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Action speaks louder than words

Investors reward proactive strategies

J.P.Morgan

For questions or further information, please contact:

Corporate Finance Advisory

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

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

1. Action speaks louder than words...but not nearly so often

This time last year, senior decision-makers at large global companies moved **from fear of the financial crisis and its ramifications to frustration** about where to invest in the face of anemic economic growth.[1] Emerging from the crisis, corporate balance sheets were neither weak nor over-levered, but rather strong and cash-rich. Despite their unparalleled financial strength, many firms were struggling to find attractive opportunities to put their fortress balance sheets to work and invest in growth. Misgivings about unpredictable government regulation, fragile economic growth and weakened consumer demand, as well as excess productive capacity, delayed more aggressive corporate investments.

Today, uncertainty about economic growth continues, now coupled with an accentuated focus on sovereign risk. For example, last month J.P. Morgan lowered its U.S. GDP growth forecast for 2012 from 2.7% to 1.2%.[2] On the sovereign front, capital markets sustained the shocks of a U.S. government downgrade by S&P, along with rapidly increasing concerns about sovereign credit quality in Europe and its repercussions to the financial system.

There has, however, been **one key change** since last year. Leading firms have decisively set their courses and have **moved from defense to offense.** Whether their strategies entail reaching competitive size and scale through transformative acquisitions, or shrinking to enhance clarity through spin-offs and divestitures; whether their strategies involve distributing excess capital via dividends or buybacks, or raising new capital opportunistically, **investors have rewarded firms that execute their offensive strategies successfully.**

The key takeaway of this report is that investors are looking for firms to take advantage of their strong balance sheets and historically low cost of capital. Investors do not favor any particular strategy over another and the various strategies are not mutually exclusive. In fact, many of these strategies may be complementary. Often, firms need to divest and refocus before they can execute large, game-changing acquisitions. Similarly, while many firms have excess liquidity, they may still access capital markets to take advantage of historically low cost of debt to term out short-term debt maturities, make pension contributions, de-risk future growth plans and/or return capital to shareholders.

We start the report by reviewing the state of corporate balance sheets. Thereafter, we discuss the key proactive strategies available to decision-makers and weigh the benefits, considerations and market reaction for each strategy. We conclude by providing a clear action plan for senior executives.

2. Fortress balance sheets

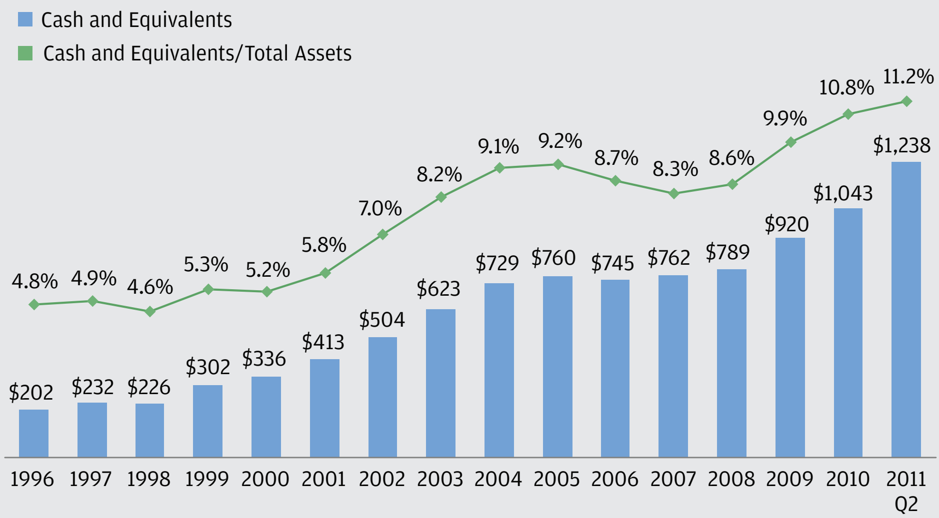
2.1. Cash rich firms

Corporate cash balances have reached unprecedented heights. Federal Reserve data suggest that U.S. firms are experiencing their highest cash levels since the 1950s. Since last year, corporate cash balances have continued to grow at an accelerating pace, with selected (S&P 500 non-financial) increasing from about $1 trillion to about $1.2 trillion (or 19%).

[1] "From fear to frustration: A special report for the 2010 J.P. Morgan CFO Forum," Corporate Finance Advisory, J.P. Morgan, September 2010, http://www.jpmorgan.com/directdoc/JPMorgan_CorporateFinanceAdvisory_FromFeartoFrustration.pdf.
[2] "U.S. Weekly Prospects," Bruce Kasman, J.P. Morgan, September 2, 2011.

