Investors Brace for a Decline in Valuation Multiples

Summary of BCG's 2014 Investor Survey

April 2014

THE BOSTON CONSULTING GROUP

Executive summary

In February 2014, The Boston Consulting Group invited approximately 1,000 portfolio managers, buy-side analysts, and sell-side analysts to participate in BCG's sixth annual online investor survey

- Purpose was to understand investors' views on the global economic environment and on priorities for business value creation
- 131 individuals from around the world responded (a response rate of about 13%)

Four key themes emerged from the survey:

- There is a growing concern that equity markets may be overvalued
- A decline in valuation multiples is likely
- Investors are focusing more on the short term than they have in the recent past
- There is heightening scrutiny of core management processes

Investors appear to be looking for companies that are pursuing a “dual value-creation strategy,” carefully balancing short- and long-term performance

Pursuing a dual value-creation strategy will be challenging for many companies

- Four steps will help them define a stronger and more sustainable TSR strategy: Define a long-term growth strategy; understand what drives differences in the valuation multiple; develop a disciplined approach to cash payout; and upgrade core management processes

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Background on BCG's 2014 investor survey

This is BCG's sixth annual investor survey; each of the six was conducted in a challenging yet very distinct environment

- March 2009, immediately following the nadir of the crisis
- March 2010, as the first signs of recovery appeared
- March 2011, with uncertainty around macroeconomic conditions and growth prospects
- February 2012, with a slowdown in global recovery and increasing uncertainty in economic outlook
- February 2013, with cautious optimism in financial markets while the "real" economy remained fragile
- February 2014, with an uncertain outlook for financial markets in the context of high multiples and quantitative easing (QE) tapering

Profile of 2014 survey respondents: 131 portfolio managers, buy-side analysts, and sell-side analysts

- Collectively manage around $1 trillion: fund sizes range from less than $500 million to more than $20 billion
- 80% are most familiar with the S&P 500; 10% with EuroStoxx; respondents familiar with Euronext, FTSE, Nikkei, and HangSeng are also represented
- Global representation: around 40% of respondents focused primarily on the U.S. market
- Wide range of investment philosophies, including growth oriented, value, and special-situations strategies

Source: BCG investor survey conducted in Q1 2014

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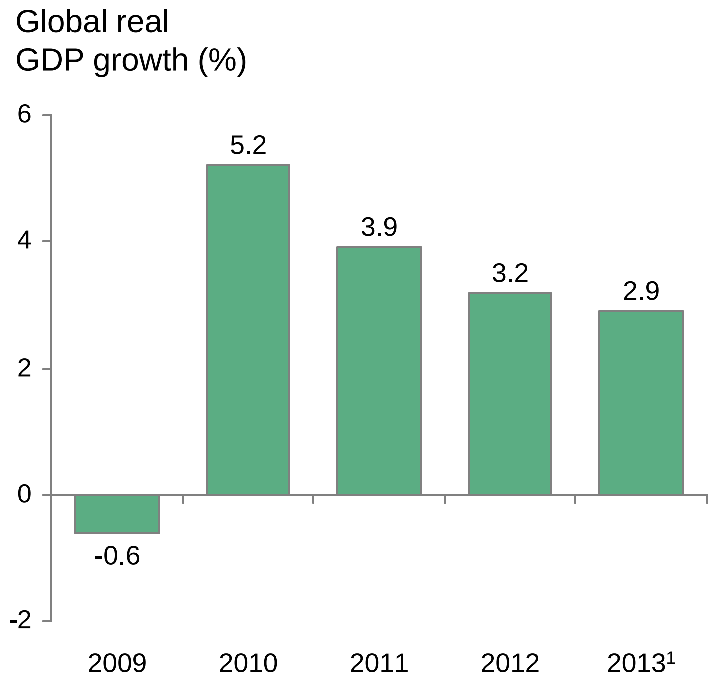
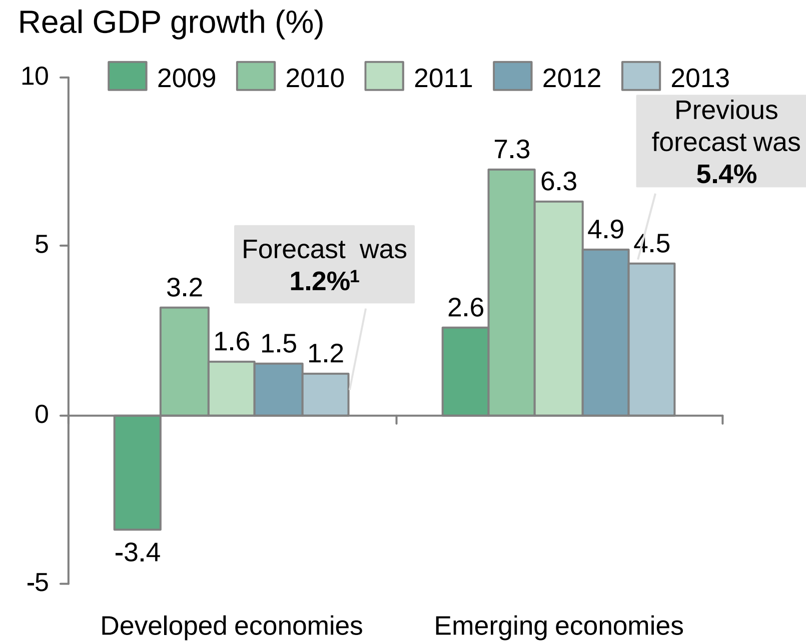
Context: The global economy slowed in 2013 …

Driven by deceleration in both advanced and developing economies

Growth of the global economy continued to decelerate in 2013



Emerging economies drove most of the growth but performed below expectations



However, the outlook for global GDP is more positive: the 2014 forecast is 3.5%; for 2015 and beyond, the forecast is about 4.0%

