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Ready, Steady, GROW

In the race for growth, capital providers give corporates the green light to invest

August 2015

OUR VIEW

- UK plc able to take advantage of **most favourable capital and funding environment** in years to invest in long term growth
- Shareholders **strongly supportive** of investment strategies focused on delivering growth
- Robust UK plc balance sheets capable of taking advantage of highly liquid and **cheapest debt in history**
- Right time to review **investment strategy** and **capital structure**
- **#CapitalForGrowth** – we are helping companies capitalise on the support of equity and debt providers to invest capital in long term, sustainable growth

#CapitalForGrowth

> *Growth is never by mere chance; it is the result of forces working together.* JC Penney

Ever since the onset of the global financial crisis, UK companies have explored ways to return to sustained 'growth'. Yet, with top line growth hard to achieve and despite delivering numerous efficiency savings initiatives, bottom line growth has also been elusive…

Against this backdrop, companies have also had to juggle the different needs of their debt and equity providers.

The environment is, however, changing and 'forces' *are* working together. Both debt and equity markets are willing to give UK companies the green light to invest in their businesses to support long term growth.

Or as the twitter generation would say:

> UK plc can take advantage of the most supportive debt and equity markets in years to invest in growth.
> **#CapitalForGrowth**

How have capital allocation priorities been changing?

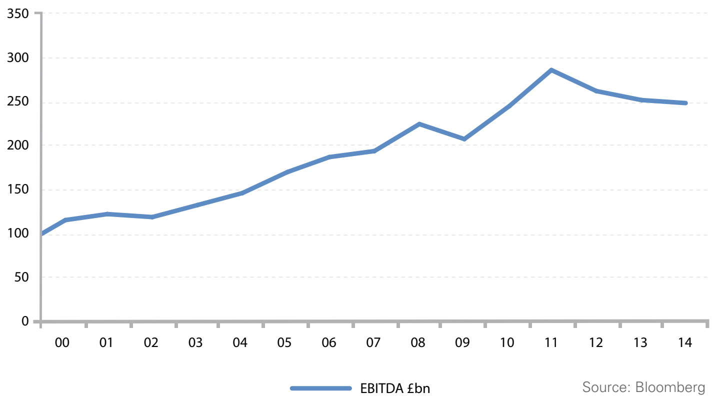
For good reasons, corporates have successfully managed their businesses through the post financial crisis focusing on items within their control to deliver earnings growth – cost and efficiency savings.

While these actions have helped underpin profitability in a challenging market environment, underlying growth has remained muted. Since 2010, EBITDA across FTSE 350 corporates has been broadly flat (2014: £252bn; 2010: £247bn) despite significant cost and efficiency savings[1].

One might point to recent signs of an increasingly robust recovery with GDP at last exceeding pre-crisis levels and the FTSE 100 finally breaking through the once aspirational 7,000 barrier.

With a UK economy perceived to be bouncing back, this has meant companies having to tread a careful path in managing market expectations on growth.

Aggregate EBITDA: FTSE 350 (ex financials)



[1] FTSE350 excluding financials; Source: Bloomberg

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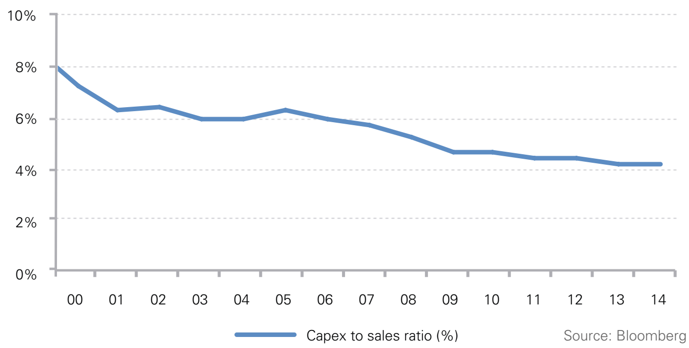
How have capital allocation priorities been changing?

The trends since 2007 suggest a reappraisal of capital allocation priorities would be appropriate to ensure these mitigate stagflatory risks from seven 'lost years' and take advantage of support from the markets to deliver long-term sustainable growth:

In the seven years prior to the financial crisis, capex amongst the FTSE 350[2] equated to 6.0% of revenue; in the seven years since this has been just 4.4%, a fall of over 25%[3]. While this trend may in part be explained by a shift in the nature of investment towards IT and greater levels of outsourcing, many analysts expect capex to increase with the upturn phase in the cycle.

