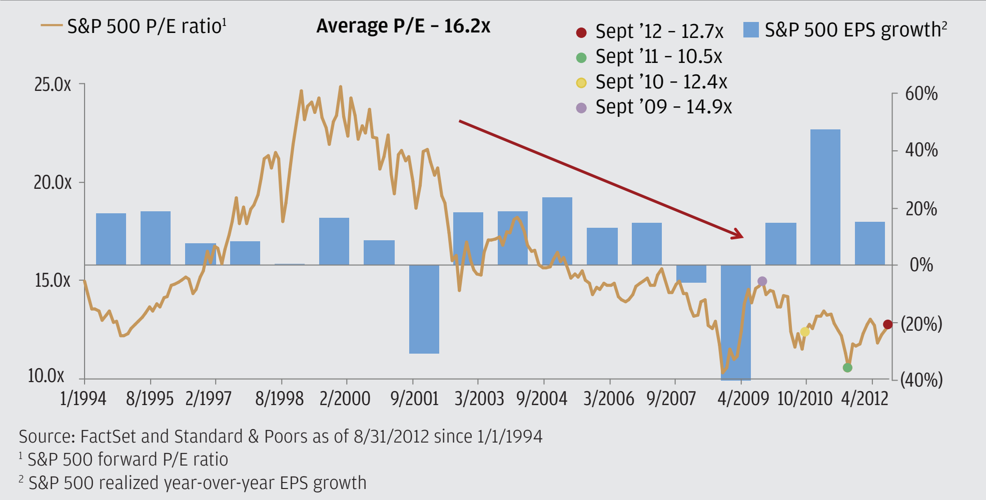
Value creation remains challenging

Despite robust earnings growth reported by most S&P 500 firms over the last few quarters, equity valuation multiples continue to hover near their historic lows, even on a growth adjusted basis (see Figure 3). These rock bottom valuations are leading shareholders to be more vocal in their demand for change. Ideas that were considered radical or controversial just a few years ago are now thoroughly examined. Boards and senior managements are leaving no stone unturned in their hunt for shareholder value. In the next section, we discuss some of the more successful approaches we have seen during the last year.

Figure 3

Valuation multiples continue to drop despite robust earnings growth

S&P 500 forward P/E ratio and EPS growth since 1994



Source: FactSet and Standard & Poors as of 8/31/2012 since 1/1/1994

[1] S&P 500 forward P/E ratio

[2] S&P 500 realized year-over-year EPS growth

EXECUTIVE TAKEAWAY

In periods of high macroeconomic uncertainty, most stocks trade in line with the market as investors focus on market headline risk. Lately, however, the correlation among S&P 500 stocks has declined, as investors pay more attention to company-specific decisions.

3. Creating value through divergent thinking

Firms are creating value by embracing innovative or non-conformist transactions both on the asset and liability side of the balance sheet. Transactions that grow or shrink the firm, as well as transactions that raise or distribute capital, have been well received. The keys to successful, innovative transactions are threefold: (1) They need to fit with the firm's overall strategy, (2) They need to opportunistically take advantage of anomalies in today's environment and (3) They need to be well articulated to investors.

