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Executive Summary

The global corporate sector is entering 2019 on the heels of episodic turbulence in 2018 and with mixed signals for the year ahead. On the one hand, current corporate and macroeconomic fundamentals remain sound, with continued GDP growth, low unemployment, and healthy corporate balance sheets. On the other hand, some financial market indicators, such as a flat U.S. yield curve, higher equity volatility, and rising credit spreads, point to increasing risks. Rising U.S. interest rates may also continue to exert upward pressure on the dollar with increasing risks for emerging markets. Against this backdrop, we see equity markets rewarding firms for maintaining financial flexibility.

As GDP growth momentum slows and becomes less balanced across the globe, developing a robust growth strategy becomes a key priority for companies in all sectors. We find that investors historically preferred organic growth, evidenced by higher shareholder returns for firms that mainly grew organically. However, companies will need to use acquisitions to overcome a lack of organic growth opportunities; those that have historically done so performed noticeably better than those who abstained from large acquisitions despite lagging growth.

On a positive note, firms are entering 2019 with significant capital deployment firepower. A large share of the firepower is held by a handful of technology titans, who have expanded aggressively and successfully beyond their sector boundaries. These titans now account for an unprecedented share of total equity market value and growth expectations. In 2019, the pressure on companies across wide swaths of the global economy to effectively fight these titans will only intensify. Those companies most at risk will need to use their firepower judiciously to defend their competitive positions.

A strong M&A market in 2018, U.S. tax reform, shareholder activism, and increased appetite from private equity will likely drive divestiture and LBO activity in 2019. Proactive and tax-efficient pruning that improves the rate of return on capital is particularly rewarded by investors. LBO activity in 2019 will increasingly focus on larger, whole-company buyouts, driven by a shift towards more focused firms and market volatility potentially slowing the pace of M&A. The larger deal size may give rise to more consortium deals, expanding the universe of buyout candidates and requiring the participation of new partners to traditional private equity.

Activism will likely continue its role in corporate boardrooms in 2019, following a strong year of campaign activity in 2018. Public campaigns are, however, only part of the story since investors of all kinds now engage more actively with their portfolio companies. Therefore, the challenge for executives and directors in 2019 is to proactively mitigate the broader risk of investor discontent before it gives rise to a disruptive campaign. This approach should involve enhanced investor relations, analytics to better understand and anticipate investor sentiment and behavior, as well as active cultivation of a supportive long-term investor base.

Mounting trade-related tensions will remain a key risk in 2019. Earnings estimates have already been significantly lowered for both U.S. companies with exposure to China and Chinese firms with exposure to the U.S. These trade tensions should prompt a re-evaluation of global supply chains and production locations. They also merit revisiting risk management policies, as policy uncertainty may continue to spill into the broader macroeconomic environment. Trade tensions and slowing growth present a particular challenge in emerging markets, but these markets still offer attractive long-term growth prospects, especially when taking into account currently depressed equity valuations.
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1. Navigate Macroeconomic Uncertainty

Both the start and end of 2018 were characterized by market turbulence as investors questioned the sustainability of synchronized global economic growth and accommodative monetary policies. Growing uncertainty around trade arrangements, geopolitical tensions, Brexit, Italy’s fiscal position, and higher emerging market volatility all point to a potentially challenging future. A closer look at key leading indicators, however, reveals a more nuanced outlook.

**Current corporate and macroeconomic fundamentals remain strong.** Globally, GDP growth remains healthy, unemployment in the U.S. has remained at historic lows, and inflation in developed markets remains well under control. While corporate leverage is high, global balance sheets remain healthy with substantial liquidity supported by robust free cash flow following U.S. tax reform. Despite recent equity market volatility, global earnings growth is still forecasted at 6.2% for 2019.

**Some market indicators point to rising risks.** In the U.S., a flat yield curve, as we observe today, has been one of the most reliable indicators of an economic downturn over the past five decades. Other indicators such as elevated valuations, CFO confidence, high leverage, and rising credit spreads also signal the later phases of an expansionary cycle. Moreover, the synchronized global GDP growth of 2016-17 has started to diverge. Stronger growth in the U.S., combined with faster monetary tightening, may lead to further divergence in interest rates and dollar appreciation.