1. Based on IMF forecast as of October 2013
Source: IMF; BCG analysis

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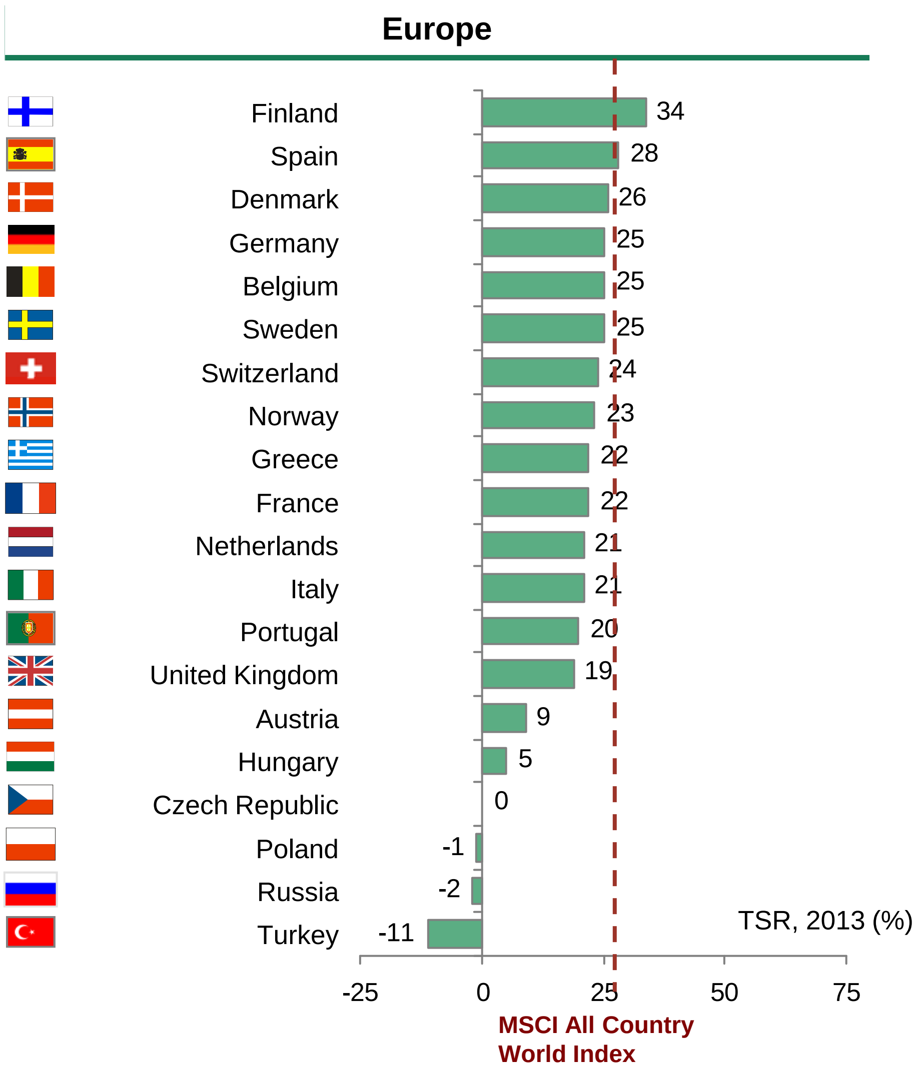
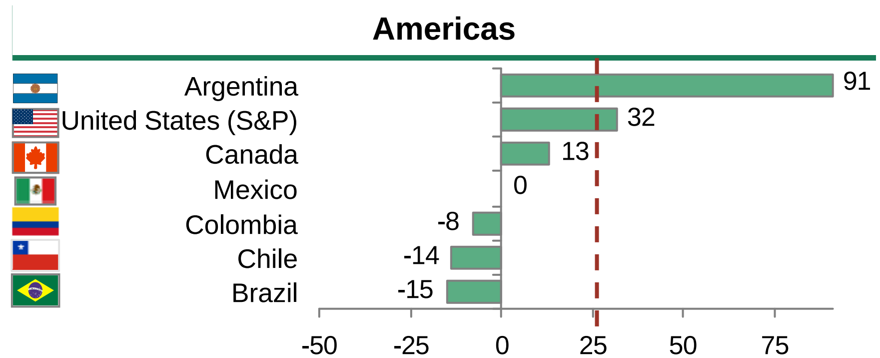
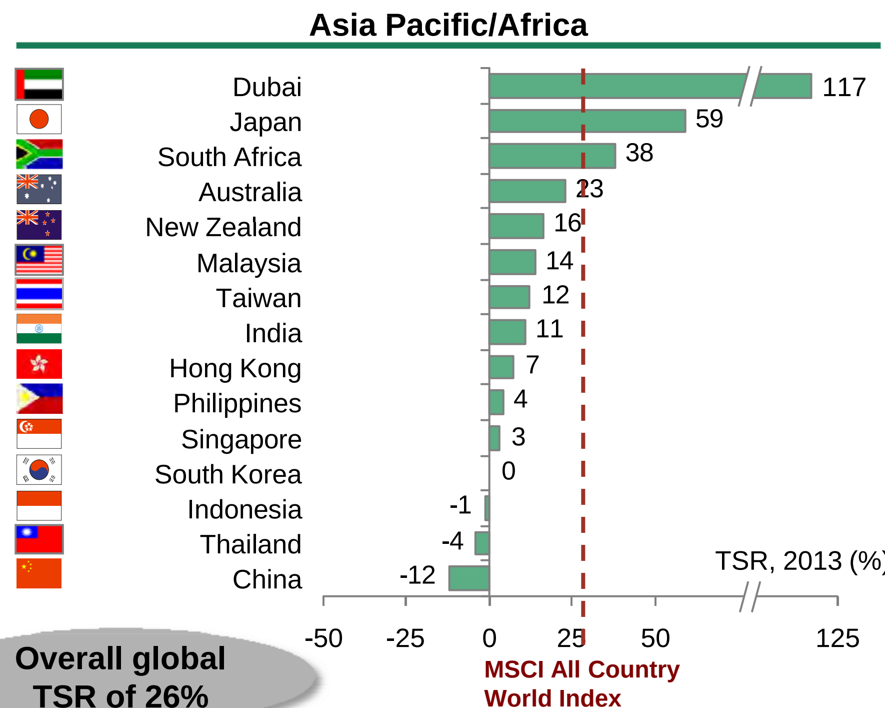
… but 2013 saw very strong TSR of 26%

Perform. was split between high-return developed markets and often low-return emerging markets







Overall global TSR of 26%

Note:TSR = the internal rate of return of all cash flows to an investor during the holding period of an investment. Individual country TSRs are computed in local currency and include only blue-chip stocks Sources: Thomson Reuters Datastream; BCG analysis

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Summary of key findings

1

Signs of overvaluation

Overall, sentiment for 2014 is more balanced than 2013

- 36% of investors think the market is overvalued (an all-time high in BCG survey history—three times last year's response)
- Respondents who considered the market "undervalued" have almost disappeared, dropping from 23% in 2013 to a mere 3% in 2014

TSR expectation for 2014 is 6.5%, the lowest level since BCG started this survey; investors think it will be hard to drive TSR through valuation multiple expansion

- Earnings growth expected at 5% and dividend and buyback yield expected at 3.4%, implying a CAGR decline of about 2% in the P/E multiple

2

A dual focus for value creation

Investors believe multiples are likely to drag TSR down in the near term, making improvement in fundamental performance (growth and margin expansion) increasingly important

Organic growth is viewed as the top-priority investment of free cash flow (FCF) for healthy companies

Long-term focus and R&D are still perceived as investment priorities, but uncertainty regarding emerging markets appears to have increased focus on the short term

- Investors are more receptive to the pursuit of opportunistic divestitures and M&A

Investors believe "stock picking" is becoming increasingly important in driving portfolio TSR

3

The management challenge

The majority of investors see room for improvement in aligning business, financial, and investor strategies to realize optimal TSR

- They believe management teams are not aggressive enough in exploiting the current environment, which suggests that companies need to manage and reshape their business portfolio where appropriate

Credible management is seen as a top investment criterion

Value-based management and strategic planning are seen as areas with the highest potential for improvement in companies they invest in

