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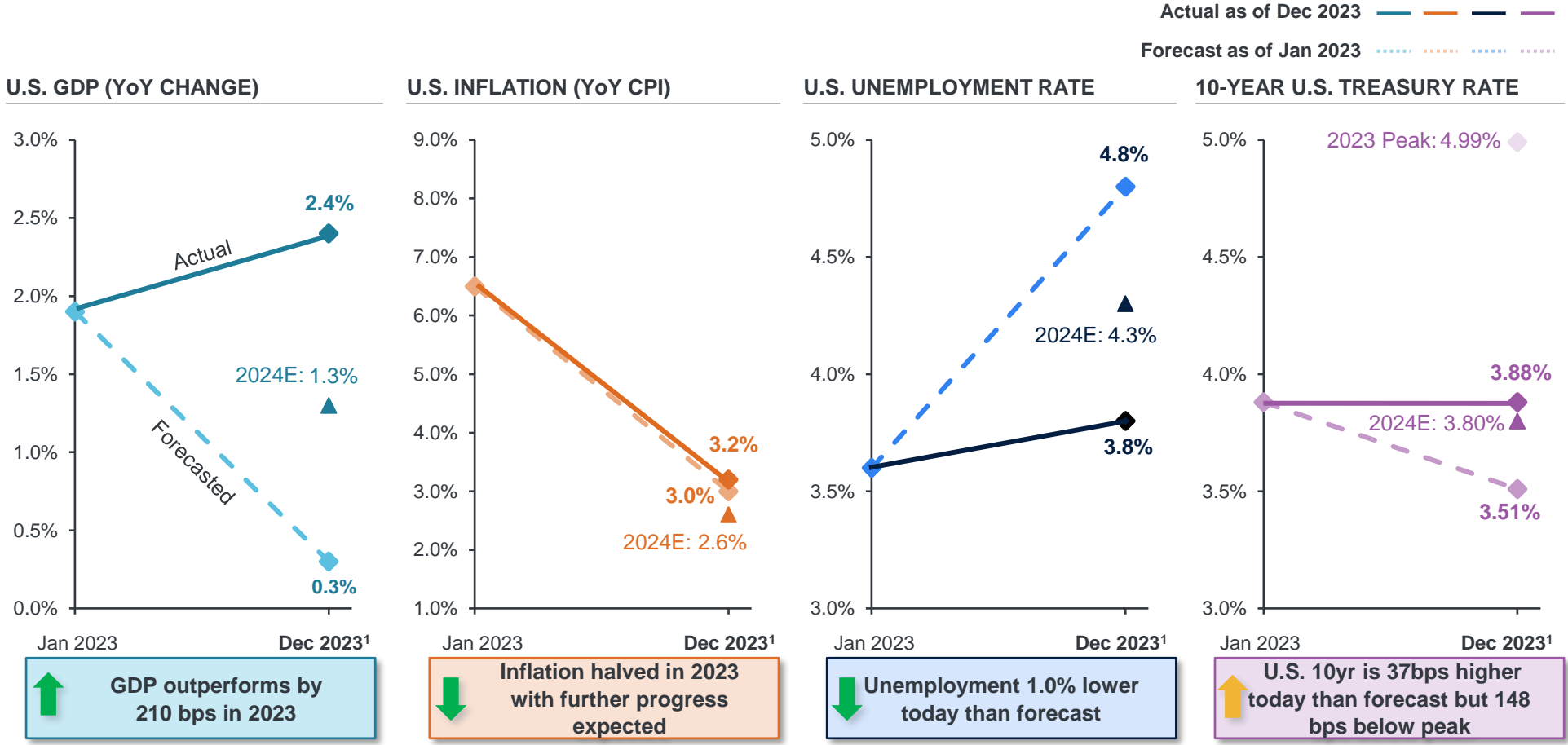
Corporate Compass