**Figure 1. Cyclical Indicators Portend Uncertainty; Moderating Rewards for Growth, Higher Rewards for Flexibility**

<table>
<thead>
<tr>
<th>Key cyclical indicators</th>
<th>P/E impact of interquartile moves in growth and leverage (x)¹</th>
</tr>
</thead>
<tbody>
<tr>
<td>▪ Yield curve (U.S. 10yr - 1yr)</td>
<td>▪ Value at year-end 2018</td>
</tr>
<tr>
<td>3.4% (0.5%)</td>
<td>3.44x</td>
</tr>
<tr>
<td>16.2x</td>
<td>3.63x</td>
</tr>
<tr>
<td>13.0x</td>
<td>2.82x</td>
</tr>
<tr>
<td>9.8x</td>
<td>0.75x</td>
</tr>
<tr>
<td>71.5</td>
<td>0.93x</td>
</tr>
<tr>
<td>68.5</td>
<td>1.01x</td>
</tr>
<tr>
<td>39.5</td>
<td>184</td>
</tr>
<tr>
<td>2.4x</td>
<td>670</td>
</tr>
<tr>
<td>1.8x</td>
<td>138</td>
</tr>
</tbody>
</table>

Source: Bloomberg, FactSet, Moody's, Duke CFO Survey.

**Increasing rewards for financial flexibility; moderating rewards for growth.** The recent decline in equity valuations, coupled with increased uncertainty, has altered investor preferences. For example, in the last quarter of 2018, earnings multiples for growth-driven tech stocks contracted about 30% more than the broader market. Although growth is still by far the most significant determinant of valuation, the growth premium for the highest-growth firms relative to the lowest, controlling for other factors, has compressed from 3.6x to 2.8x in 2018. At the same time, the premium for lower leverage remained high in 2018 after rising in 2017.

Against this changing macroeconomic backdrop, companies need to enter 2019 prepared to proactively defend their valuations and manage disruptive threats to their competitive positions. The rewards for increasing growth are still high, and companies with financial flexibility should be prepared to prudently deploy capital. Should market volatility remain elevated, there will be substantial rewards for those firms that are best able to deploy their balance sheet strength to deliver growth and long-term shareholder value.
2. Assess the Relative Merits of Growth Alternatives

The global corporate sector has delivered robust growth over the past few years. Since 2014, earnings per share (EPS) has grown at an annual rate of 8.7%, led by North American firms that grew EPS by 11.2%. For 2019, analysts envision continued, but slower, growth at 6.2% globally and 6.1% in North America. As GDP growth momentum slows and becomes less balanced across the globe, developing a robust growth strategy becomes a key corporate finance priority for companies in all sectors.

**EPS growth matters the most.** Despite recent market volatility, the ability to deliver growth has been a key driver of stock performance, as measured by total shareholder return (TSR). Though all growth metrics such as revenue and EBITDA growth are valued, EPS growth has typically been most strongly linked to TSR. Since 2010, companies that delivered above-average EPS growth within their sectors experienced TSR outperformance of 77.6% relative to their sector peers whereas those with below-average growth underperformed by 57.3%.

**How companies achieve growth also matters.** For some companies in high-growth sectors, growing organically through bolt-on acquisitions to expand their footprint may be beneficial, whereas companies in low-growth sectors may need to pursue transformational M&A to boost their growth prospects. By our estimates, almost one-third of global EPS growth since 2010 is due to acquisitions, with half of that amount due to transformative acquisitions (defined as more than 25% of the acquirer’s market capitalization).²

![Figure 2. Growth in EPS Drives Returns, and M&A can Boost Growth and Returns When Well Executed](source: FactSet, Thomson Reuters)

**Organic growth has delivered higher sector-adjusted total shareholder returns.** Although both organic and transformational M&A-driven growth have resulted in greater share price outperformance, TSRs have consistently been higher for companies that accomplished their growth organically. However, the differential between organic and M&A-driven growth has narrowed in recent years. Over 2010-14, fast-growing companies that relied primarily on organic growth outperformed their more acquisitive peers by 7.9%, but over the last four years, this differential decreased to 4.3%.