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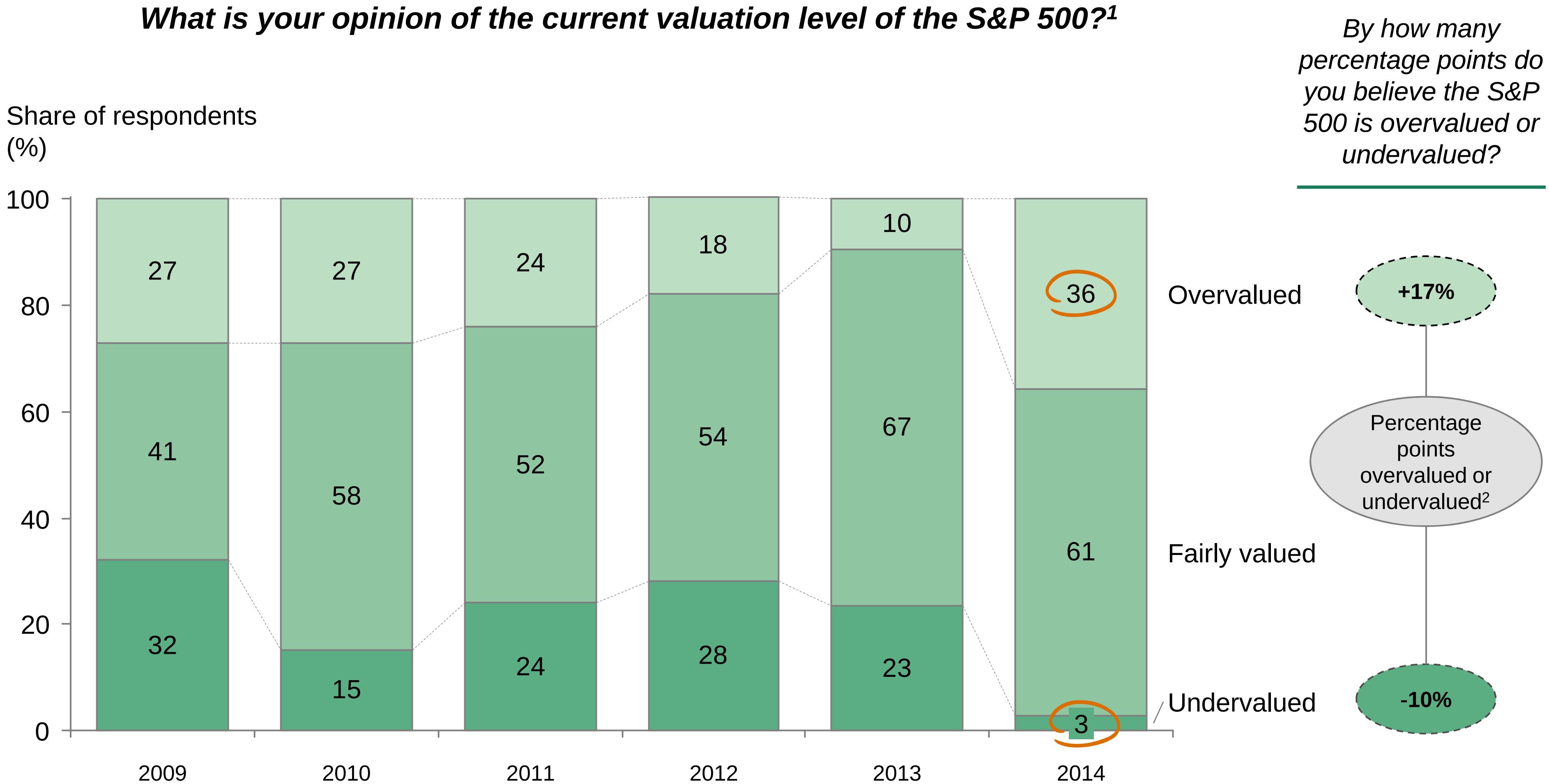
1

Thirty-six percent of investors (an all-time high) think that the S&P 500 stocks are overvalued

***What is your opinion of the current valuation level of the S&P 500?*[1]**



1. This survey question was asked only of respondents most familiar with the S&P 500 index 2. Average percentage points by which investors believe S&P is overvalued or undervalued—investors who, in the 2014 investor survey, indicated that they believe the S&P is overvalued or undervalued
Sources: BCG investor surveys conducted in Q1 2011–2014. BCG Value Science; BCG analysis

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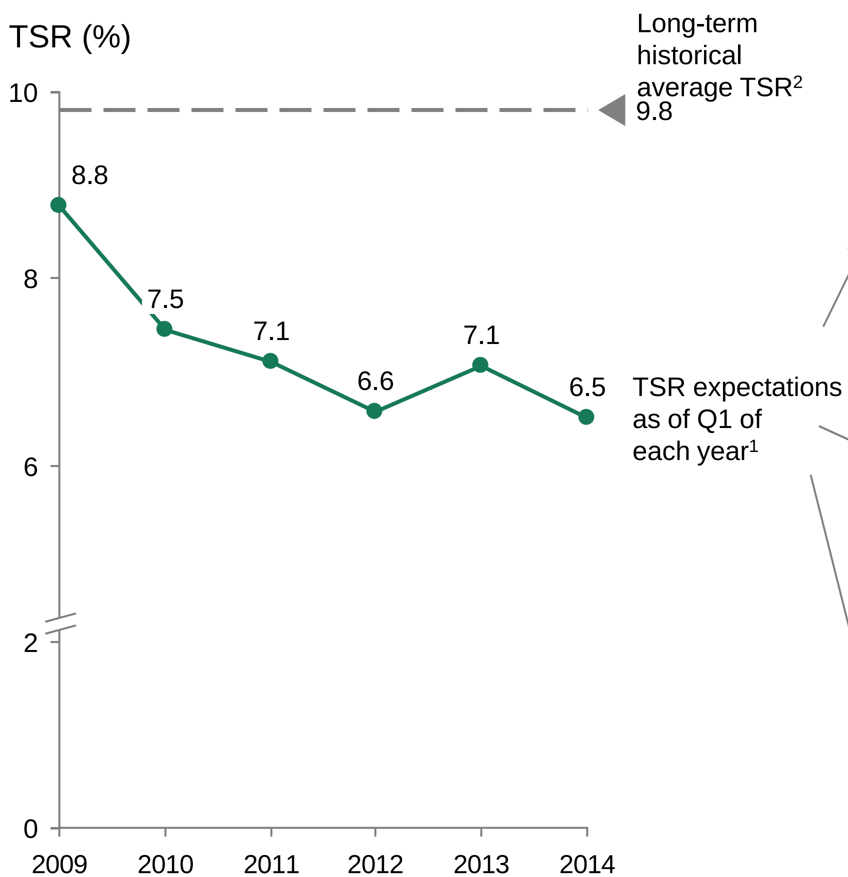
1