Figure 1

Historically high cash balances (S&P 500 non-financial)



Source: FactSet
Note: Data as of Q2 2011 and includes highly liquid, cash-like assets held on-balance-sheet; S&P 500 excluding financial and insurance companies.

During the 2007-2009 financial crisis, firms nurtured large cash balances due to fears of bank and capital market shutdowns, and for downside protection. If these fears have subsided, **why are cash balances still growing today?**

1) **Low investment levels relative to operating cash flows:** Because of limited growth opportunities and excess production capacity, firms continue to invest little relative to their operating cash flows (and little relative to historical investment norms).

2) **Reduced interest payments on reduced debt levels:** Firms have continued to de-lever, and, more importantly, now pay significantly lower interest on this leverage (see Figure 3 in the next section).

3) **Easy access to capital market liquidity:** Firms that need external liquidity have been able to access debt (or equity) capital markets to de-risk future growth plans or to pre-fund upcoming maturities.

4) **Proportionally low cash distributions:** Although shareholder distributions have increased post-crisis, they are nowhere near pre-crisis levels. In fact, dividend payout levels relative to earnings are at historic lows.

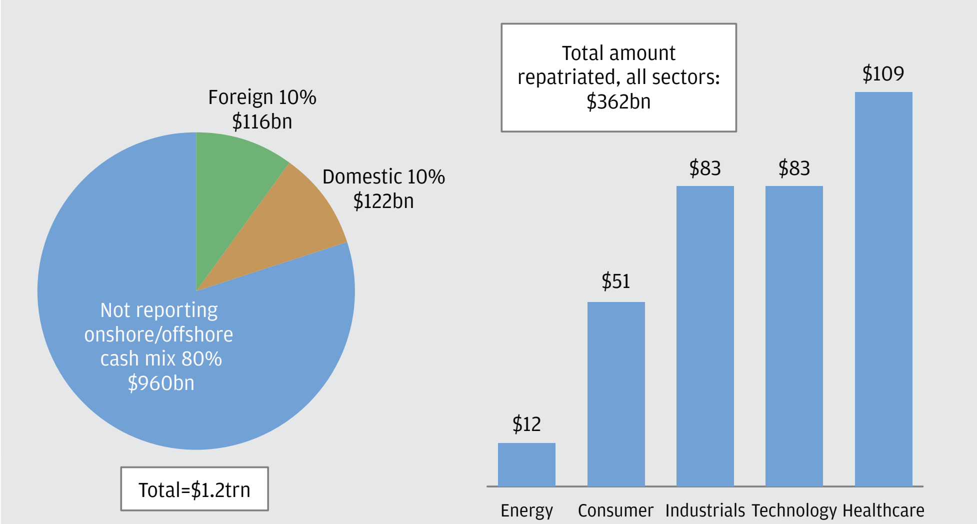
5) **Acquisition activity has picked up, but not in a commensurate fashion:** Some firms preserve cash balances for opportunistic acquisitions. As we will discuss in a later section, acquisition activity has picked up significantly, but it is not yet back to pre-crisis levels.

6) **Worldwide taxation:** While the previous five factors explaining growing cash balances apply to most firms in developed markets, this factor is unique for U.S. domiciled firms. Unlike most other countries, which employ a territorial tax system, U.S. authorities tax profits earned globally. Cash taxes have to be paid, however, only when these global profits are repatriated. Many U.S. firms do not repatriate part of their overseas profits. We estimate that about half of the S&P 500's cash mountain is "trapped" offshore. For example, the S&P 500 firms reporting the status of their cash (approximately 50 firms) indicate that in aggregate, half of the group's cash balance is trapped offshore (see Figure 2). These cash balances are concentrated in certain global industries, such as technology, pharmaceuticals and consumer products.