**Investors particularly reward acquisitions that compensate for an organic growth deficit.** Transformational M&A, when properly executed, has proven to be an effective path to overcome organic growth challenges. Companies that increased their EPS growth positions through M&A outperformed their peers by 29.5%, compared to companies that maintained the same growth without M&A, who outperformed by only 4.6%.

**Disciplined execution is key.** Failure to appropriately execute on transformational M&A led to substantial underperformance. In fact, a reason for investors’ preference for organic growth is that it does not come with the same risks.
3. Optimize Capital Deployment Firepower

Robust cash generation, emanating from solid economic growth and U.S. tax reform in 2018, has helped offset increases in both capital spending and shareholder distributions, resulting in $5.2 trillion of cash on corporate balance sheets globally (Q3 2018), with $1.7 trillion coming from S&P 500 firms. In 2019, firms will need to strategically use their capital deployment firepower to generate growth amidst the risk of technological disruption while at the same time meeting investor demands for shareholder distributions. However, corporate executives also need to be focused on maintaining financial flexibility to manage any risks that may emerge in the later innings of the economic cycle.

**Capital deployment firepower is strong, but unevenly distributed across firms and regions.** We estimate that corporate capacity for acquisitions and capital distributions is currently about $10.6 trillion. This firepower is highly concentrated, with half coming from the top 100 global firms. In the U.S., tax reform helped drive firepower up 7%, from $5.3 to $5.7 trillion. Even with a two-year adverse cash flow impact, firepower in North America is expected to remain strong at $4.1 trillion, with 70% of firms able to maintain sufficient liquidity through such a decline. In the absence of attractive strategic investments, these well-capitalized companies will feel pressure from investors to deploy firepower towards shareholder distributions. On the other hand, outside the U.S., the decline in firepower in a stressed environment is greater, requiring a more conservative approach to capital deployment.

**Figure 3. Firms Have Significant Financial Flexibility and Are Increasingly Rewarded for Share Repurchases**

<table>
<thead>
<tr>
<th>Region</th>
<th>Firepower for acquisitions and distributions by region ($trn)</th>
<th>Adverse cash flow impact</th>
</tr>
</thead>
<tbody>
<tr>
<td>North America</td>
<td>$5.3 (2017) $5.7 (1H 2018)</td>
<td>$4.1</td>
</tr>
<tr>
<td>EMEA</td>
<td>$2.4 (2017) $2.1 (1H 2018)</td>
<td>1.0</td>
</tr>
<tr>
<td>Rest of world</td>
<td>$2.9 (2017) $2.8 (1H 2018)</td>
<td>1.6</td>
</tr>
</tbody>
</table>

Source: FactSet, Bloomberg.

**Dividend payouts around the world remain high, but the dividend premium could come under pressure if rates rise further.** Globally, dividend spend was up 36% in 2018, having a record year. In Asia and Europe, dividend payouts were upwards of 50% and 60% in 2018, respectively. While dividend payers have historically benefited from a valuation premium, this is likely to come under pressure if interest rates continue to rise.

**Share repurchases are likely to remain an attractive capital allocation alternative in 2019.** In 2018, global share repurchase announcements reached a record high of $895 billion. The lion’s share of the growth in repurchases came from the U.S., partly driven by U.S. tax reform. Over the past two years, increased share repurchase activity coincided with a meaningful pickup in investor receptivity, especially for cash-rich firms. We estimate that 85% of global non-financial firms have the ability to generate a rate of return on share repurchases that exceeds their cost of equity, up from 75% at the end of 2017, when valuations were much higher. The discretionary nature of share repurchases makes them a particularly attractive distribution alternative at the current stage of the economic cycle.
4. Think Like the Tech Titans

The tech titans are among the largest firms today and are disrupting a multitude of industries by crossing sector boundaries in ways rarely seen before.7 The ability to leverage artificial intelligence, big data, cloud computing, and digital connectivity is allowing these firms to dramatically disrupt business models and capture a larger fraction of global growth.

Despite the recent drop in the tech titans’ equity valuations, they still account for an outsized share of both aggregate market capitalization and growth expectations. The tech titans now represent 8% of global equity market capitalization and account for 23% of the growth premium in the global P/E multiple – compared to 4% of market cap and 6% of the growth premium in 2013. Corporate executives should pay closer attention to technological disruption broadly and the leadership position of these titans to develop an action plan to manage these threats.

