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IN A TOUGH MARKET, INVESTORS SEEK NEW WAYS TO CREATE VALUE

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This article is the second in the 2016 BCG Value Creators series. In May 2016, we released the 2016 Value Creators rankings, which track the top performers worldwide and in 28 industry sectors on the basis of their total shareholder return (TSR) from 2011 through 2015.

RECENT VOLATILITY IN GLOBAL equity markets has led to an uptick in bearishness among investors. According to BCG's eighth annual investor survey, investors are scaling back their expectations for total shareholder return (TSR) and looking for companies that are building value-creating businesses, not just returning cash to shareholders in the form of dividends and stock buybacks.[1]

The survey—conducted in early 2016 by BCG in partnership with Thomson Reuters, the world's leading provider of business and financial information—received responses from more than 700 portfolio managers and buy-side and sell-side analysts, representing firms that are collectively responsible for approximately $2.5 trillion in assets under management. BCG has conducted the survey every year since 2009 to understand investors' views on global capital markets and priorities for shareholder value creation.

Four themes stand out in this year's findings:

- **Investors are more bearish—at least about the near term.** Thirty-two percent of respondents described themselves as "bearish" or "extremely bearish" about equity markets in 2016—an increase of nearly 70% from 2015 and the highest percentage since 2009, during the financial crisis.

- **Survey respondents have modest expectations for TSR.** The respondents' bearish sentiment is reflected in their estimate for TSR: 5.5% annually over the next three years, the lowest estimate since we began conducting the survey and considerably below the S&P 500 90-year average of 10.1%.

- **Investors anticipate high cash payouts but may have a limited appetite for more.** At a time when

share buybacks are near record heights, respondents believe that most of the TSR in the next three years—4.4%—will come from cash payouts (dividends and buybacks). But they don't believe that payouts alone will deliver superior performance. They put a higher priority on other uses of excess cash, especially growth-oriented investments.

- **Investors are looking for new value-creation strategies.** In an environment of modest GDP growth, near-record levels of profitability and free cash flow, and high valuation multiples, investors appear to be seeking companies with credible strategies for value-creating growth. They are increasingly interested in companies that are using cash for strategic M&A and that have experienced management teams and compelling equity stories based on strong fundamentals and intelligent capital allocation.

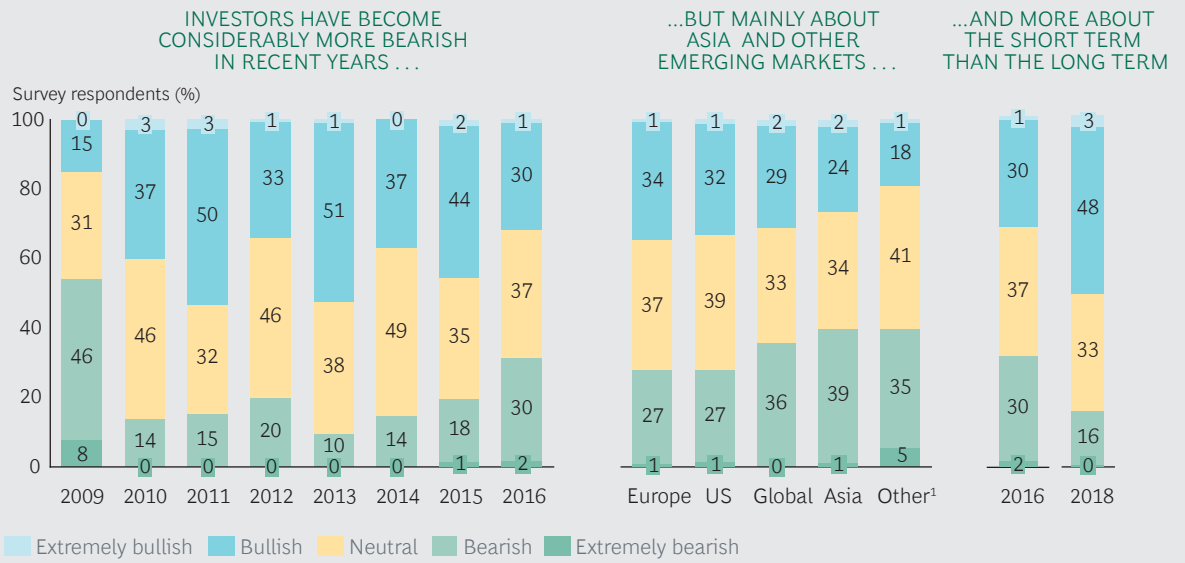
An Uptick in Bearishness

The rise in bearish sentiment is perhaps the most striking finding of this year's survey. In 2015, 19% of respondents said they were either "bearish" or "extremely bearish" about the market's prospects; this year, 32% did. This is the highest percentage since 2009, in the midst of the global financial crisis, when 54% of respondents described themselves this way. (See Exhibit 1.)