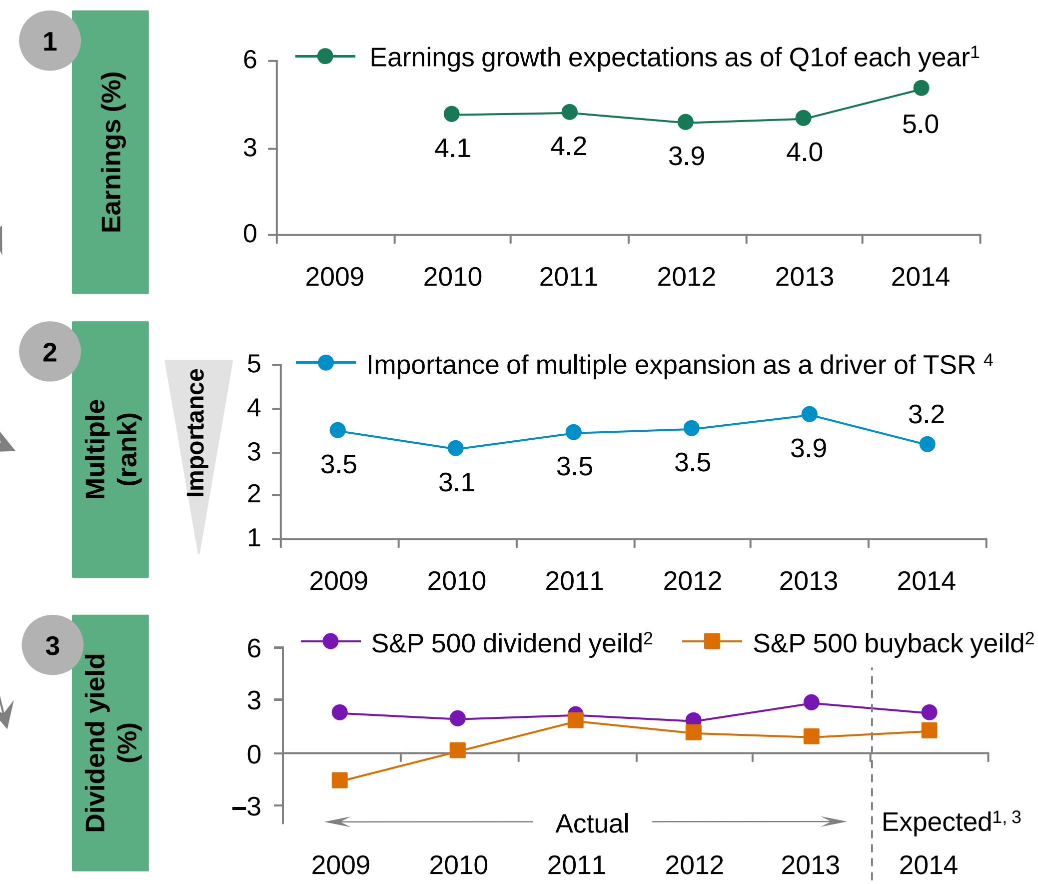
2014 TSR expectation – 6.5% – is the lowest in five years

Multiples are expected to be a much lower driver than in the past

TSR expectations are at their lowest since the first survey in 2009



Multiples are expected to contribute less to TSR than previous year in favor of earnings



1. Expectations calculated as weighted average of midpoints of answer choice intervals (for example, 7% for a 6 to 8% interval), weighted by distribution of responses (for example, 53% of investors chose the 6 to 8% interval for expected TSR in 2014); assumed 1% for <2% interval and 13% for >12% interval 2. Market-capitalization-weighted average yield for S&P 500 companies, 1926–2013 3. Expected value based on Q1 2013 survey results (weighted average) 4. Expectation as of Q1 of each year; weighted-average importance rank

Sources: BCG investor surveys conducted in Q1 2013, 2012, 2011, 2010, and 2009; BCG Value Science Center

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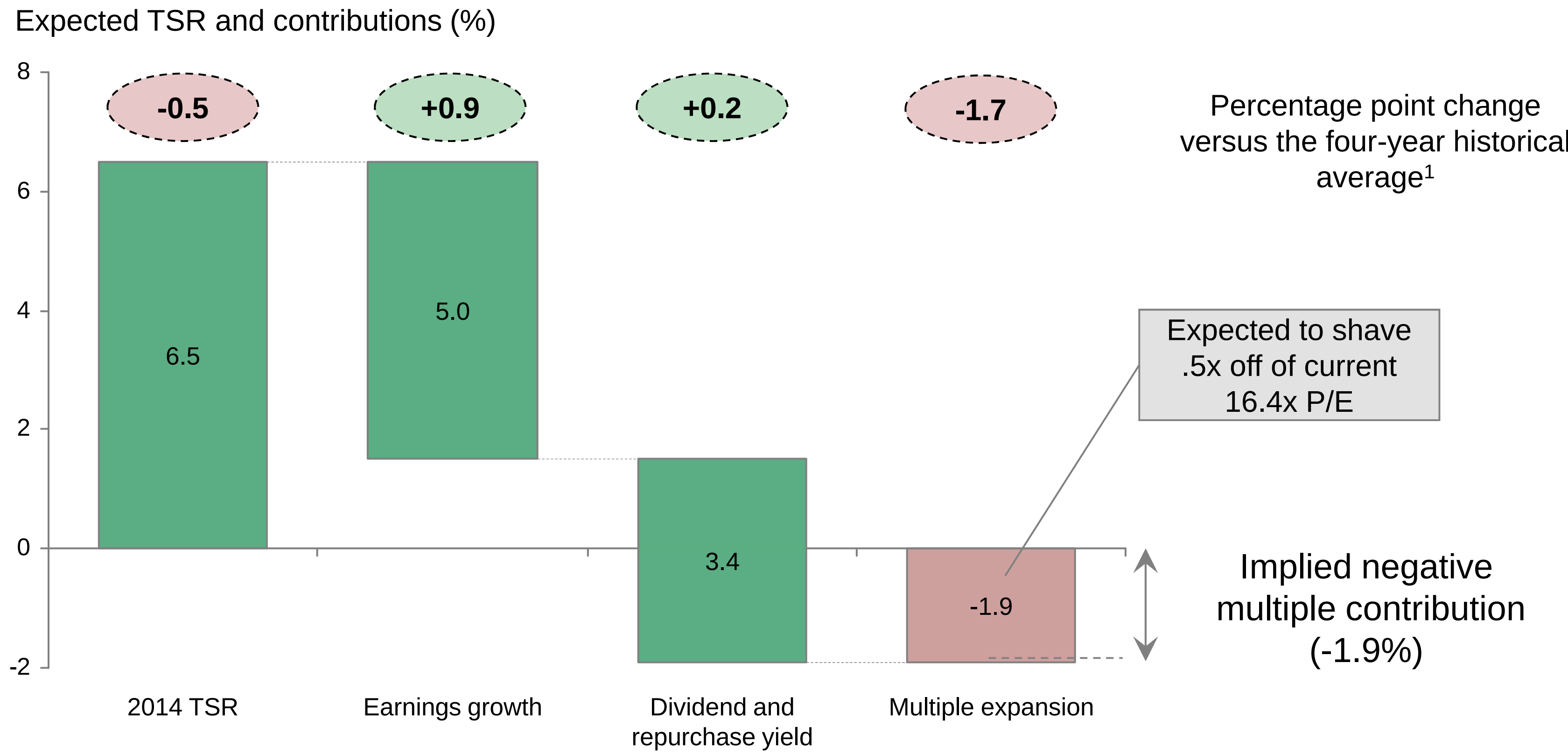
Investors expect multiple contraction, as implied by their expectations for TSR, earnings growth, and yield



Besides focusing on earnings growth and dividend yield, companies will need to *defend* their multiple

1. Historical averages for expected TSR, earnings growth, dividend and repurchase yield, and multiple expansion computed over the 2010–2013 time period
Sources: BCG investor surveys conducted in Q1 2010–2014

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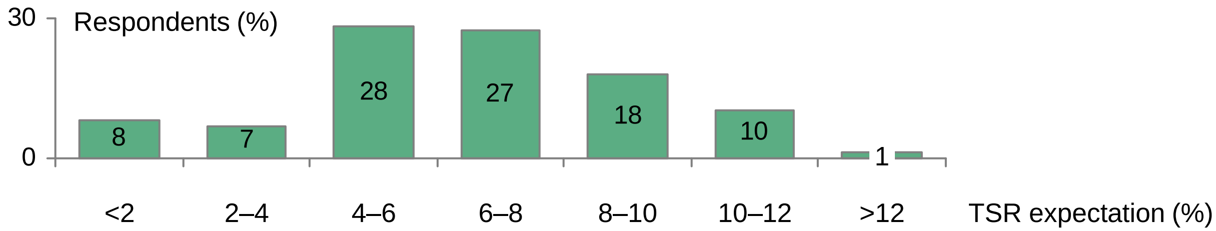
1