Figure 4. Outsized Growth Premium for Tech Titans Driven by Superior Profitability and Capital Efficiency

<table>
<thead>
<tr>
<th>Year</th>
<th>MSCI excluding tech titans</th>
<th>Tech titans</th>
</tr>
</thead>
<tbody>
<tr>
<td>2013</td>
<td>94%</td>
<td>6%</td>
</tr>
<tr>
<td>2018</td>
<td>77%</td>
<td>23%</td>
</tr>
</tbody>
</table>

Relative contribution to growth premium in global P/E multiple

Source: FactSet.

Tech titans have redefined the conglomerate business model. Harnessing the power of information technology, tech titans – the new-economy conglomerates – combine scalable, asset-light strategies to generate superior operating margins, higher returns on capital, and growth in shareholder value. Tech titans achieved a median return on invested capital (ROIC) of 19.8% versus 8.5% for legacy conglomerates in 2018, bolstered by better asset turnover (49% gap).

Tech titans remain acutely focused on leveraging their balance sheet firepower for investments to generate growth. On a relative basis, tech titans spend 80% on R&D, capital expenditures, and M&A as a percentage of total expenditures (including distributions) while legacy conglomerates have only spent 49% historically. These firms are also adept in leveraging significant balance sheet flexibility and identifying inorganic growth opportunities early on in a firm’s life cycle. Since 2013, tech firms have acquired more private targets, public firms within five years of IPO, and faster-growing firms (relative to industry medians).

All firms need to manage potential disruptions to their underlying business models. The ongoing evolution of underlying ecosystems requires firms to leverage their significant capital deployment firepower to manage these risks. For example, auto firms will need to continue redefining their business models by partnering with ride sharing and technology companies or acquiring new capabilities beyond their traditional core competencies.

Replicating capital-light business models with higher operating efficiency and a focus towards adjacent market opportunities should be a key priority. Even for those firms with high capital intensity, leveraging big data to understand analytical issues such as consumer behavior and supply chain dynamics can provide important competitive advantages.
5. Manage Complexity of Large M&A Transactions

Last year proved to be another strong year for M&A, with global volume reaching $4.2 trillion. Uncertainty from tariffs, China-U.S. trade disputes, and geopolitical risks, however, weighed on volumes, especially for larger deals in the second half of the year. Nevertheless, the imperative of responding to technological disruption and changing consumer patterns requires ongoing transformation of business models through M&A. Ample liquidity on corporate balance sheets is also likely to support M&A going forward. However, M&A plans need to incorporate market volatility and an uncertain regulatory and trade outlook.

Executing large transactions will require attention to the growing risks in the M&A marketplace. Much of the growth in 2018 M&A activity was fueled by large deals ($5 billion and greater), whose volume rose by nearly 50%. Investors responded enthusiastically to announcements of deals below $5 billion, with buyers experiencing median share price outperformance of 0.4% at announcement, compared with negative 1.4% for larger deals. The mixed response to large deals reflects their growing completion risk, resulting from a rise in cancelled deals. For $10+ billion transactions, the volume of cancelled deals was almost as large as that of completed deals in 2018. Regulatory involvement was a major contributor to deal withdrawal, with 48% and 40% of large cancelled deals in the U.S. and Europe, respectively, having faced some form of regulatory scrutiny in the past three years. In the U.S., the expanded definition of covered transactions under FIRRMA will require both buyers and sellers to pay particular attention to potential regulatory issues.10

![Figure 5. Large M&A Rose Sharply in 2018 but Faced Increasing Completion Uncertainty](image)

Source: FactSet, Dealogic, Thomson Reuters.

Pursuing a large transaction, even if it does not eventually close, need not be penalized by investors. Over the past three years, while uncertainty around deal closure contributed to the mixed announcement returns for large transactions, buyers did not experience any meaningful decline in stock price following announcement. Even in terminated deals, there is no evidence of return underperformance — from announcement to withdrawal — for either the buyer or the seller, indicating investors’ recognition of the need to address growth and competitive challenges through an active M&A strategy.