The 2016 increase is primarily a reaction to the slowdown in China and other emerging markets. As the middle chart in Exhibit 1 illustrates, the percentage of respondents who are bearish or extremely bearish rises to 40% among those who focus on Asia and emerging markets in Africa, the Middle East, and South America. The percentage drops to less than 30% among investors who focus on the US and Europe. When asked to choose the main reasons for their pessimism, 72% of the bears selected the slowdown in China's economic growth as a key factor.

Despite the relatively high levels of bearishness this year, it's important to emphasize that the sentiment is strongest for the immediate future. We asked the bearish-bullish question for two periods—2016 and three years out, through 2018. As Exhibit 1 illustrates, the percentage of respondents

EXHIBIT 1 | Investors Are More Bearish Than at Any Point Since the Financial Crisis



Sources: BCG Investor Survey, 2009–2016; BCG analysis.
Note: Every year, respondents are asked, "Where would you place yourself on the bear-bull spectrum for this year's performance of the equity markets you follow?" In 2016, they were asked that question about the next three years, through 2018. Regions in the middle chart indicate the locations of the equity markets respondents follow.
[1]Includes Africa, Australia and New Zealand, the Middle East, and South America.

who are bearish or extremely bearish declines by half for the longer time frame. A slight majority of respondents (51%) said they were "bullish" or "extremely bullish" for the longer term.

Expectations for Lower TSR

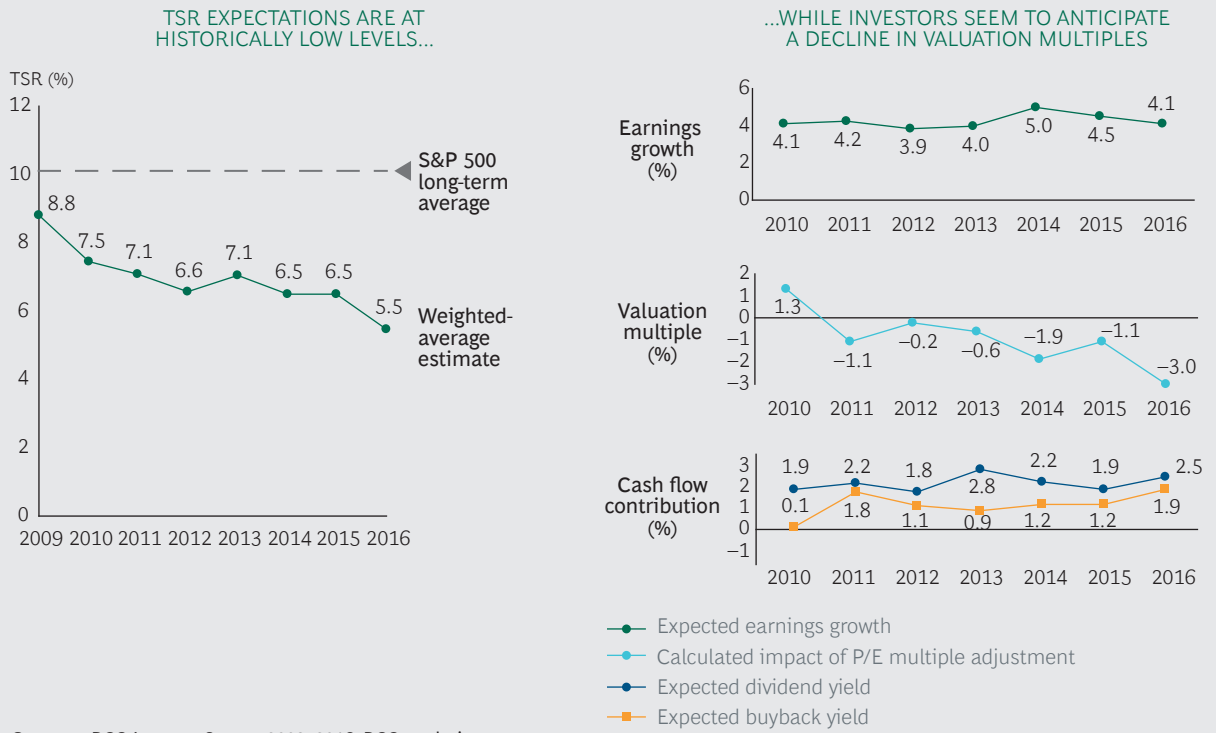
Higher levels of bearishness correspond to expectations for lower TSR. Every year, we ask respondents to estimate average annual TSR for the next three years and the underlying rate of earnings growth and dividend and share-repurchase yields. In 2016, the weighted-average estimate of TSR was 5.5%—a full percentage point below the 2014 and 2015 estimates and the lowest in the eight years we have been conducting the survey. (See Exhibit 2.)