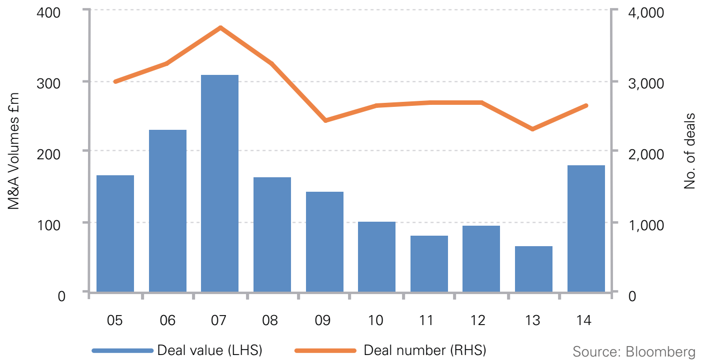
In addition, despite increasing optimism and some high profile mega-deals, M&A transaction numbers hit a floor in 2013 and remain close to post-Lehman lows[4]. Transaction multiples remain high but our experience shows a noticeable uptick in activity over the last 12 months, with the recent spate of high profile and large value deals likely to encourage greater confidence and transaction flow.

Capex to revenue ratio: FTE 350 (ex financials and resources)



> *... A reappraisal of capital allocation priorities would be appropriate to ensure these mitigate stagflatory risks from seven 'lost years' and take advantage of support from the markets to deliver long-term sustainable growth...*

UK M&A volumes[4]



[2] Excluding financials and resources companies
[3] Source: Bloomberg
[4] Source: Thomson Reuters

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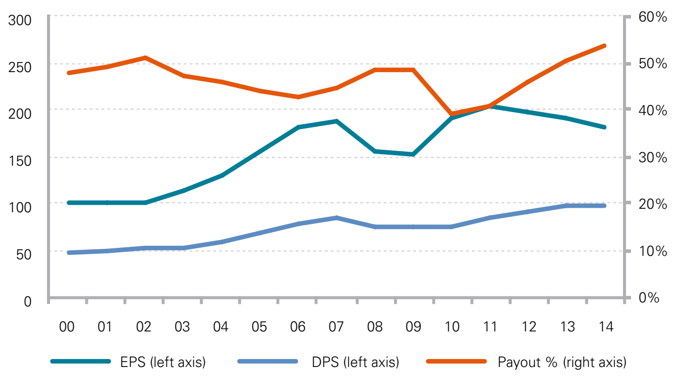
How have capital allocation priorities been changing?

At the same time, dividend returns to shareholders have been rising despite declining earnings – since 2010, earnings per share across the FTSE All Share are down 5% while dividends per share have increased by over 30%. As a result the pay-out ratio has increased from 39% to 54% and looks set to rise further this year[5].

This is by no means suggesting distributing profits is wrong. The implication however, is that in recent years many businesses have considered distribution to have provided shareholders better value than investment.

But pay-out levels cannot continue to increase indefinitely if not supported by underlying growth.

FTSE All Share: EPS, DPS, Payout Ratio



Source: KPMG Makinson Cowell analysis

What are UK companies' stakeholders really seeking?

Our KPMG Makinson Cowell investor studies provide us with a unique, independent perspective of shareholder and debt investor attitudes across the market.

For some investors, increasing reliance has been placed on consistent or even annuity-like dividends with the result that pay out ratios have risen to unprecedented levels. But to sustain this, what investors want is earnings growth.

In our experience, shareholders and debt investors alike are firmly supportive of balanced capital allocation strategies that deliver both shareholder returns and continued reinvestment to support long term value growth while retaining a strong financial position.

Clearly in the post 2008 era of heightened risk awareness, scepticism for non-core activity has risen. However, support is palpable for organic investment in core operations and bolt on acquisitions where this is seen as the lifeblood of a company's long term competitiveness in an increasingly competitive global market.

Those parties able to explain their rationale for investment within a disciplined capital allocation framework should have the support of their stakeholders.

> *“... In our experience, shareholders and debt investors alike are firmly supportive of organic investment and bolt on acquisitions to support long term growth ...”*

[5] Source: KPMG Makinson Cowell analysis

Is the hurdle rate too high?