Figure 2

Approximately 50% of cash is trapped offshore, according to available data

S&P 500 reported offshore cash[1] | Repatriation in '05 under HIA[2] ($bn)



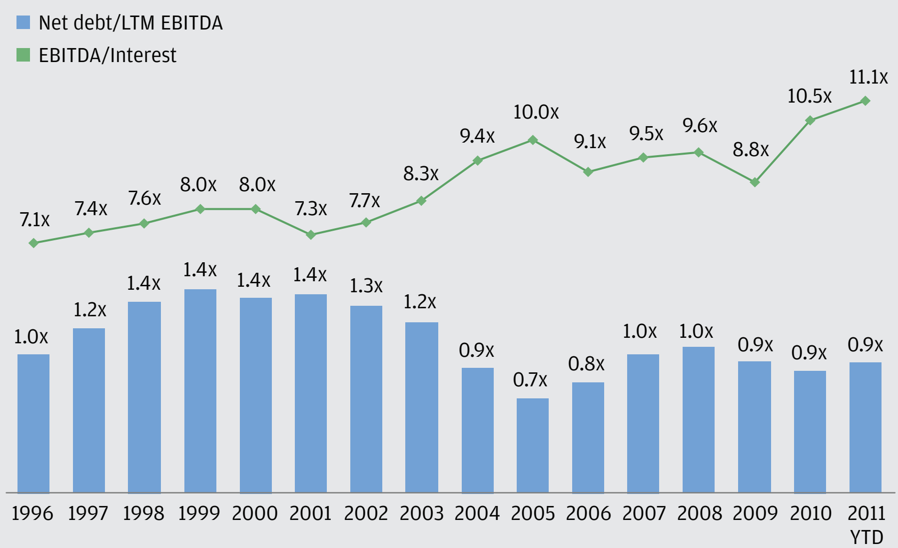
Source: FactSet, IRS, J.P. Morgan estimates
[1] Excludes Financials.
[2] Refers to the Homeland Investment Act, which provided a one-time tax holiday for the repatriation of overseas earnings; the effective tax rate on qualifying dividends was 5.25%.

2.2. Declining leverage

Anyone not familiar with the current state of corporate balance sheets would likely surmise that they are overstretched coming out of a deep recession. Surprisingly, a number of factors contributed to just the opposite. Through the crisis, firms were able to cut back on capex, buybacks, and expenses, generating sufficient cash flow to pay down debt. In addition, firms were also able to extend debt maturities by paying down short-term debt with longer-term debt without excessively increasing their cost of debt financing due to historically low interest rates. In Figure 3 on the next page, we show how coverage ratios of non-financial S&P 500 firms increased from 7.3x to 11.1x over the past 10 years.

Figure 3

Large non-financial firms have historically low debt burdens



Source: FactSet, Bloomberg, J.P. Morgan
Note: Analysis based on fixed set of S&P 500 non-financial firms that were in the index as of 12/31/07.

2.3. Underfunded pensions and the off-balance sheet threat

Although on-balance sheet leverage has decreased by virtue of the factors discussed in the previous section, off-balance sheet leverage has increased for the subset of firms with defined benefit pension plans. These firms have been hit by the third perfect pension storm over the past 10 years.[3] A perfect pension storm is a situation where pension assets suffer because of poor returns; simultaneously, pension liabilities rise as the present value of liabilities is estimated with lower discount rates. While these liabilities are small for most firms, they are material to others and should not be ignored as these firms consider which corporate strategies to pursue.

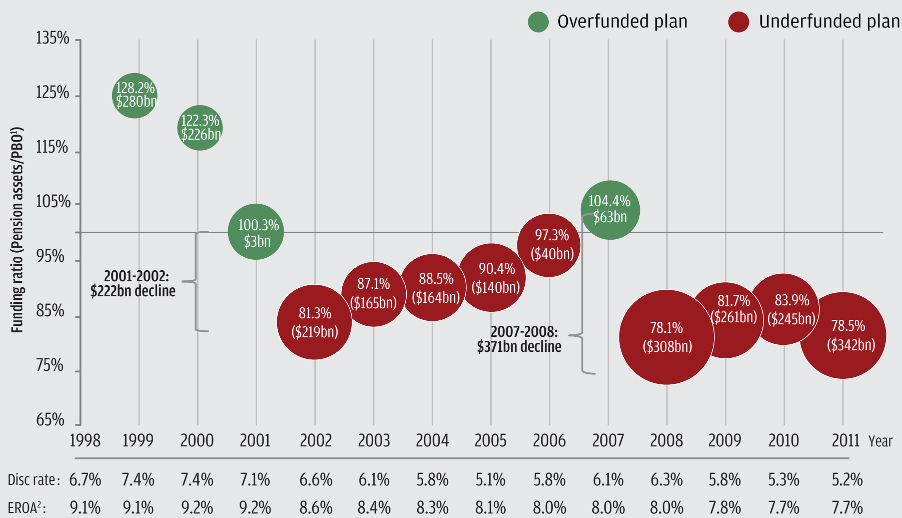
3. Corporate strategy: from defense to offense

In today's low growth environment, playing offense is critical for many companies' continued success. Investors are focused on proactive strategic moves and reward firms with well-articulated and well-executed offensive strategies. Reacting to competitor moves is often viewed as "too little, too late" by the market. Firms with abundant liquidity and low leverage that choose to keep the status may create "lazy" balance sheets and attract shareholder activists. In Figure 5, we lay out the various alternatives in the corporate finance strategic arsenal and show how investors have applauded proactive firms.