Hence, management and boards should focus on managing the risks surrounding large transactions rather than shelving their strategic plans in 2019. Investors should be provided with greater clarity around regulatory issues in announced transactions. Companies should also develop a plan to address activist interference around M&A, a factor that was present in one-third of all large terminated deals in 2018. Such risks may be managed through disclosure of acceptable remedies and divestitures for addressing potential antitrust concerns. In addition to the inclusion of reverse termination fees to manage deal completion risk, pre-funding of acquisition debt, advance FX and interest rate hedges, and equity collars can help manage some of the financial risks in large M&A in 2019.
6. Rebalance the Corporate Portfolio

Global divestiture volume reached $766 billion in 2018, driven in particular by asset sale volume that was only 3% away from a new ten-year high. Companies divested for a variety of reasons, such as sharpening management focus, enhancing transparency, exploiting valuation opportunities, responding to technological disruption, complying with antitrust, and raising capital. Sometimes they divested under pressure from an activist; since 2000, nearly 15% of activist campaigns specifically requested a divestiture. As companies continue to manage their portfolios in 2019, we see additional tailwinds for divestiture activity.

**Strong 2018 M&A volume likely to support 2019 divestiture activity.** Large acquisitions often leave the acquirer with assets that are not core to its strategy. Additionally, regulators will often insist on a divestiture due to antitrust. Accordingly, we find that companies were almost three times as likely to announce a divestiture if they had made an acquisition in the prior two years. As companies digest 2018’s $4.2 trillion of M&A, we may see elevated divestiture activity in 2019. To facilitate antitrust approval, recent large merger agreements increasingly even contain language indicating specific assets that the companies would be willing to divest.

**Additional tailwinds include U.S. tax reform and increased private equity activity.** The lower corporate tax rate reduces the tax burden associated with an asset sale, an important factor in the decision to divest. Indeed, we find that corporates with the lowest effective tax rates were four times more likely to sell an asset than those with the highest rate. Financial sponsors are also likely to play a key role in divestitures, buying one-third of divested assets since 2010. Their market share increased to 38% in 2017-2018, from 27% in 2010.

**Divestitures can improve the seller’s growth profile.** Companies frequently sell those parts of their business that are growing slowly or even declining. These assets, by slowing a company’s overall growth, can hinder its efforts to attract the right investors and the premium valuation that their faster-growing businesses warrant. Accordingly, we find that, following a divestiture, sellers saw their estimated near-term growth rates improve by as much as 150 basis points relative to peers who did no divestitures.14

**Investors reward the right divestiture at the right time.** The market responses to divestitures following large M&A were meaningful, driven by the ability to achieve scale, faster deleveraging, and antitrust compliance. Large divestitures not preceded by an activist campaign garnered a meaningful excess return upon announcement, in contrast to those that followed a campaign. This illustrates the strategic importance of doing a divestiture at management’s discretion, rather than under pressure from an activist. Finally, divestitures undertaken by companies with low effective tax rates and divestitures that improved the seller’s return on invested capital were better received by investors.

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Source: FactSet, Thomson Reuters.

![Figure 6. Propensity to Divest Increases with Past Acquisition Activity; Right Divestiture at Right Time Rewarded](image)

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7. Anticipate Rising Buyout Interest

Global LBO volume was $314 billion in 2018, with 95 announced transactions of $1 billion or more. LBO activity will likely remain robust with a focus on larger LBOs due to several trends.

**Activists targeting larger firms.** Activists are increasingly focusing on large companies, urging them to consider all strategic alternatives to maximize shareholder value, including buyouts. Two-thirds of campaigns in 2018 targeted firms larger than $1 billion and one-fifth targeted those larger than $10 billion, the highest percentages over the past decade.

**Valuation pressures for larger firms.** Reflecting the growth challenges facing many large companies, those with market capitalizations above $10 billion trade at FV/EBITDA multiples that are about 0.8x lower, on average, than their sector peers. A pullback in valuations will present opportunities for sponsors, particularly for larger transactions.

**Enormous dry powder and expanding investor universe.** Substantial fundraising has allowed sponsors to participate across more asset classes, and pursue bigger transactions. With about $2 trillion of dry powder, of which more than $700 billion is dedicated to buyouts, financial sponsors have record capacity to pursue LBOs in 2019. Limited partners in PE funds have also emerged as active direct participants in LBOs along with sovereign wealth funds, pension funds, and strategic investors. The growth in infrastructure and core capital funds with longer investment horizons and differentiated return objectives allows a broader range of companies to consider an LBO. Since 2010, over half of all $5 billion and larger LBOs included such non-traditional LBO investors.