Earnings growth and dividend and repurchase yields are expected to be the largest drivers of TSR

Investors expect 6.5% TSR in 2014[1]



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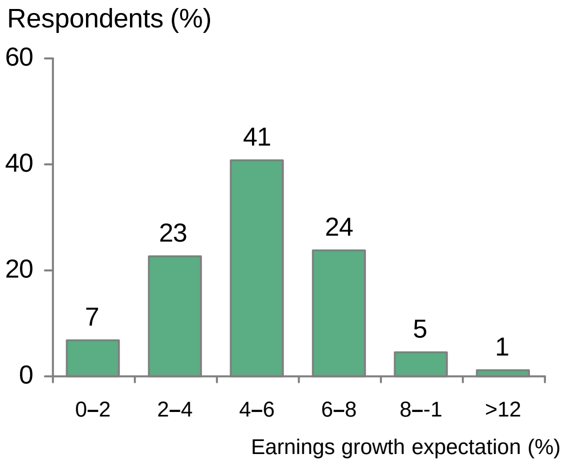
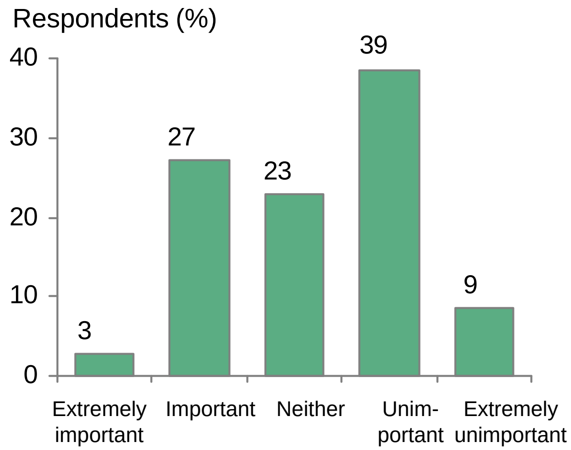
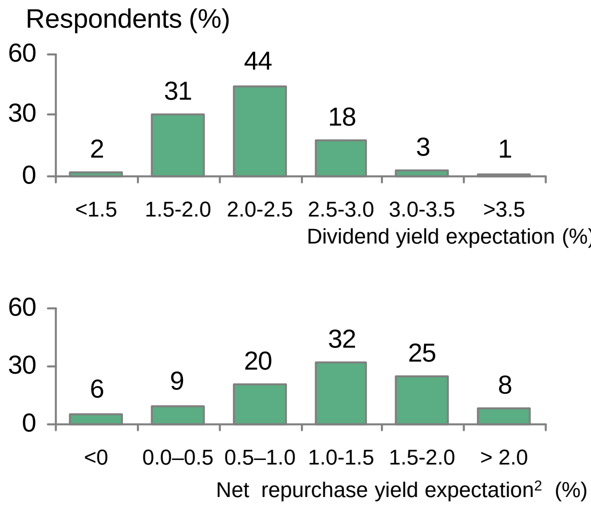
1 Earnings growth: expect ~ 4–6% contribution to TSR



2 Investors expect multiple expansion to be a less important driver of TSR



3 Dividend and repurchase yields expected to contribute ~ 3–4%



1. Weighted expectation based on midpoints of response intervals 2. Net yield is gross repurchase yield adjusted by share issuance
Note: Questions were phrased as follows: What do you think the average annual total shareholder return will be over the next several years, assuming normal levels of inflation? Once the economy settles to its new normal, what do you think the earnings growth will be? Will multiple expansion be an important driver of the change in share price and total shareholder return? Over the next three years (2014–2016), what percentage-point level do you expect dividend yield to contribute to annual TSR? What percentage-point level do you expect net repurchase yield to contribute to TSR?
Source: BCG investor survey conducted in Q1 2014

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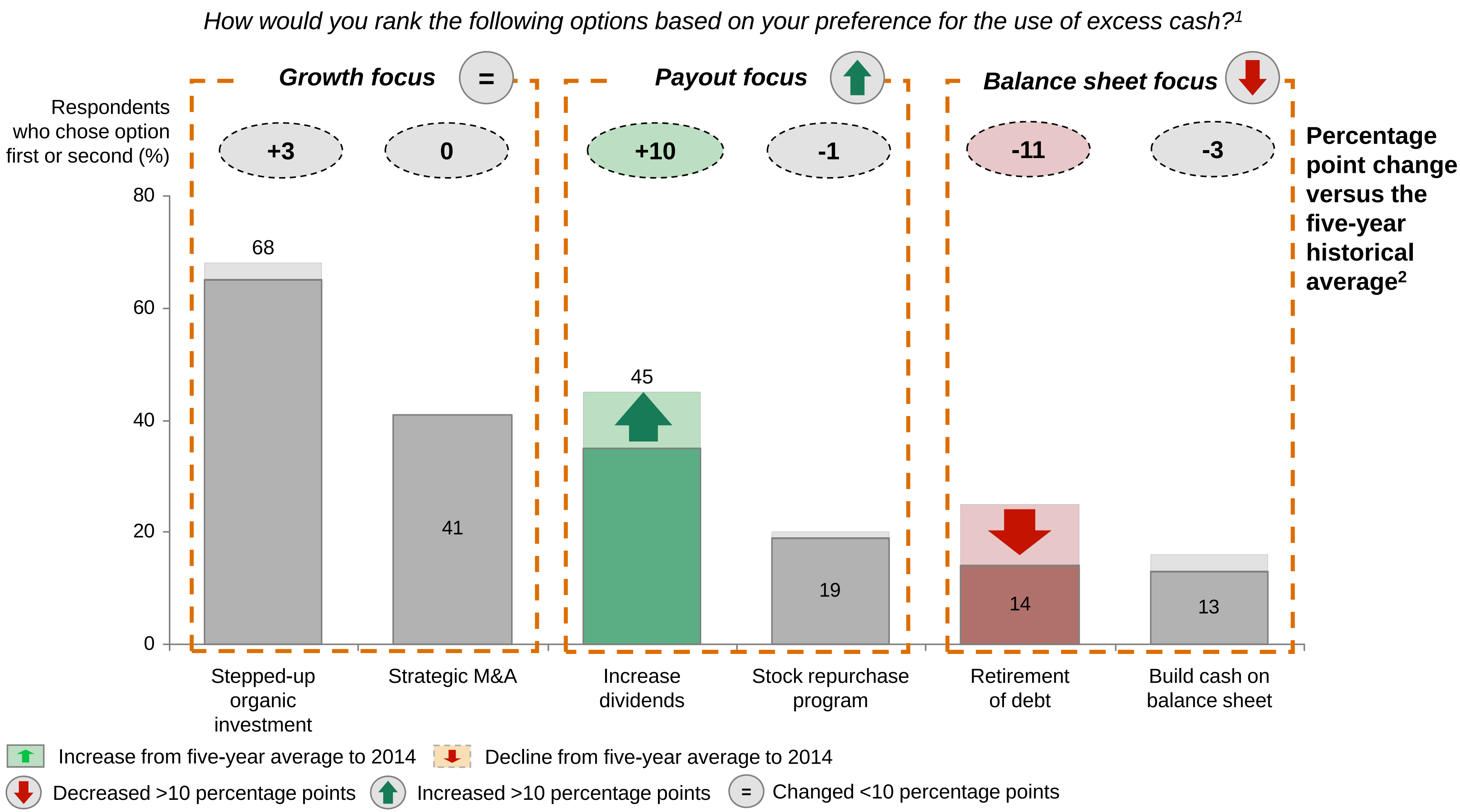
2