[3] "Navigating Through Another 'Pension Storm:' Prudent Pension Management in an Uncertain Market Environment," Corporate Finance Advisory, J.P. Morgan, August 2011, http://www.jpmorgan.com/directdoc/JPMorgan_CorporateFinanceAdvisory_Pensions.pdf.

Figure 4

Low discount rates have led to surging unfunded pension liabilities



Size of the bubble represents materiality of the pension plan (PBO[1]/market capitalization)

Source: Bloomberg; Capital IQ; J.P. Morgan; "Corporate Pensions Become An Acceptable Expense While OPEBs Remain A Target For Cuts, Concerns, and Casualties" article published by S&P in May 2011; "S&P 500 2010: Pensions and OPEBs" database published by S&P in May 2011; S&P 500 historical market cap per S&P's website
Note: 2011 values estimated by J.P. Morgan and exclude contributions made by companies in 2011; EROA and discount rates prior to 2011 per reported financials by S&P 500 firms; 2011 asset returns calculated using BarCap Aggregate Bond Total Return Index, S&P 500 Total Return Index, S&P 500 Case-Shiller Home Price Index, and DJ/CS Hedge Fund Index, with portfolio allocation of 47% equity, 40% fixed-income, 3% real-estate, and 10% other assets; 2011 PBO calculated using year-end 2010 Citigroup Pension Discount Curve rate.
[1] Projected Benefit Obligation.
[2] Expected rate of return.

3.1. Gaining size and scale via transformative acquisitions

After a significant decline in M&A activity during the financial crisis, when firms focused on defense rather than offense, **M&A is rebounding**. As shown in Figure 6, M&A volume increased by more than 10% in 2010 and is expected this year to approach 2005-2006 levels. Historically investors have primarily bid up the equity values of potential **"target firms,"** but they have recently begun to **reward acquirers** who announce large strategic transactions.[4] This trend started earlier this year and has continued unabated even during the recent market turmoil. In these transactions investors particularly value:

1) Like-for-like transactions with significant synergies
2) The opportunity to fuel top-line growth in new regions or products
3) The use of cheap debt capital or of excess cash (offshore or onshore)

[4] "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.

Figure 5

From defense to offense: Executing an effective corporate strategy

Status Quo
- Continue cash buildup or delever

Strategic
- Bigger/Transformational
- Smaller/Focused
- Joint ventures

Financing
- Pre-fund debt maturities
- Fund acquisitions/Build firepower
- Address underfunded pensions
- Finance shareholder distributions

Distributions
- Dividends
- Share buybacks
- Special dividends

Source: Bloomberg, FactSet, company press releases
Note: Excess return defined as company stock total return less S&P 500 total return * beta.
[1] Selected transactions since 2008.
[2] Twenty lowest 10-year historical corporate coupons.
[3] Selected debt-financed distributions since 2010.
[4] All distribution announcements from 2008–Q2 2011 of firms in the Russell 1000.

Figure 5

From defense to offense: The market has reacted positively to...