**Credit markets are open for the right transactions.** Although credit spreads, especially in the high yield market, rose in 2018, market access and depth remain available for the right covenant structure, leverage levels, and credit fundamentals.

![Figure 7. Rising Financial Sponsor Dry Powder and Growth in Investor Universe Supporting LBO Momentum](image)

Source: Dealogic, Prequin.

**Consortiums expand universe of buyout candidates.** Consortia of two or more sponsors can facilitate buyouts of larger companies without adversely affecting competition between buyers. Historically, sponsor returns in consortium LBOs have been lower than in sole-led LBOs, indicating that their participation facilitates competitive outcomes for selling shareholders.

Boards should proactively prepare for rising interest from sponsors with plans to respond quickly and appropriately. Seasoned advisors play a critical role in providing real-time insight, identifying and evaluating opportunities, developing necessary financial policies, and overseeing process and execution management.
8. Prepare for Adverse Effects of Trade War

Mounting trade-related tensions will be a key risk in 2019. Trade disputes have already affected global trade flows and hurt commodity demand. An extended trade war and protectionist policies are likely to suppress global growth with regional spillovers, in particular in the U.S. and China, reducing China’s GDP growth by 50bps.\(^{15}\) China’s large trade imbalance — especially against the U.S. — has contributed to the Shanghai Composite index falling by 25% in 2018 over concerns of weakening foreign demand.

**Assess the impact of enacted and threatened tariffs.** The imposed tariffs have pressured companies globally, with large negative investor reactions around key tariff announcements. Particularly affected are Chinese firms with large U.S. export exposures. These firms exhibited a 12.1% downward revision to 2019 earnings estimates, accompanied by a 12.4% stock price underperformance.\(^{20}\)

Among U.S. firms, those with close supply chain ties to China are the most vulnerable. These firms have also come under significant pressure with stock price underperformance of 25%, driven by 30% revenue exposure to China for the median firm. Not surprisingly, these firms also exhibit higher stock volatility and equity betas, resulting in a higher cost of capital relative to peers.\(^{21}\) A similar pattern holds for U.S. companies supplying the most strategic products to China, such as semiconductor manufacturers. Public disclosure of vulnerability to tariffs is limited, underscoring firms’ need to properly communicate to investors their strategies and ability to mitigate these risks.

**Figure 8. Mounting Trade Fears Disrupt Businesses with Higher Exposures to U.S. and China\(^{22}\)**

<table>
<thead>
<tr>
<th>Change in 2019 EPS estimates (%)</th>
<th>Excess returns around key tariff announcements (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>U.S. firms</td>
<td>Chinese firms</td>
</tr>
<tr>
<td>Low</td>
<td>High</td>
</tr>
<tr>
<td>(1.6)</td>
<td>(1.1)</td>
</tr>
<tr>
<td>Low</td>
<td>High</td>
</tr>
<tr>
<td>U.S. exposure</td>
<td></td>
</tr>
</tbody>
</table>

Source: FactSet.

**Re-evaluate long-term supply chain effects.** Rising tensions have pushed many multinational companies to reassess their supply chain vulnerability to higher input costs. Firms need to evaluate supply chain risk and consider the diversification benefits of expanding production into other low-cost countries or shifting to a more regional manufacturing footprint. The range of supply chain alternatives should also take into account the hurdle rates for both existing and new investments.

**Be aware of broader inflationary pressures and price volatility.** Protracted trade wars can translate into higher inflation and heightened FX and commodity price volatility. Many executives are already bracing for these impacts. In recent earnings calls, nearly half of U.S. firms have indicated the possibility of passing along some of the higher input costs to customers.\(^{23}\) In the retail sector, for example, prices would need to rise 3.5% to offset a 10% tariff, with remaining costs absorbed by the factories and through currency devaluations. Executives should carefully consider how to manage these risks both in terms of a longer-term strategic rebalancing of their geographic footprint through asset sales and divestitures, as well as tactical hedging solutions.
9. Evaluate Risks and Rewards in EM

In 2018, emerging markets (EM) lost some luster as they faced trade war uncertainties, slowing GDP growth rates, higher U.S. interest rates, and a stronger dollar. The economic and geopolitical environment in EM is expected to remain challenging in 2019. As most multinational firms continue to rely on EM growth, executives should carefully calibrate their EM strategies to account for future growth potential and the associated risks.