Investors want companies to focus their cash deployment on organic growth and increased dividends



1. Only first and second choices are considered in the chart 2.Historical average taken over 2009–2013
Sources: BCG investor surveys conducted in Q1 2009–2014

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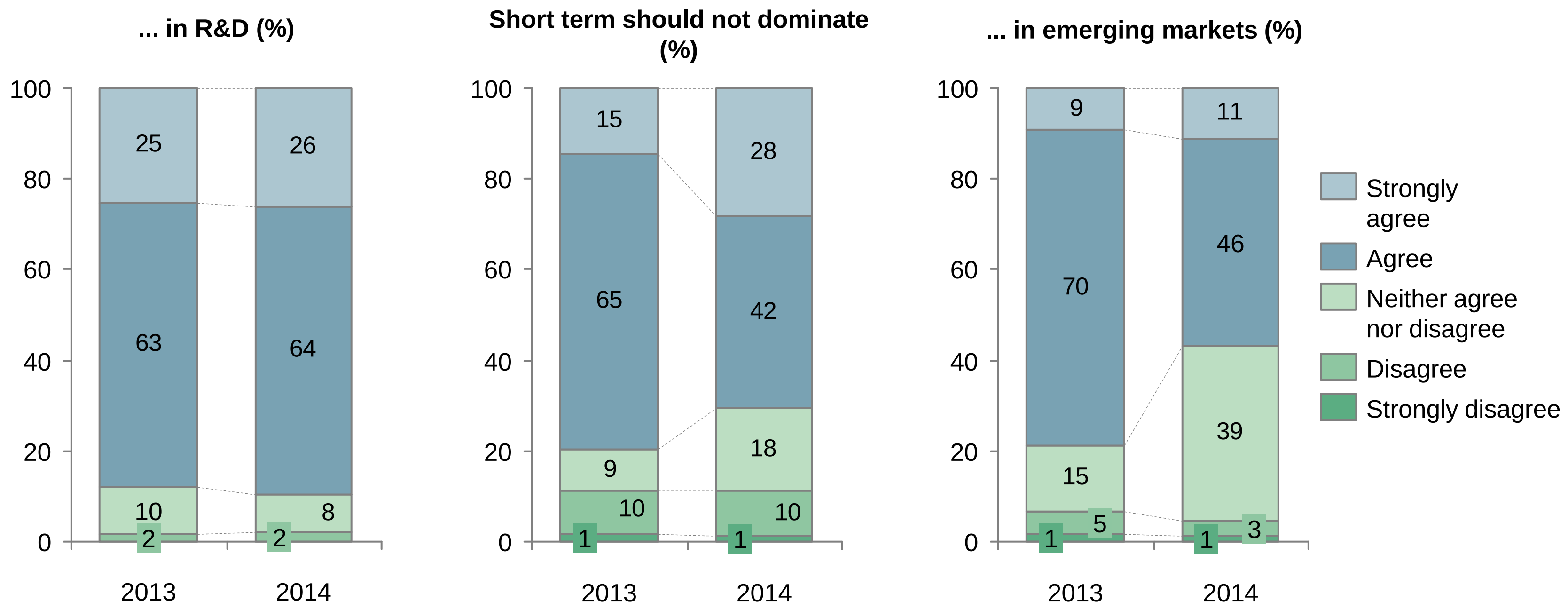
2

Long-term focus and R&D still viewed as key FCF investments

Long-term and emerging market losing interest compared with last year

How would you react to the following statements for companies with strong free cash flow and a healthy balance sheet for the next 12 to 18 months?

When it makes sense strategically, financially, and from a risk perspective, companies should invest more aggressively...



Investors feel less strong preference for the long versus short term, possibly owing to the need for earnings to catch up to valuations

Note: Any apparent discrepancies in totals are due to rounding
Sources: BCG investor survey conducted in Q1 2014; BCG investor survey conducted in Q1 2013

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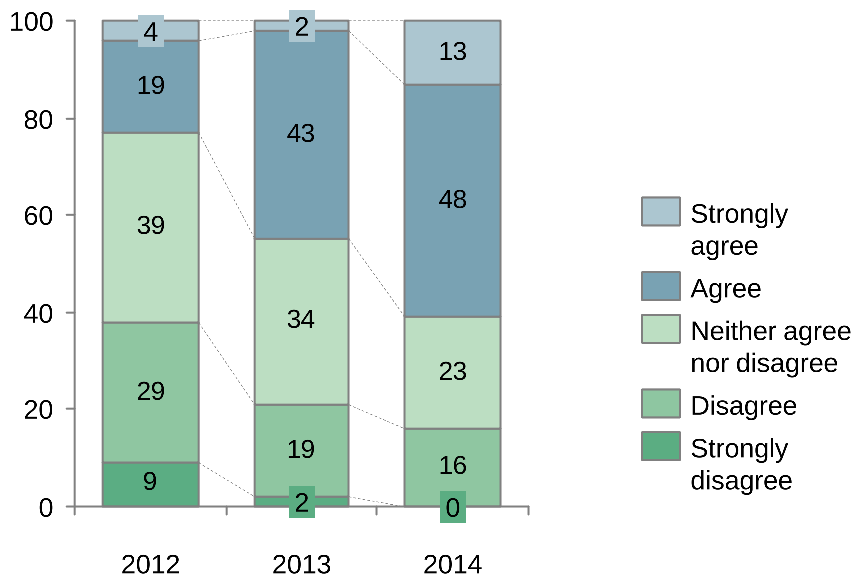
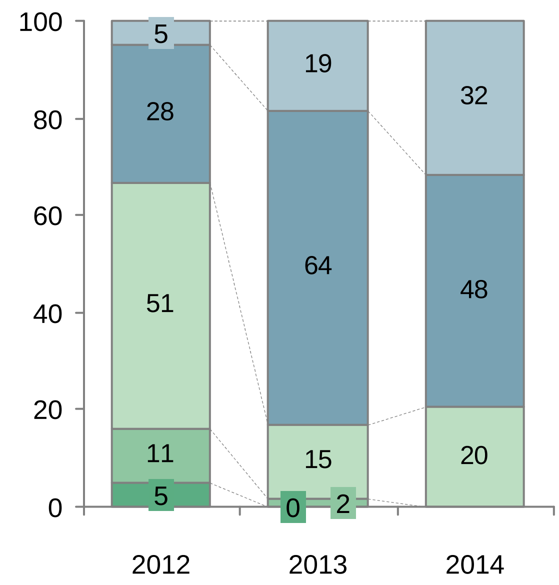
Investors are increasingly receptive to a more aggressive pursuit of M&A and more divestitures

How would you react to the following statements for companies with strong free cash flow and a healthy balance sheet for the next 12 to 18 months?