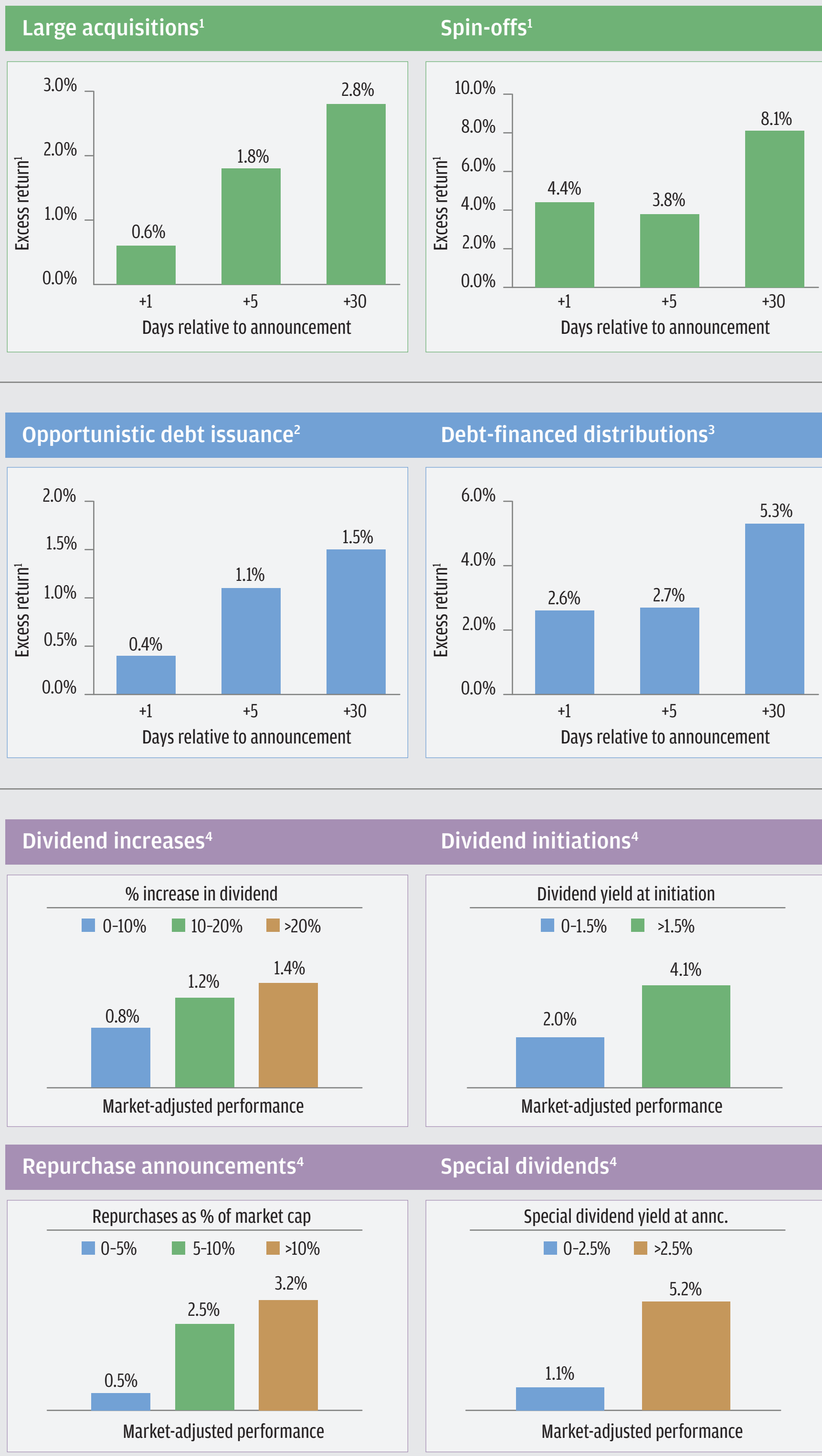
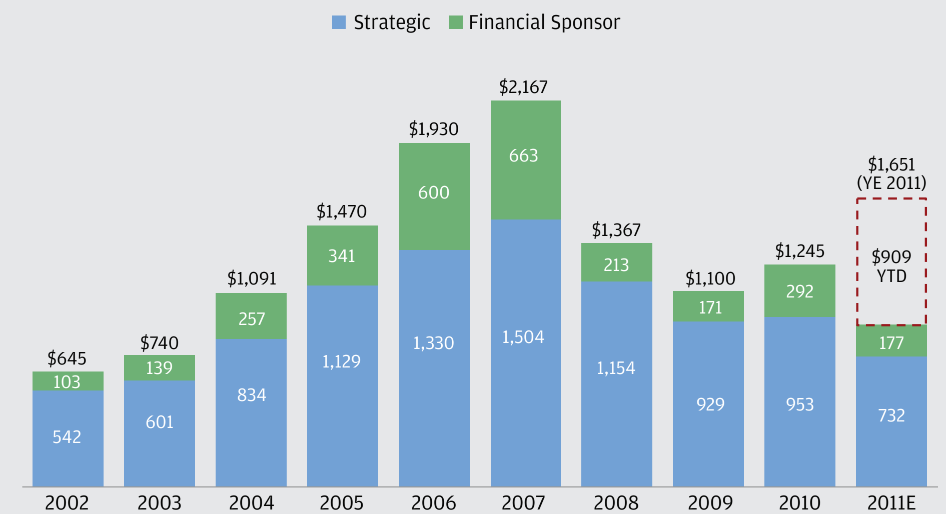


Figure 6

Rising corporate M&A volumes



Source: J.P. Morgan, Dealogic M&A Manager as of 7/21/2011
Note: Rank eligible deals with value greater than $10mm.