Figure 4

Independent thinkers leave no stone unturned

Source: J.P. Morgan

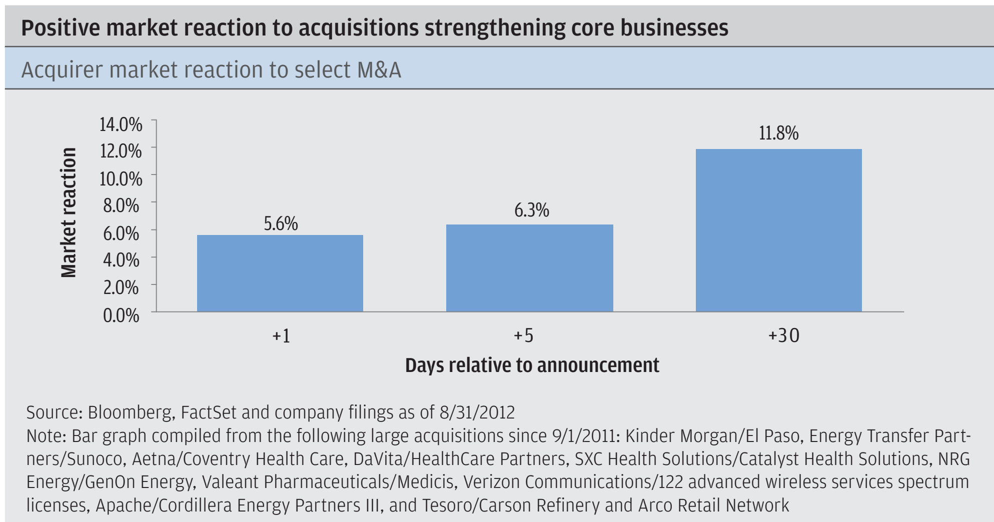
3.1 Innovative M&A strategies

Since 2010, equity investors have responded favorably to buyers/bidders in M&A transactions.[1] It was once the case that, on average, investors had a lukewarm or even negative reaction to buyers announcing an M&A transaction. Now, however, several firms with a reputation for astute M&A have witnessed double-digit stock gains on the announcement of M&A transactions, in particular when the transaction was synergistic and paid for mostly in cash (see Figure 5).

Figure 5

Positive market reaction to acquisitions strengthening core businesses

Acquirer market reaction to select M&A



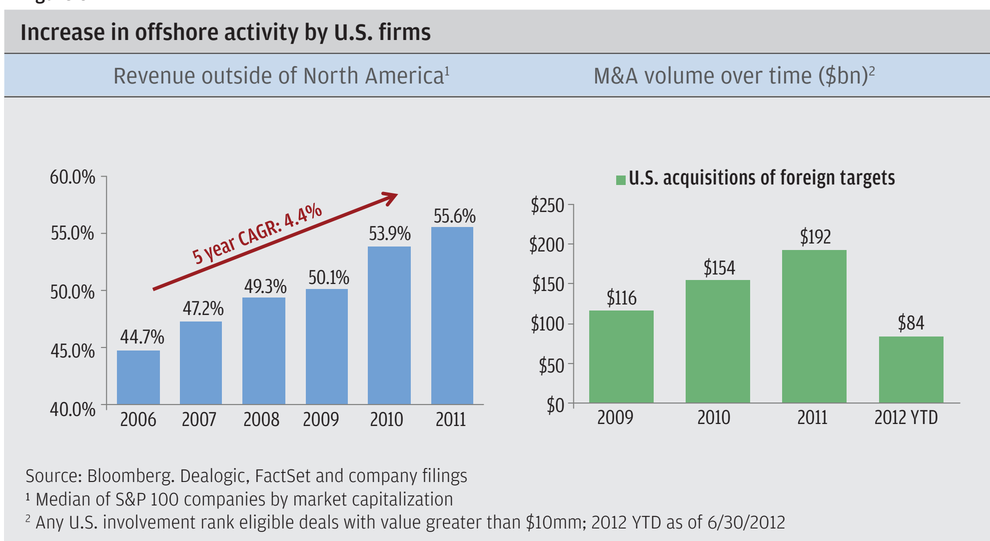
Source: Bloomberg, FactSet and company filings as of 8/31/2012
Note: Bar graph compiled from the following large acquisitions since 9/1/2011: Kinder Morgan/El Paso, Energy Transfer Partners/Sunoco, Aetna/Coventry Health Care, DaVita/HealthCare Partners, SXC Health Solutions/Catalyst Health Solutions, NRG Energy/GenOn Energy, Valeant Pharmaceuticals/Medicis, Verizon Communications/122 advanced wireless services spectrum licenses, Apache/Cordillera Energy Partners III, and Tesoro/Carson Refinery and Arco Retail Network

[1] "The New Face of M&A: How a Trillion Dollars Will Change the Strategic Landscape," Corporate Finance Advisory and Mergers & Acquisitions, J.P. Morgan, April 2011, http://www.jpmorgan.com/directdoc/JPMorgan_CorporateFinanceAdvisory_NewFaceMA.pdf

Three types of M&A-related transactions deserve particular attention in this new environment:

