

Trending Topics from J.P. Morgan Corp Fin Advisory | Week of April 30, 2018

Every two weeks, we write on four themes or trends to serve as a source of thought-leadership for management teams. Areas we cover traditionally include corporate strategy and M&A, capital markets, capital structure/allocation, market intelligence, or other accounting and regulatory subject matter.

Topics covered in this issue include:

1. J.P.Morgan readies USD blockchain debt issuance for prime time
2. Shrinking to grow: European separation activity kicks into high gear in 2018
3. Insights into the yield curve and strategies for the current market environment
4. Activism remains a predominant theme into 2018

1. J.P. Morgan readies USD blockchain debt issuance for prime time

Over the last 12 months, non-U.S. firms began to explore blockchain debt issuance, such as Daimler's €100mm in June 2017 and Telefonica Deutschland's €50mm in January 2018. Both of these offerings were small German promissory loan notes issued into a niche of the European debt markets.

In April 2018, J.P. Morgan debuted the first USD blockchain debt issuance as sole manager on a \$150mm one-year Floating Rate Yankee Certificate of Deposit for National Bank of Canada. The offering was executed via traditional processes with a parallel simulation of the issuance using blockchain technology:

- The offering was structured to demonstrate greater technological complexity and capital markets applicability through blockchain, as evidenced by the broader external distribution and variable interest rate payments.
 - The transaction garnered participation from large institutional investors such as Goldman Sachs Asset Management and Western Asset Management, as well as corporate investors such as Pfizer.
- The use of smart contracts and tokens simulate various processes throughout the lifecycle of the debt instrument, including origination, book-build process, allocation and settlement.
 - Further, the technology automates notifications and calculation of interest rate and maturity payments.

- The blockchain debt issuance application runs on J.P. Morgan's Quorum®, an open-sourced variant of the Ethereum blockchain.
 - Information privacy and data integrity is core to the system: (i) private transaction processing with specific user access and permissions, (ii) encrypted data transferred directly between counterparties, and (iii) a log of transaction stored on-chain.

Key Takeaways

- The capital markets continue to embrace blockchain technology and this serves as a proof of concept for viable debt issuances in the U.S.
 - In the future, the technology could be enhanced to allow for secondary trading or more immediate settlement.
- This transaction exemplifies J.P. Morgan's expertise at the intersection of technology and capital markets.

2. Shrinking to grow: European separation activity kicks into high gear in 2018

European firms across all sectors continue to unlock value and increase corporate clarity through separations (e.g., carve-out, spin-off). In the last 24 months, separation activity in Europe has been comparable to that of the U.S. However, the EMEA trend is on the rise with five announcements in 2018YTD (versus only one in the U.S.¹) and strong median outperformance since announcement (~9%).

Focusing only on spin-off and carve-out transactions in the Stoxx 600 greater than €500mm in value, we note the below:

- In the last 24 months; firms announcing separations have outperformed the market; generating median excess returns of 11%.
 - Recent precedents include: Altice (Altice USA); Kering (Puma); Telecom Italia (network business); Fiat (Magnetti Marelli); Prudential (M&G Prudential); Whitbread (Costa Coffee).
- Though there have been many spin announcements recently, carve-outs remain on the rise.
 - Roughly 33% of transactions were carve-outs from 2008-2013, and since then about 50% have been carve-outs.
- Notably, the strongest outperformance is observed in companies smaller than €20bn, reinforcing the value of the focus premium.

Key Takeaways

- Firms across the globe should take a second look at separation opportunities across their portfolios.
- Though mega caps have long focused on optimizing their portfolios, medium to large cap firms can enjoy the strong market outperformance.
- Separations through carve-outs are on the rise, though spinoffs may still make sense for the right cases.

¹ 2018YTD data pertains to S&P 500 spin-offs only and excludes Reverse Morris Trusts

3. Insights into the yield curve and strategies for the current market environment

The yield curve has been a focus of many lately given the rise in LIBOR, the 10y UST breaking through 3.00%, and the notable flattening of the past few months. Below are a few key points to know:

Whereas LIBOR and Fed Funds typically move in tandem, the spread between 3m LIBOR and the Effective Fed Funds Rate has widened by over 50 bps since last summer.

- We believe the widening of this spread was caused by supply / demand imbalances in the money markets.
 - Treasury bill supply has surged, which has caused yields in short term government paper to rise and drag other money market rates higher as well.
 - Financial CP borrowings have climbed significantly early this year, further adding supply to the market.
- The Fed began daily publication of LIBOR's replacement, SOFR (Secured Overnight Financing Rate) on April 3.
 - While it's important to continue monitoring the development of SOFR, we anticipate that LIBOR will continue to be the industry standard benchmark for at least the next several years.

By many measures the U.S. swaps curve is at its flattest level since the financial crisis. For example, the spread between 2y swaps and 30y swaps is at a 10y low of ~30 bps (versus an average of ~210 bps and a high of ~350 bps).

- The front end of the curve rose as the LIBOR/Fed Funds spread widened and markets priced in additional Fed tightening (now pricing in four more 25 bp hikes).
- The back end of the curve has risen much less meaningfully given continued demand for long duration paper from foreign buyers, pension funds, and insurance companies.
- Notably, the swaps curve inverts past the 30y point meaning:
 - For rate locks past six months, companies can lock in 30y swap rates at lower levels than 10y rates.
 - The mid-market seven-year forward 30-year rate is lower than today's spot 30y rate.

Key Takeaways

- Given the flatness of the swaps curve the primary benefit of floating rate debt is less attractive (i.e., less expensive interest expense). Corporates should consider creating interest expense certainty via pay-fixed swaps.
- With the forward premium for 30-year rate locks in the low single digits, consider hedging any known issuances/debt refinancings over the next several years.

4. Activism remains a predominant theme into 2018

Activism activity in the U.S. started strongly in Q1 2018, with 98 new campaign announcements (versus 181 globally), of which 67% resulted in at least one board seat for the activist.

- Both Tier-1 and first-time activists are driving strong activism activity in the U.S.
 - Tier-1 activists that have been relatively quiet in 2017 led the charge: Starboard Value launched six campaigns to date and Icahn nominated slates at Newell Brands, Xerox and SandRidge Energy.
- In Q1 2018, ~90% of activist demands favored M&A, versus 75% and 66% in the whole of 2017 and 2016 respectively.
 - Elliott Management has been the most active M&A activist in 2018, pushing for the sale of GKN to Melrose Industries and Travelport Worldwide to sell itself.
 - In Europe, the split between favoring and pushing against deals was more even.
- While institutional investors have long defined environmental, social and governance (ESG) issues among their voting priorities, many activists are now following suit.
 - Some activists, such as ValueAct and JANA Partners, are prioritizing ESG issues at portfolio companies.

Key Takeaways

- Activists continue to attract the attention of boards, institutional investors and the media.
 - The momentum is expected to continue as activists look to capitalize on the thriving M&A environment.
- As large institutional investors and potential LPs increasingly believe ESG is a critical component to deliver long term shareholder value, ESG will be at the forefront of activist investing.

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