3.2. Increasing corporate transparency and focus: Spin-offs and divestitures

With the threat of a new acute financial crisis waning and access to capital improving even for smaller firms, many large, multi-sector firms are evaluating the possibility of refining their corporate focus by divesting or spinning off units. With the goal of corporate transparency in mind and in the absence of significant cash needs, many firms have announced spin-offs/split-offs of key units subject to tax-efficiency constraints. Similar to transformative acquisitions, these spin-offs dramatically alter the risk and growth profile of the spinnor. In most cases, equity investors have applauded these announcements because the spin achieves the following objectives:

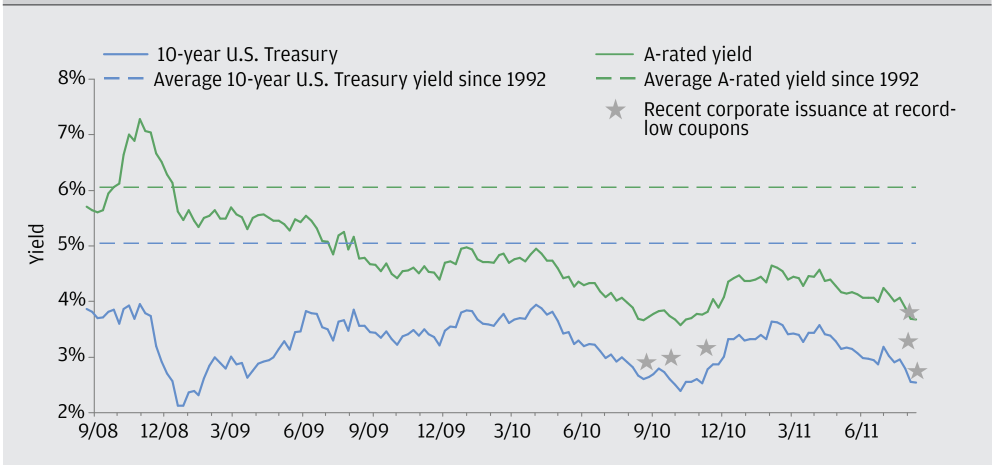
1) Detaches high growth from low growth divisions, and permits the separated entities to tailor their financial policies accordingly
2) Satisfies different investor clienteles who may be focused on growth versus income
3) Generates independent acquisition currencies
4) Creates managerial incentives with better alignment to their respective businesses

4. Historically low cost of debt and opportunistic financing

The historic credit downgrade of the U.S. government by S&P, coupled with macroeconomic concerns related to the U.S. and Europe, have led to a massive flight to quality this summer, resulting in record low Treasury yields. At the same time, yield-starved investors have increased their demand for corporate bonds, which generated supply and demand dynamics favorable to corporate issuers. Several large and well-known investment grade firms have recently taken advantage of this environment to access the bond markets and print record low coupons (Figure 7). Investors have also responded well to firms announcing this type of opportunistic financing, whether proceeds were used for return of capital, investments, pension funding, or extension of maturities.

Figure 7

Opportunistic financing and record-breaking coupons



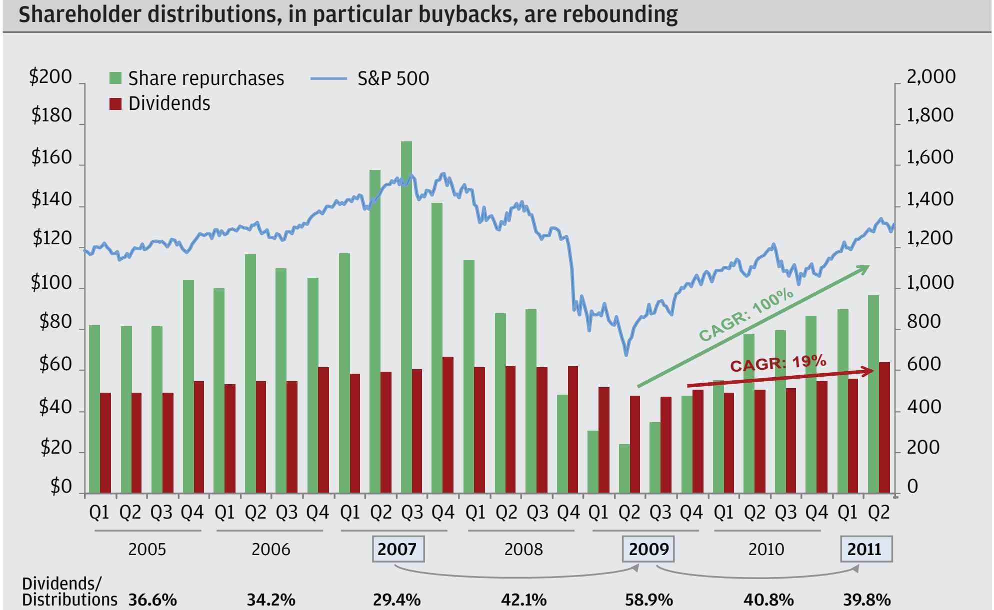
Source: Bloomberg, Securities Data Corp., Thompson Reuters