With the alignment of such 'forces', it does raise the question 'what is holding us back?'. With the cost of debt at historic lows and equity volatility substantially reduced, this would imply corresponding reductions in the marginal cost of capital.

We have found investors increasingly question whether corporate investment hurdle rates are too high for the current environment and whether the application of post 2008 management prudence is starting to become a constraint on growth.

Return requirements should be considered carefully to ensure that investment strategies remain aligned to long term interests and the generation of value.

> *"… We have found investors increasingly question whether corporate investment hurdle rates are too high and whether prudence is starting to become a constraint on growth…"*

How are lenders looking at growth?

So much of the reticence to invest has been driven by liquidity and the availability of financing.

After the credit crunch, both corporates and banks have deleveraged significantly. Corporate leverage levels across the FTSE 350[6] currently average around 1.5x (from peaks of 2.0x in 2009) in line with mid-2000s levels despite limited EBITDA growth. Modest capacity has therefore been generated to use the balance sheet selectively for investment means.

The result has seen lenders roar back to the market. Lender supply across all markets far outweighs borrower demand delivering the most favourable debt market conditions since before the words 'sub-prime' became etched into everyone's consciousness.

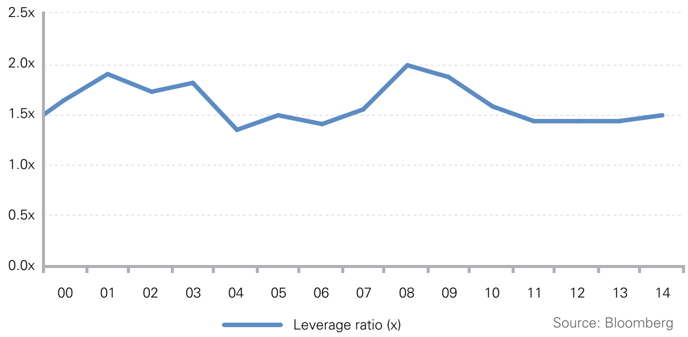
In particular lenders are looking for growth, investment and transactional stories to offset the 'diminishing returns' of vanilla refinancings and put their capital to work.

While uncertainty surrounding "Grexit" has recently impacted markets, underlying liquidity remains strong and robust.

This hunger has fed through to pricing. After the financial crisis hikes, the cost of financing is at all-time lows. Five year yields for investment grade credits are around 2.25% while 'crossover' high yield names can access the market from around 4.5%[7], notwithstanding some recent volatility created by the Greece Predicament.

While it would be exaggerating to claim debt is 'free', if you take into account the tax deductibility, it is not far off.

Aggregate leverage ratio: FTSE 350 (ex financials and resources)



Source: Bloomberg

Historic corporate bond yields (5 years)

Source: Bloomberg

"... While it would be exaggerating to claim debt is 'free', if you take into account the tax deductibility, it is not far off..."

[6] Excluding financials and resources companies
[7] Source: Bloomberg

Summary: The forces are working together

This article is not intended to advocate spending ourselves out of the most sustained recession the world has ever seen.

It is however intended to challenge current attitudes to capital allocation and investment, and to reconsider whether shareholder value over the medium term would be further enhanced through greater investment today.

Rarely has there been a more supportive environment to invest: the macro environment has returned to stability; corporate balance sheets have been restored to a position of strength; shareholders are supportive of considered investment strategies; the debt markets are as available and cheap as any point in history.

The forces of growth are working together, and those willing and able to harness them will be best positioned to make sustained growth a reality.

Or with the succinctness of a twitter user: ***#CapitalForGrowth***.

WHAT SHOULD I BE CONSIDERING?

- What is the right **capital structure** for my business in today's market environment?
- What are my **shareholders' attitudes** to investment, growth and returns?
- How should I be **allocating capital** to deliver shareholders long term sustained value?
- Are my **investment hurdle rates** consistent with my cost of capital?
- What **financing options** would be available to deliver my plans?

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About the Capital Advisory Group

KPMG's Capital Advisory Group is formed from Debt and Equity Advisory specialists from KPMG and Makinson Cowell.

We provide our clients with independent advice on developing and executing their financing strategies. We work closely with our clients in managing relationships and communications with their debt providers and equity investors to maximise stakeholder support for their strategic plans and access to liquidity.

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