*Companies should be **more aggressive on M&A** when it makes sense strategically and financially (%)*



*Companies should be **more aggressive on divestitures** when it makes sense strategically and financially (%)*



Sources: BCG investor surveys conducted in Q1 2012–2014

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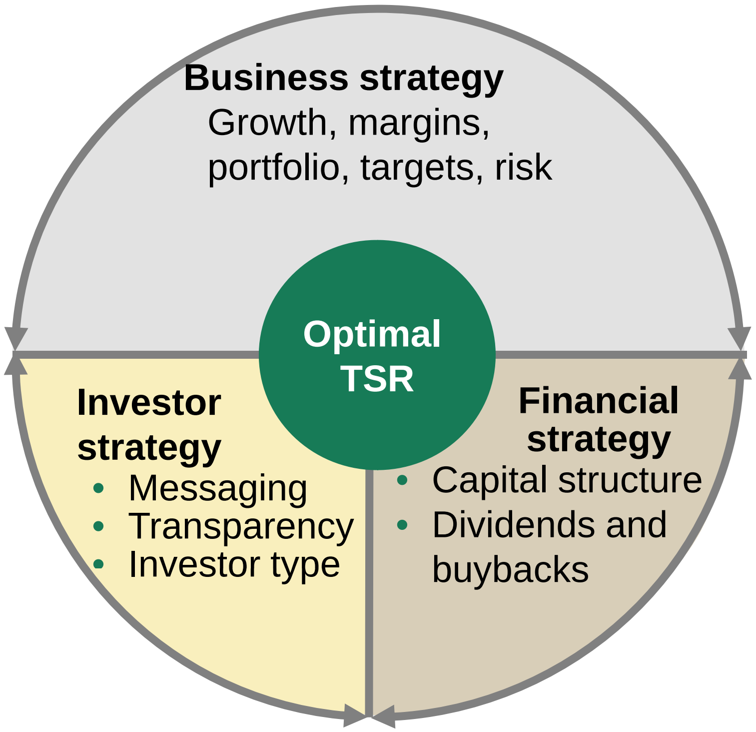
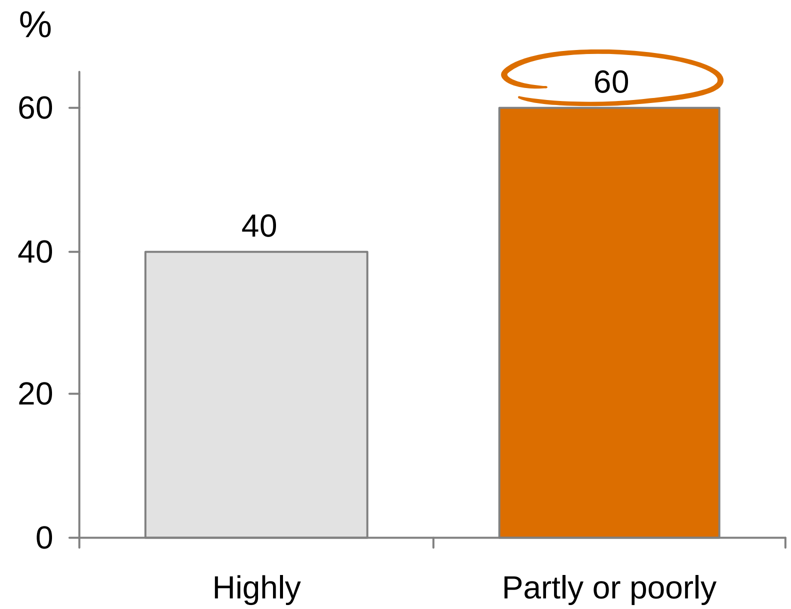
The majority of investors see room for improvement in aligning corporate strategy to realize optimal TSR

Optimal TSR can be achieved only by aligning corporate strategy …



… but almost two-thirds of investors see potential for improvement

Of the companies you follow or invest in, how well aligned are their business, investor, and financial strategies?



Aligning business, investor, and financial strategies is key to improving valuation and TSR

Source: BCG investor survey conducted in Q1 2014

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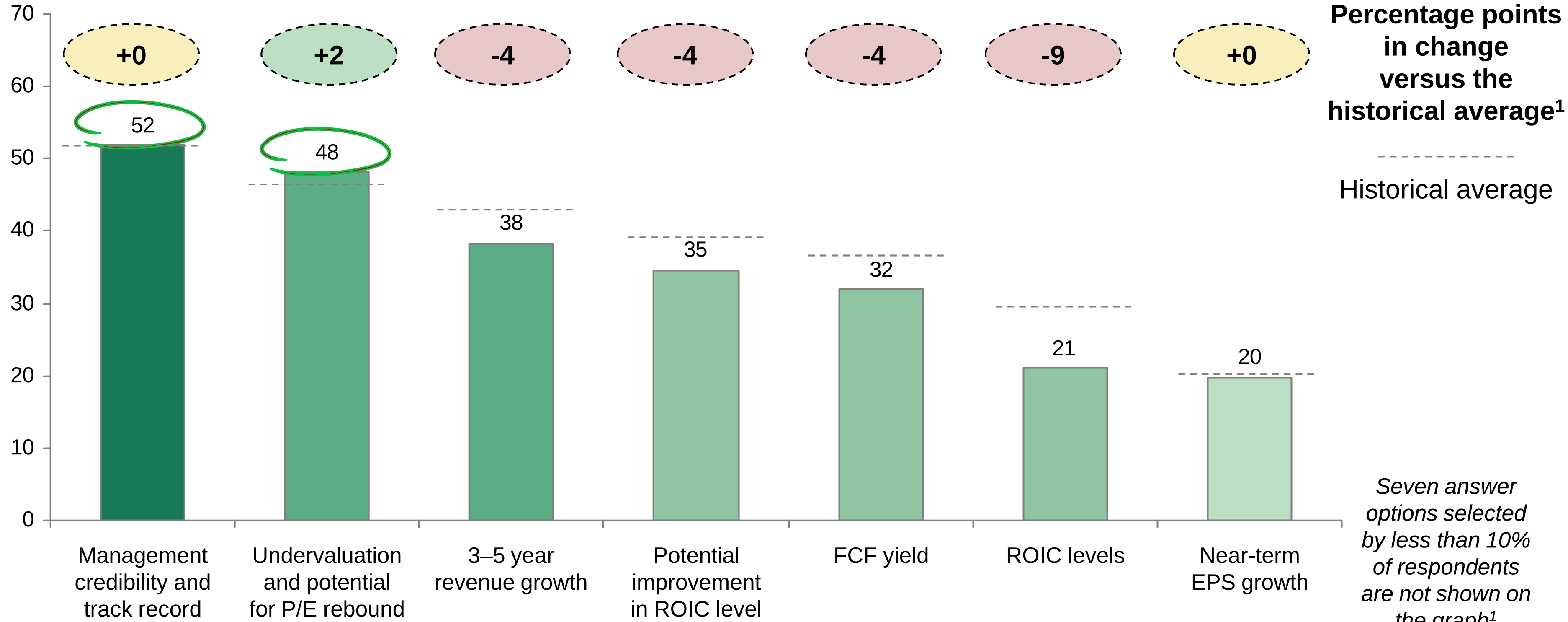
Credible management and attractive valuations are most important investment criteria

3

Which of the following fundamental metrics or characteristics would be most important to you in deciding whether to invest in (or give a "buy" recommendation to) a financially healthy company over the next 12 to 18 months?