1. **Acquisitions using offshore cash:** While large U.S. firms are awash in cash, much of this cash is offshore. The low returns and significant opportunity cost of offshore cash have been a source of significant frustration for many decision-makers and investors alike. Recently some U.S. firms have been able to identify attractive and synergistic targets overseas to use their offshore cash more productively. However, because it is mostly technology and healthcare firms that tend to accumulate offshore cash, the universe of attractive targets has been well-scoured. In addition, a key concern of investors is that firms do not overpay for targets when many possible buyers are considering the same target. Accordingly, buyers should remain opportunistic and even aggressive, but nevertheless disciplined.
2. **Business combinations leading to an inversion:** The offshore trapped cash issue is driven by the U.S. system of worldwide taxation. Unlike most other developed economies, the U.S. taxes both domestic and non-domestic earnings. Non-domestic earnings are not taxed, however, if they continue to be reinvested overseas. When a U.S. firm merges with a non-U.S. firm, the combined company can redomicile to the non-U.S. jurisdiction under certain conditions. Corporate inversions can make firms more competitive, especially when they operate in a global market.
3. **Asset repositioning through spin-offs:** Though most M&A-related activities involve gaining scale or access to new markets and technologies, there is also significant emphasis on corporate focus and transparency. Corporate focus can be improved by shrinking prior to pursuing additional growth, especially when valuation multiples or capital structure objectives differ. In a market environment where investors favor pure plays (i.e., firms with a single business focus), conglomerates mixing significant cash returns and extraordinary growth prospects often do not realize full valuation benefits. Today, firms are exploring separating assets that management would have asserted were essential in their broader strategy just a few years ago, regardless of the structural complexity of such separations.

Figure 6



Source: Bloomberg. Dealogic, FactSet and company filings

[1] Median of S&P 100 companies by market capitalization

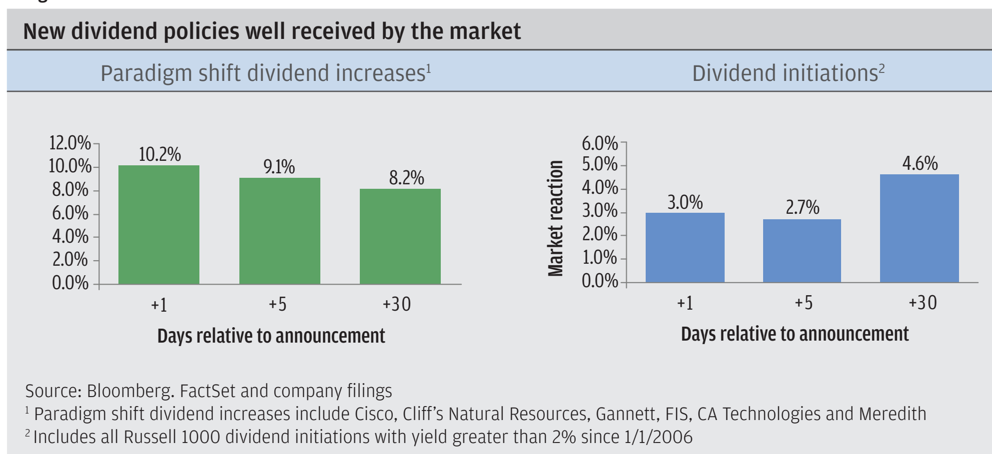
[2] Any U.S. involvement rank eligible deals with value greater than $10mm; 2012 YTD as of 6/30/2012

3.2 Financial policy ideas AWAY from the peer median

Making your voice heard. Today's low rate environment, macroeconomic uncertainty and high demand for income support higher valuations for dividend paying stocks. While equities as an asset class have experienced significant outflows in recent years, dividend paying stocks have enjoyed inflows and premium growth-adjusted valuation multiples. Many companies have noticed this trend and used their strong cash flows and balance sheet flexibility to increase their dividends by 10-20%, but a few firms have taken more aggressive action to attract investors' attention. **Paradigm shift dividend increases in the last year led to 10% outperformance on the day following the announcement.**[2]

"Well, at your age..." Dividends were traditionally perceived not only as a positive signal of stable cash flow, but also a signal of limited investment opportunities and growth prospects. This perception combined with the need for flexibility, led most "maturing growth" growth firms to hoard cash or rely solely on share repurchases to return capital to shareholders. This traditional approach changed this year as mature companies in these once ultra-growth sectors started initiating dividends. **Material dividend initiations (of at least a 2% yield) have led to stock outperformance of 5% in the 30 days following the announcement** (Figure 7).