Declining EM equity prices have created an opportunity to deploy capital at attractive valuations. As a result of widespread risk and uncertainty, companies in many EM countries trade at a substantial valuation discount to their developed market (DM) peers, after adjusting for firm-specific fundamentals. The discount is particularly large in Russia and Korea but also present in China, Brazil, and Mexico. Across these countries, alongside India and Indonesia, the median discount rose to 1.9x earnings in 2018, from a discount of 0.7x in 2012.

Recent headwinds aside, EM continues to be the main engine of long-term growth: its share of global GDP is projected to rise to 43% by 2023 from 39% in 2018; nearly half of global GDP growth is expected to come from EM Asia alone. Even after accounting for higher GDP growth volatility, future EM growth, especially in Asia, remains superior to DM.

Managing currency risk remains essential. We estimate that the typical U.S. multinational firm has 20% EM revenue exposure. As a result, a 15% dollar appreciation — similar to the previous dollar strengthening cycle from 2014 to 2015 — could undo nearly 60% of next year’s projected sales growth. A stronger dollar also poses a significant risk to many EM companies, especially in Latin America and Asia, which often source earnings in local currencies but borrow in dollars.

Adjust hurdle rates in light of increased EM credit spreads and equity volatility. The average EM CDS spread rose by 22% in 2018, reflecting higher economic and political risk. Coupled with higher equity volatility in many EM countries, this has resulted in a higher cost of capital and necessitates adjusting hurdle rates accordingly.

Diversification of funding sources is also a key imperative for EM corporates. EM corporates’ tendency to rely on bank debt leaves them more exposed to potential pressures in regional banking systems. In Asia, for example, the median large-cap corporate relies on bank funding for nearly 70% of its debt funding needs. The strong linkages between EM governments and banking systems imply that sovereign economic and political risk can inhibit bank lending to corporates. Firms should assess risk from their local and regional banking group and should actively consider capital market alternatives to bank capital wherever feasible.
10. Pay Attention to Corporate Responsibility

Over the past five years, investor focus on environmental, social, and governance (ESG) issues has grown rapidly, reshaping the broader corporate responsibility agenda. Global asset managers with an ESG focus account for more than $20 trillion of capital today, representing close to 25% of all professionally managed assets globally. Even activist hedge fund managers such as ValueAct and Jana joined the fray in 2018 by launching dedicated funds with an ESG focus. Beyond the investor community, ESG has been an increasing area of attention across many constituencies including customers, government regulators, credit rating agencies, supply chain vendors, and company employees.

Increasing stakeholder demand for ESG has led to third-party agencies assigning ESG scores for many firms, who have responded by pursuing environmentally and socially friendly practices. These include a focus on renewable energy sources, clean transportation, eco-efficient products, and pollution prevention, with growing materiality. For example, shifts towards electrification and away from diesel in the auto industry have accelerated through regulation. Median ESG scores across MSCI firms have improved by 16% from 2013 to 2018, with European corporates scoring higher, on average, than other regions. In addition, more firms (22% of S&P 1500 firms) are highlighting ESG in their investor communications than ever before.

Improving ESG scores can help lower equity volatility. There is ongoing debate on the value-add benefits from pursuing an ESG-focused strategy. We find that companies with higher ESG scores exhibit slightly lower stock price volatility and equity beta compared to firms with a lower ESG score. As interest in ESG grows, the valuation impact could increase.

Firms can leverage strong green bond demand to finance ESG-focused investments. Green bond issuance has accelerated significantly in recent years, from $10 billion in 2013 to $175 billion in 2018. A large proportion of this volume has been driven by corporate issuers, who now represent 41% of total green bond issuance. While there is no clear evidence of pricing advantages for green bonds in the primary market, they can sometimes exhibit modest outperformance in the secondary market.