Modest expectations for TSR reflect in part similarly modest expectations for earnings growth: 4.1%. Moreover, investors appear to be anticipating a decline in valuation multiples. If one subtracts the estimate for average annual earnings growth, dividends, and share buybacks from the estimate for annual average TSR, the result is an implied decline in valuation multiples equivalent to –3 percentage points of TSR. Put another way, investors seem to be anticipating a decline in valuation multiples that will offset roughly three-quarters of the TSR created by earnings growth, leaving cash returned to investors as the dominant source of TSR. Under this scenario, approximately 80% of TSR over the next three years would come from dividends and buybacks.

Looking Beyond Cash Payouts

Even as the investors we surveyed are expecting the lion's share of TSR in the next three years to come from cash payouts, they want companies to consider alternative uses for their excess cash. Every year, we ask respondents to indicate their priori-

EXHIBIT 2 | TSR Expectations Have Declined



Sources: BCG Investor Survey, 2009–2016; BCG analysis.
Note: The S&P 500 long-term average is the average yield for S&P 500 companies, weighted by market capitalization, from 1926 through 2014. The weighted-average estimates for TSR, earnings growth, and dividend and buyback yields are calculated as the average of midpoints in the answer-choice intervals, weighted by the distribution of responses. The estimated impact of P/E multiple adjustment is calculated by subtracting the estimated earnings growth and dividend and buyback yields from estimated TSR. The time series begins in 2010 because data was not collected in 2009.

ties for the use of free cash flow at a financially healthy company. Exhibit 3 compares the 2016 responses with the average for the previous seven years. As the middle two bars in the exhibit show, the percentage of respondents who listed either dividend increases or share buybacks as one of their top two priorities is lower than the average.

Some background helps put this finding into context. In 2015, nonfinancial companies in the S&P 500 returned more than $1 trillion to shareholders—share buybacks made up over 60% of the total, and dividends accounted for the rest. Buybacks have increased more than fourfold since 2009, accounting for roughly 3% of the average 8.5% growth in earnings per share. By contrast, capital expenditure budgets in the S&P 500 have grown only 44% over the same period.

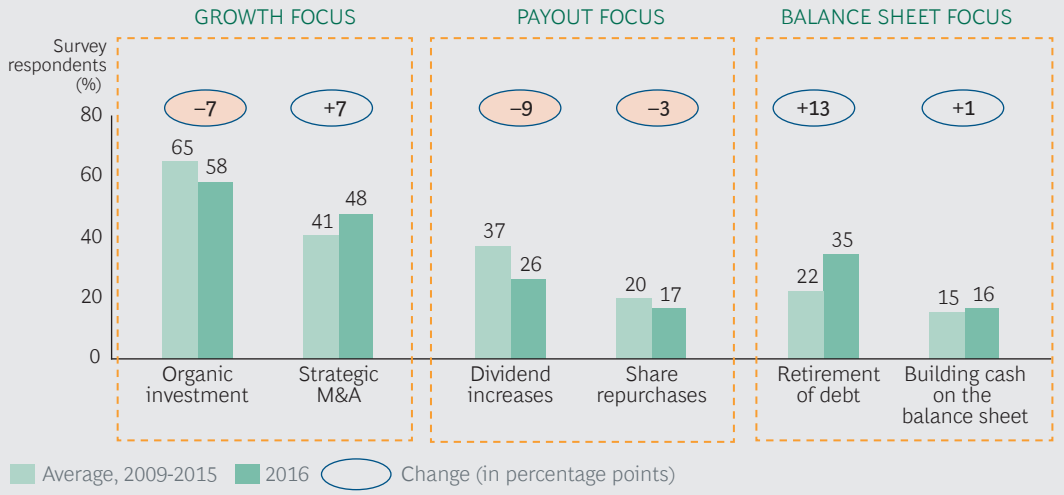
After a period in which companies returned record amounts of cash to shareholders, investors may be looking for companies to use that cash to improve the fundamental value of their businesses. In this regard, it is striking that despite a slight relative decline, investment in organic growth remains a top priority for a majority of investors and is chosen by more respondents than any other area. And the percentage of respondents who see strategic M&A as a priority has grown relative to the average, perhaps reflecting a belief that lower valuations are making deals more attractive.