Figure 7



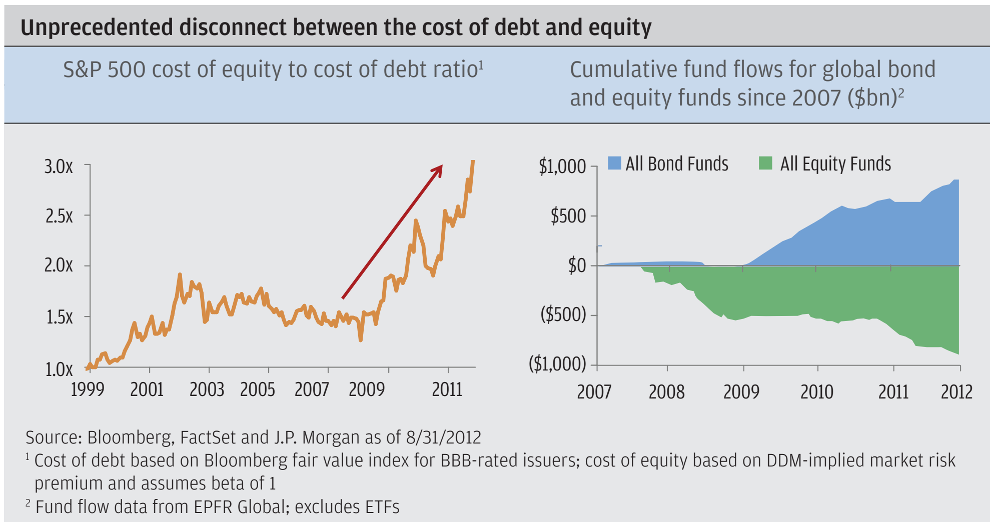
New dividend policies well received by the market

Source: Bloomberg. FactSet and company filings
[1] Paradigm shift dividend increases include Cisco, Cliff's Natural Resources, Gannett, FIS, CA Technologies and Meredith
[2] Includes all Russell 1000 dividend initiations with yield greater than 2% since 1/1/2006

Breaking a taboo. As mentioned earlier in this report, equity valuation multiples are depressed. The credit markets have, however, been rallying since the peak of the crisis. This has led to a surging disconnection between the cost of equity and cost of debt, driving their relative cost to a record high. The massive inflows into bond funds and out of equity funds shown in Figure 8 are partially caused by technical factors and market dislocations. Most notably, pension funds, suffering from poor returns and high volatility on their assets over the last decade, are shifting their asset allocations towards fixed income. Companies can take advantage of this capital structure "arbitrage" by issuing low coupon debt and repurchasing undervalued stock. While some have used their debt capacity within their current rating to implement this strategy, other firms went further and **"broke a taboo" by accepting a rating downgrade to execute debt-financed share buybacks or pay special dividends.**

[2] Paradigm shift dividend increases, defined as significant changes in a company's dividend policy, include Cisco, Cliff's Natural Resources, Gannett, FIS, CA Technologies and Meredith

Figure 8



Unprecedented disconnect between the cost of debt and equity

S&P 500 cost of equity to cost of debt ratio[1]

Cumulative fund flows for global bond and equity funds since 2007 ($bn)[2]

Source: Bloomberg, FactSet and J.P. Morgan as of 8/31/2012

[1] Cost of debt based on Bloomberg fair value index for BBB-rated issuers; cost of equity based on DDM-implied market risk premium and assumes beta of 1

[2] Fund flow data from EPFR Global; excludes ETFs

Hidden gems. Sometimes the most valuable things are in plain sight. Companies that hold significant non-core real estate assets often do not get a significant valuation benefit from equity investors. One strategy explored by divergent thinkers this year is divesting their non-core real estate portfolios to unlock this value. Firms in some sectors, such as cell towers and billboards, have explored ways to convert their entire companies into Real Estate Investment Trusts (REITs). A REIT conversion reduces corporate-level taxes and is also paired with a much more aggressive distribution policy (but also loss of flexibility due to distribution requirements and other limitations). These transactions have generally been well received by investors and equity analysts and have led to strong and sustainable positive market reactions.