5. Returning capital and proactive financial policies

Today's financial landscape is cluttered with cash-rich balance sheets that are largely a vestige of the crisis when capital markets were closed and liquidity premia skyrocketed. Recently, many firms have begun to aggressively step up shareholder distributions.[5] Share buybacks, which plummeted during the crisis from $172bn in Q3 2007 to $24bn in Q2 2009, have rebounded post-crisis to $97bn in Q2 2011 (Figure 8). In contrast, dividends have remained relatively stable throughout the crisis in most industries (excluding the financial and real estate sectors), at about $50bn per quarter.

Figure 8

Shareholder distributions, in particular buybacks, are rebounding



Source: J.P. Morgan, Standard & Poor's, Bloomberg

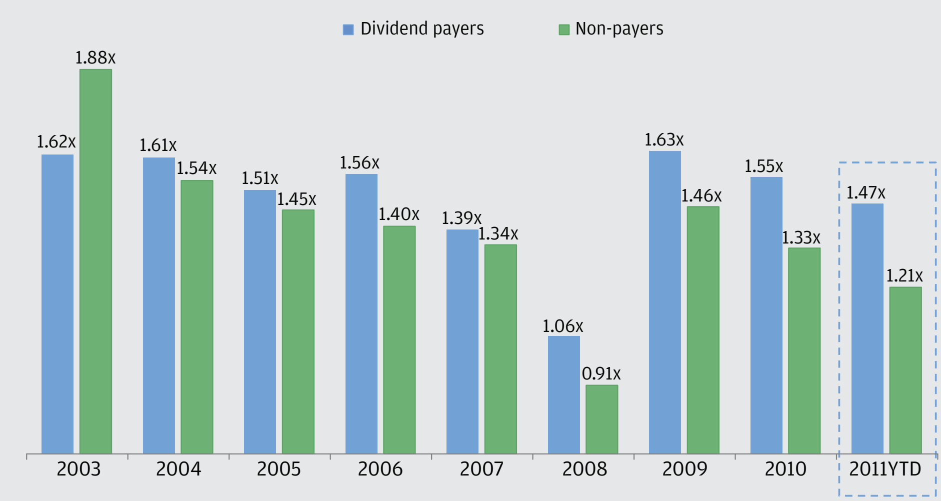
[5] "Q1 2011 Distributions: Facts & Trends," Corporate Finance Advisory, J.P. Morgan, April 2011, http://www.jpmorgan.com/directdoc/JPMorgan_CorporateFinanceAdvisory_Q12011Distributions.pdf

As we showed in Figure 5, investors have rewarded all forms of distribution policies. Importantly, in today's low-growth environment, investors reward dividend-paying firms with higher PEG ratios than non-dividend payers (Figure 9). This phenomenon is consistent with (1) a world in which yield-starved investors are willing to pay up for steady sources of income, and (2) a world in which investors are relatively skeptical of high future EPS growth expectations. Of course, many dividend-paying firms are also more likely to enjoy strong and more stable cash flows, which would also drive valuation. However, even with this stability, they did not enjoy the higher returns per unit of growth 10 years ago than they do in the current market environment. Opportunistic (and in some cases, debt-financed) share repurchases have also been applauded by investors. Moreover, even special dividends, which have often been viewed as a bearish signal for share value, have also been well received.

For companies enjoying cash flows that are consistently stronger than the requirements of their ongoing investment opportunities and liquidity "safety net," initiating an ordinary dividend may be advisable. The data suggests that dividend initiations should not only be considered by slow-growth firms, but also by high-growth firms who have enough capital to fuel their investments in excess of an initial and growing dividend commitment. On the other hand, many firms with declining growth still do not pay dividends. Overall, we recommend a dividend level that is material enough to make a difference to investors, yet still leaves room to steadily grow the dividend over time without burning through the firm's liquidity buffer.