Respondents who selected the metric as one of their top three investment criteria (%)



Seven answer options selected by less than 10% of respondents are not shown on the graph[1]

1. Historical average over responses, 2009–2013

Note: Respondents were given 15 answer options; the top 9 responses, which are shown, were selected as number 1, 2, or 3 criteria by more than 20% of respondents in 2014. Answer options that are not shown: dividend yield, gross margin percentage, change in gross margin percentage, buyback approach, leverage ratios, credit rating or debt ratio, and M&A posture. ROIC = return on invested capital; EPS = earnings per share

Source: BCG investor survey conducted in Q1 2014

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Takeaways

Results of the 2014 BCG investor survey suggest that companies will experience total shareholder return (TSR) headwinds in 2014

- Bearish sentiment is increasing with uncertainty regarding emerging markets and QE tapering
- Investors are expecting a TSR of 6.5% for 2014—lowest expectations since the first survey six years ago
- Earnings growth expected at 5% and dividend and buyback yield expected at 3.4%, implying a CAGR decline of about 2% in the P/E multiple
- Management teams expected to drive value from M&A and buybacks despite declining valuations

On average, companies are expected to fight valuation multiple declines in the short term, while investing in value-creating growth over the long term to defend their relatively high valuation levels

- Establishing a floor under current multiples through financial policy and investor communication
  - Investors see "credible management" as a key investment criterion due to expected headwinds
  - Investors want companies to develop and communicate a holistic value-creation strategy
  - Investors want companies to increase dividends; this signals management confidence
- Sustaining valuation over the long term by investing in value-creating growth
  - Investors prefer organic growth but are getting more open to M&A and, notably, to divestitures to aggressively manage and reshape their business portfolio, when appropriate
  - Investors want improvements in value based-management and strategic planning

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Sources: Thomson Reuters Datastream; BCG analysis

In this environment, what steps can companies take to drive strong and sustainable TSR? (1/2)

Companies may begin to experience TSR headwinds, so we believe the following four steps will help companies define a stronger and more sustainable TSR strategy

1 Define and "seed" a long-term growth strategy

- Identify promising organic and inorganic growth opportunities that will be TSR accretive
- Look for the right moves to be more aggressive with respect to portfolio reshaping
  - Make acquisitions only if there is strong strategic, operational, cultural, and TSR logic
  - Evaluate business portfolio for divestiture opportunities, ensuring a fact-based and emotion-free approach
- An effective long-term growth strategy at many companies will require substantial retooling of the business portfolio and strong execution skills

2 Defend current P/E value by developing a robust understanding of what drives differences in valuation multiples in your sector

- Important to identify key levers for P/E expansion: about 80% of the multiple can be identified and actively managed

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In this environment, what steps can companies take to drive strong and sustainable TSR? (2/2)

3 Ensure strong stewardship of your hard-earned capital and FCF

- In today's yield-scarce environment, evaluate the possibility of a modest-to-large dividend-payout increase—possibly shifting the mix from buybacks—as long as it won't substantively impact the ability to invest in growth and make opportunistic acquisitions
- Be prudent with share buybacks and avoid temptation to leverage up unless dramatically undervalued
- Ensure healthy capital structure to allow capital markets access in the event of another financial crisis
- Be clear with investors on acquisition criteria and approach to reduce their uncertainty and risk perception

4 Upgrade core management processes

- Identify actions that can be taken to strengthen the alignment among your business, financial, and investor strategies
- Improve core management processes including target setting, strategic planning, and risk management to ensure that they reflect the company's value-creation agenda

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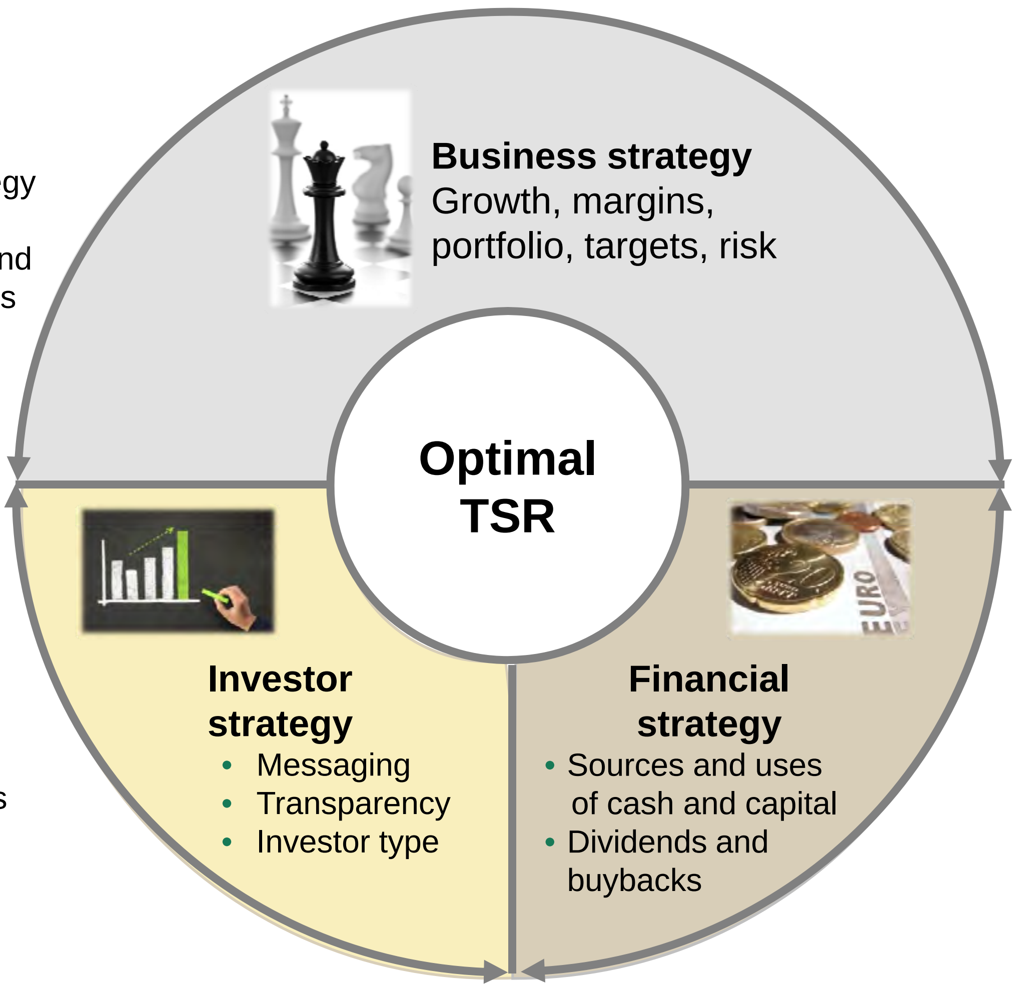
It is critical that companies align their business, financial, and investor strategies

- Competitive advantage
- Portfolio strategy
- M&A and divestiture strategy
- Capital allocation
- Organic growth, margin, and asset productivity initiatives



- Investor segmentation
- Target investor mix
- Investor migration plan
- Investor communication
- Investor relations practices
- Multiple valuation

- Return cash to shareholders
- Regular dividends
- Share buybacks
- Special dividend
- Leverage ratio and rating aspirations
- Net working-capital management

Source: BCG analysis

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