Another factor at play is the likelihood that the US Federal Reserve will increase interest rates (62% of respondents follow US capital markets). In recent years, many companies have taken advantage of the low interest rate environment to borrow money cheaply and use it to buy back their own stock during a period when stock prices were on the rise. But if interest rates increase even as valuations decline, this may no longer be a viable strategy. Indeed, the fact that an above-average percentage of respondents chose debt retirement as a top priority for the use of excess cash may signal a growing concern among investors that too much leverage will expose companies to liquidity problems in today's uncertain macroeconomic environment.

Wanted: New Strategies for Value Creation

Other findings in our survey confirm an increased focus on fundamental value. For example, when asked to identify their most important criteria for deciding to invest in a company, the experience and credibility of the management team and the clarity of its business strategy and vision were

EXHIBIT 3 | Cash Payouts Are a Lower Priority Than Other Potential Sources of Value



Sources: 2016 BCG Investor Survey; BCG analysis.
Note: Respondents were asked, "How would you rank the following options based on your preference for the use of excess cash by healthy companies?" Percentages indicate the respondents who ranked each option first or second in 2016, compared with the average from the surveys from 2009 through 2015.

among the top choices—32% of respondents chose each of those criteria as one of their top three. (See Exhibit 4.) TSR drivers were also popular: undervaluation was chosen by 32%, three-to-five-year revenue growth was chosen by 29%, and free cash flow yield was chosen by 27%. Less popular criteria, by contrast, were strictly financial metrics such as a company's free cash flow as a percentage of sales, the level of return on invested capital, and leverage ratios.

When we asked respondents to describe the areas in greatest need of improvement at their portfolio companies, most cited strategic management processes, such as capital allocation, strategy development and planning, investor communications, and risk management. (See Exhibit 5.) Capabilities that are more operational (for example, financial reporting and financial planning) were at the bottom of the list.

Improving the Fundamental-Value Engine

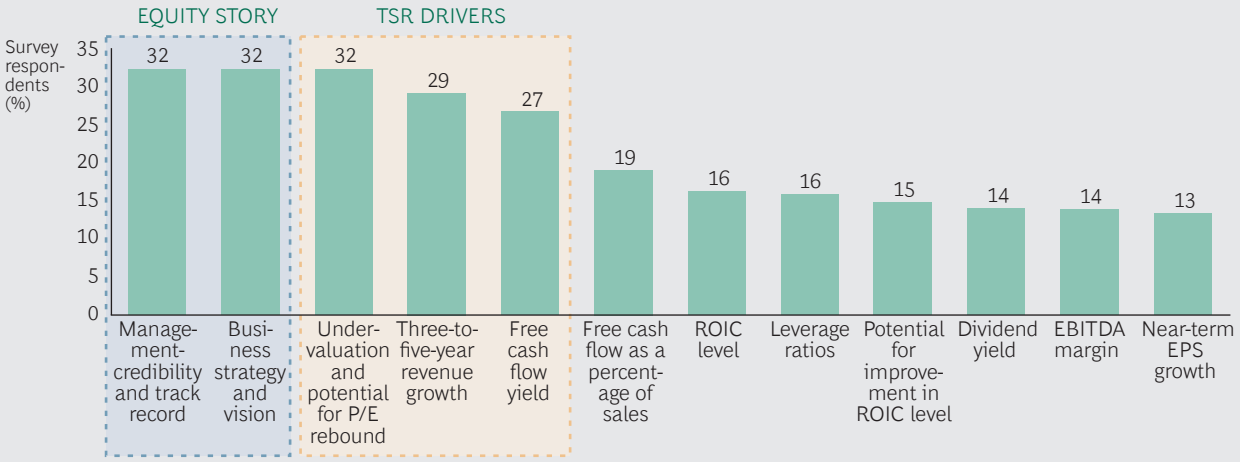
The findings from this year's investor survey should be considered in the context of companies' ongoing adjustment to a macroeconomic environment that, since the 2008–2009 global financial crisis, has been characterized by relatively low growth. For a time, emerging markets were an exception to this trend, but recent developments in China, Brazil, and other emerging markets suggest that these countries will grow more slowly in the future.

In response, companies have made a variety of moves to deliver value. They have cut costs to improve profitability and free cash flow, taken advantage of low or even negative interest rates to increase leverage, boosted payouts in the form of dividends and share buybacks, and benefited from valuation increases as capital markets have rebounded from their post-financial-crisis lows.