Figure 9

Dividend payers now receive more credit for growth than do non-dividend payers



Source: FactSet, Bloomberg, J.P. Morgan. Values as of 12/31 of each respective year, except for 2011YTD, which are as of 6/30/2011. PEG based on one-year forward EPS estimate and IBES consensus long-term growth.

6. Activist pressures

Shareholder activists have become more visible and aggressive over the past year. For many Boards of Directors and top management teams, activist threats have come to the fore. Whether or not they currently face such a threat, decision-makers should be aware that the manner in which activists evaluate the operation of firms is not much different from that in which effective management teams and boards assess their own companies. Not surprisingly, enhancing corporate focus and engaging in shareholder distributions, where appropriate, are two areas in which both effective activists and good management teams are in agreement.

As a result, effective management teams should tackle the issue of shareholder activism primarily by focusing on how to best streamline their companies and ensure that on-balance sheet liquidity can be justified: either by attractive business investment opportunities expected to materialize, or by the need for a significant liquidity cushion. Effective communication with existing shareholders is also crucial, and management teams must ensure that their strategic vision and plan for execution is coherent and clearly articulated.

As we show in Figure 10, shareholder activists typically do not direct their attention to only one perceived issue. Rather, they concentrate on a host of different issues, broadly including suboptimal leverage targets, distribution policies and unfocused corporate strategies. In some cases, a single corporate activist can home in on all of these issues, forcing the company's management to play defense on a variety of fronts. As such, we often view the best defense against future shareholder activism to be a well-thought-out offense that has been explained at every opportunity to shareholders, whose support can then be measured in the marketplace.

Figure 10

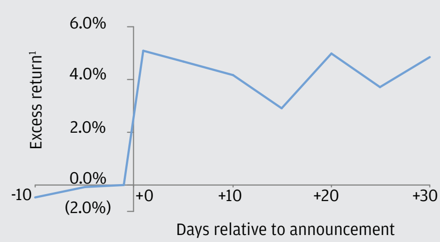
Activists often force firms to accelerate strategic offensive decisions

Recent shareholder activism

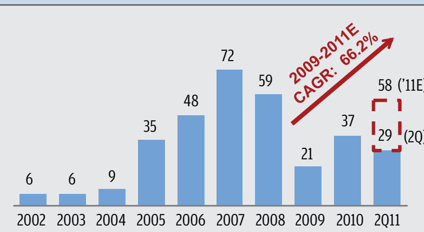
Sector	Leverage	Distribution	Focus	Sale
Consumer			✓	✓
Consumer	✓		✓	✓
Technology		✔	✓	
Industrial			✔	
Healthcare	✔	✔	✔	
Technology	✓	✓	✓	✔
Technology		✔	✔	✔
Technology				✔
Natural resources			✔	✓
Technology			✔	

✔ Activist pressure and subsequent management response
✓ Activist proposal

Selected activism: Market reaction



Activist campaigns[2]



Source: Bloomberg, FactSet, SharkRepellent and company press releases
[1] Excess return defined as company stock total return less S&P 500 total return * beta from date of 13-D filing or activist campaign announcement
[2] Board control, Board representation, enhance corporate governance, maximize shareholder value, remove Directors and remove officers campaigns for market cap > $1bn

7. Executive takeaways

As decision-makers navigate through today's environment, they are best-served by executing a clear-cut strategic offense. In this regard, executives should note that investors seem to embrace Winston Churchill's approach: "I never worry about action, but only inaction."

Below is our recommended CFO action plan:

1) **Renew M&A discussions** – Attractive valuations, cash-rich balance sheets and significant debt capacity at historically attractive rates provide a unique window of opportunity to act offensively. Firms should not only consider tuck-in acquisitions, but also "art of the possible" transactions. In some cases, firms need to first shrink and re-focus before they can embark on a renewed growth strategy.
2) **Lock-in historically cheap financing** – In addition to achieving strategic objectives, firms can borrow to fund pension plans, or refinance their existing debt. Companies should also consider rate locks or other prefunding hedging mechanisms to address near-term funding needs.
3) **Enhance shareholder value via distributions** – Excess cash and incremental debt can be deployed to repurchase shares at discounts to long-term valuations and enhance EPS accretion. Increasing or initiating dividends can further generate shareholder interest and attract long-term income investors. Growth strategies can be consistent with an ongoing increasing dividend policy.

Although there are currently multiple paths leading to shareholder value creation, firms need to move promptly, decisively and offensively towards clear strategic and financial objectives while these opportunities are available and before activists attempt to force very similar decisions.

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