Facing the "deadly duo." Poor equity returns and surging liabilities have led to record corporate pension underfunding for defined benefit plans. Despite almost $250bn in pension contributions, the funding ratio of the aggregate S&P 500 market capitalization has dropped from 104% in 2007 to 79% at the end of 2011.[3] **As a result, several major companies have announced paradigm shifts in their pension management.** These paradigm shifts include a voluntary contribution to fully fund the plan (often financed with debt), asset allocation shift towards more fixed income (as mentioned before), lump sum payment-offers to some plan participants and/or annuities purchased from insurance companies. Though there are only a few examples thus far, a favorable reaction by the market may suggest that other firms could soon follow suit.

Creative liability management. Many market participants share the view that risks are asymmetric when it comes to future interest rates. With long-term rates approaching historic lows, most S&P 500 firms rely mostly on long-term fixed rate debt (through new debt issuance, the unwinding of existing swaps), yet a few divergent thinkers are going a step further. They are analyzing their future maturities and other financing needs and are using forward-starting swaps, T-Locks and other tools to take advantage of today's low rate environment. In particular, we note that investors have responded positively to firms that have refinanced high coupon debt with longer dated lower coupon debt even if such transactions are associated with a short-term EPS reduction.

[3] "Time for a Pension Paradigm Shift? Catalysts and strategic considerations," Corporate Finance Advisory, J.P. Morgan, September 2012, http://www.jpmorgan.com/directdoc/JPMorgan_CorporateFinanceAdvisory_Pension_Paradigm_Shift.pdf

EXECUTIVE TAKEAWAY

This year a group of divergent thinkers have challenged old axioms. The market has seen some U.S. companies think creatively about M&A, capital structure, shareholder distributions, risk management and corporate structuring. Investors have applauded firms who dared to diverge from the peer median in order to generate shareholder value in this unique capital market environment.

4. First mover advantage?

Breaking away from the herd presents significant risks. Senior decision-makers first need to convince their Boards of the benefits of an innovative approach. Then, subject to board approval, they need to craft a careful message to convey the significant benefits of nonconventional approaches to their equity and debt investors. Finally, any strategy undertaken needs to be executed flawlessly, since it will occur under intense scrutiny from both the Board and investors, to ensure that investors fully reap the benefits of the transaction.

Given these risks, why would decision-makers ever take the lead in such transactions? Are they not better off waiting to gauge how the market receives the first announcements? If the market response is favorable, should it not be easy to copy the first movers and reap the same benefits?

We believe that there are significant benefits to being the first mover and potential costs to being a follower:

1. **Finite supply:** In some instances there is a limited supply of M&A targets with desired assets in the preferred jurisdiction. Further, for some types of securities or for the pension annuities we discussed, there may be a limited supply of capital from investors or insurance companies.
2. **Regulatory changes:** Regulators or tax authorities do not always embrace innovative structures. They may respond to these innovations by changing the regulatory framework to prevent more such transactions. Since the first movers are typically grandfathered, they reap a material advantage.

3. **Leadership premium:** Firms that have the reputation for smart, innovative decisions that consistently create shareholder value often trade at a premium and have an easier time attracting new talent.
4. **Activism:** Firms that are not at the forefront of innovative value creation decisions may be pressured by shareholders, in particular activist investors, to evaluate and imitate the well-received decisions. The noise around activism may weaken management, but more importantly, may lead to decisions that are not in the long-term benefit of all investors.

EXECUTIVE TAKEAWAY

At first glance, it would appear that one is almost always better off waiting for peers to announce innovative transactions. One can learn from these announcements and imitate the transaction if it was well received. There are, however, definite advantages to being first. In some instances, there is a limited supply of capital or assets. Moreover, regulations can change and second-movers are not always able to accomplish the same objective. Further, management teams that are perceived as leaders in the industry may be able to attract better talent and can even trade at a premium. Finally, waiting too long may expose the firm to activism, which in some cases may lead to inopportune long-term decisions or weaken the management team.

Notes

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