The findings of our survey, however, suggest that investors believe that these strategies are mostly played out. Margins are currently at or near their peak, making additional improvements increasingly difficult. Cash returned to shareholders will continue to constitute a large percentage of TSR, on average, and provide a floor for valuation; but cash payouts alone won't deliver superior value. Finally, although interest rates have been low, they are likely to increase in the near future. All these factors mean that valuations will be under persistent pressure.

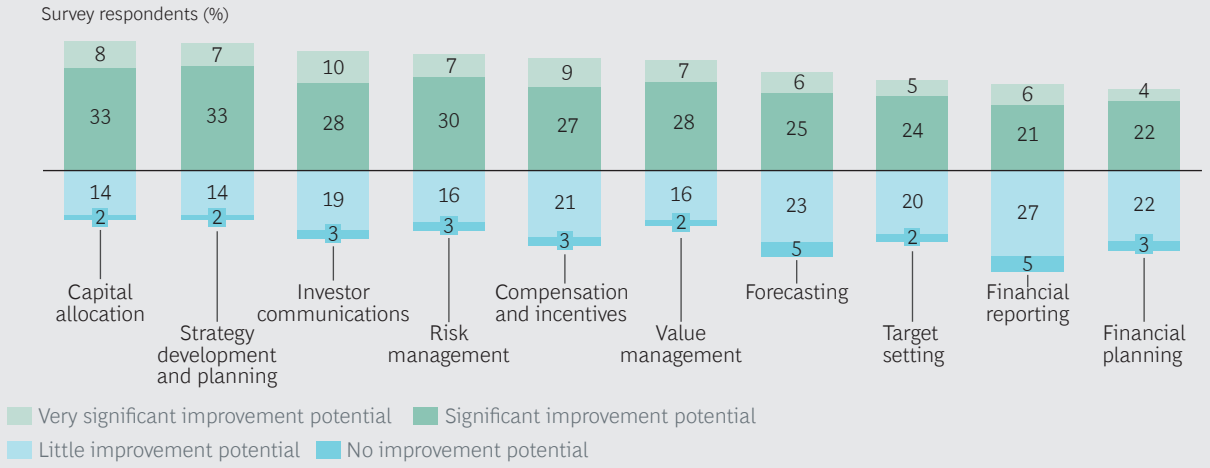
In such an environment, investors want companies to focus on improving their

EXHIBIT 4 | Investors Seek Companies with a Compelling Equity Story and Strong Fundamentals



Sources: 2016 BCG Investor Survey; BCG analysis.
Note: Respondents were asked, "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?" Percentages indicate the respondents who selected the item as one of their top three criteria. ROIC = return on invested capital.

EXHIBIT 5 | Investors Want Companies to Improve Their Strategic Capabilities



Sources: 2016 BCG Investor Survey; BCG analysis.
Note: Respondents were asked, "Given the current macro environment, where do you see improvement potential in your portfolio companies?" Percentages do not add up to 100 because the response for "some improvement potential" is not shown.

fundamental-value engine: to put in place the managerial vision, organizational capabilities, and capital investments necessary to create a strong foundation for growth in the core business. In a low-growth environment, this is an enormous challenge. But precisely because of this difficulty, delivering value-creating growth will likely be what distinguishes the superior value creators from the rest.

What can companies do to align their value creation strategies with investors' priorities? We believe four steps will be especially important:

- **Emphasize value-creating growth.** Now more than ever, companies must find new ways to deliver value-creating growth, embracing strategies such as portfolio reshaping, strategic acquisitions, and business model innovation to improve their growth prospects.

- **Understand the factors that affect valuation multiples.** To combat expected pressure on valuation multiples, companies need to understand what drives differences in their peer group. In our experience, roughly 80% of the factors that lead to differences in valuation multiples among similar companies can be identified and managed.

- **Ensure a disciplined approach to cash payouts.** Our findings suggest that in today's market environment, strong cash payouts have the potential to provide a floor for valuation. The decisions companies make about dividend and buyback policy should be carefully considered as part of a broader value-creation strategy.

- **Focus on capital allocation.** Whether investing in new opportunities for organic growth, pursuing strategic M&A, or returning cash to shareholders, a company must make tradeoffs in capital allocation. Intelligent capital allocation is the centerpiece of any robust value-creation strategy. We will explore the role of capital allocation and portfolio management in delivering superior TSR in BCG's Value Creators report later this year.

Download findings from the 2016 investor survey at http://media-publications.bcg.com/investor-survey-2016.pdf.

NOTE

1. TSR measures the combination of share price gains and dividend yield for a company's stock over a given period. It is the most comprehensive metric for a company's performance in shareholder value creation.

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5/16 revised 9/17