Power purchase agreements (PPAs) help transition to a sustainable energy source. In shifting towards renewable energy sources, firms often confront a variety of risks including long-term commodity price, sub-investment grade credit, and weather-related risks, primarily as a result of volume uncertainty. These risks can be mitigated through PPAs — either directly or through financial intermediaries who can assist in hedging these risks. Since 2015, there has been a 20% increase in the amount of clean energy provided through corporate PPAs. Firms can use these types of agreements to demonstrate their intentions to pursue ESG goals without exposure to non-core risks inherent in greenfield renewable projects.
1 Based on regression analysis of valuation on growth (short-term and long-term) and leverage while controlling for other financial factors; estimated at each year-end.

2 Based on analysts’ EPS forecasts for MSCI firms from 2010 to 2018. Target earnings added to acquirer earnings for public targets. Contribution from private targets imputed based on deal size.

3 TSRs are cumulative and sector-adjusted. High-growth firms defined as those with above-sector median forward EPS growth rates in each period.

4 Sector-adjusted TSR from 2014-2018. Growth boosted, maintained, and declined buckets defined based on whether firms moved into a higher growth, same, or lower growth quartile versus sector peers. “With M&A” defined as firms doing an acquisition with transaction value greater than 25% of market cap during 2014-2018.

5 “Firepower” defined as sum of global cash, debt capacity within current credit rating using 2020E EBITDA and 2.5 years of forecasted FCF. Excludes financials and utilities. Stress case considers a two standard deviation downside shock to FCF and EBITDA.

6 High-cash and low-cash firms are those within the top and bottom quartile of cash / assets by sector in each period. Cumulative excess returns calculated within a (-5, 5)-day window around announcement. Repurchases as of December 21, 2018, dividend increases as of year-end 2018.

7 Tech titans defined as Facebook, Amazon, Apple, Netflix, Alphabet (Google), Microsoft, Baidu, Alibaba, and Tencent.

8 Equity growth premium is the difference between the MSCI forward P/E multiple and a P/E multiple that assumes a growth rate of zero.

9 Conglomerates as defined by FactSet, GICS, or NAICS.

10 The Foreign Investment Risk Review Modernization Act (FIRRMA) passed in 2018 reforms the Committee on Foreign Investment in the United States (CFIUS), expanding covered transactions under CFIUS jurisdiction, notably minority investments, including through private equity structures.

11 Cumulative excess returns calculated within a (-10, 10)-day window around announcement.

12 Value of all deals withdrawn (closed) as a percentage of total.

13 Based on sample of 37 withdrawn deals larger than $5bn from 2016 to 2018.

14 Median change in average analyst near-term net income growth forecast from one quarter pre-divestiture announcement to one quarter post-divestiture close. Sample consists of all deals larger than $100mn between 2010 and 2018.

15 Total number of spin-off and asset sale announcements by S&P 1500 constituents between 2010 and 2018, divided by total number of firm-years. “Following M&A” defined as firms with at least one acquisition announcement in the two prior calendar years.

16 Cumulative excess returns calculated within a (-10, 10)-day window of announcement, except for ROIC improvement, which uses a (-10, 252)-day window. M&A and activism histories based on two years prior to announcement. High (low) tax rate defined as having an effective tax rate in the top (bottom) quartile of global firms announcing divestitures from 2010 to 2018.

17 Global LBO count is for deals over $1bn in size.

18 Partner for lead private equity sponsor in global deals over $5bn from 2010 to 2018.


20 Median change to analysts’ consensus EPS estimate between February and September 2018.

21 Stock volatility based on forward option-implied stock volatility.

22 S&P 1500 and MSCI China firms. High (low) China (U.S.) exposure defined based on whether revenue from China (U.S.) is above or below median for that of U.S. (China) firms. “Strategic to China” defined as U.S. firms that are suppliers to companies within the Made in China 2025 initiative. Cumulative excess returns calculated from July 11, 2018 to December 31, 2018.
24 Based on regression analysis of valuation on growth and assets while controlling for other financial factors and country effects.
26 “2016 Global Sustainable Investment Alliance Review.”
27 Based on number of firms that mention “ESG” in filings, presentations, and earnings calls each calendar year.
28 Corporate issuance includes private sector corporates with financial institutions.
29 Median stock volatility and equity beta for firms with Sustainalytics ESG scores that are higher (lower) than those predicted by a statistical model using financial, geographic, and sector data.
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