Navigating the year ahead | January 2024

Navigating the year ahead

- 2023 seemed determined to prove the adage of “this time is different,” bucking pessimistic expectations of economic and capital markets performance
- Several themes will carry into 2024 as we navigate the year ahead:
- **Interest rates and cost of capital will continue to drive valuations, strategy, and execution**
 - Even with rates off recent highs, capital allocation decision-making has become more challenging as companies re-think their capital structures and growth plans
 - Rates are driving firms to alternate means of financing (e.g., converts, private credit)
- **Scale, now more than ever**
 - A few ultra-mega-cap firms skew market valuations but also capital investment, demonstrating how scale allows firms to invest for growth even through periods of uncertainty
 - Capital intensive sectors, like those investing in energy transition, have been particularly impacted by the sharp move higher in rates despite extensive policy support
 - Markets have responded by applying a significant premium to larger companies
- **Market primed for action**
 - Equity valuations and debt pricing ended 2023 at the most attractive levels in almost two years
 - Risks of higher-for-longer rates, economic slowdown/recession, and geopolitical uncertainties persist even as hopes of a soft-landing are increasingly “priced in”
 - Those able to proactively de-risk their financial needs will be well-positioned for navigating 2024 and beyond

1 What a difference a year makes



U.S. economic performance has outperformed with GDP growth expected to be ~210 bps higher than forecasted in 2023 (2.4% vs. 0.3%)

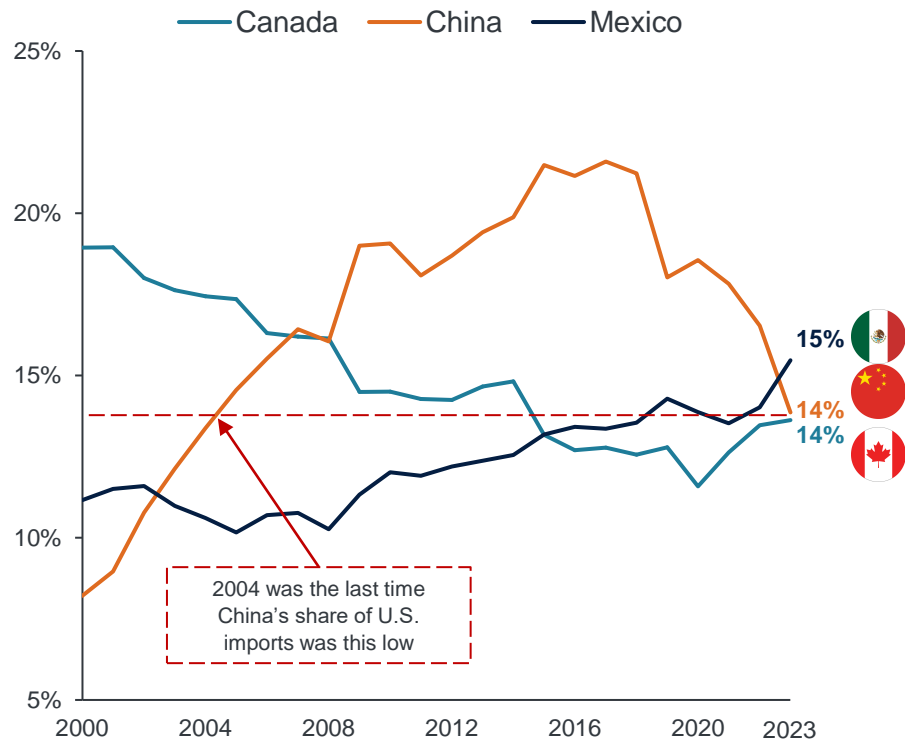
Why it matters?

- The expectation of a near-term recession has decreased substantially as moderating inflation trends support a pause in Fed rate hikes, and increased expectations of rate cuts in 2024
- Despite a more optimistic macro picture, interest rates across the curve remain at levels not consistently seen since before the Great Financial Crisis in 2008/2009, and continue to significantly impact company and investor decision-making

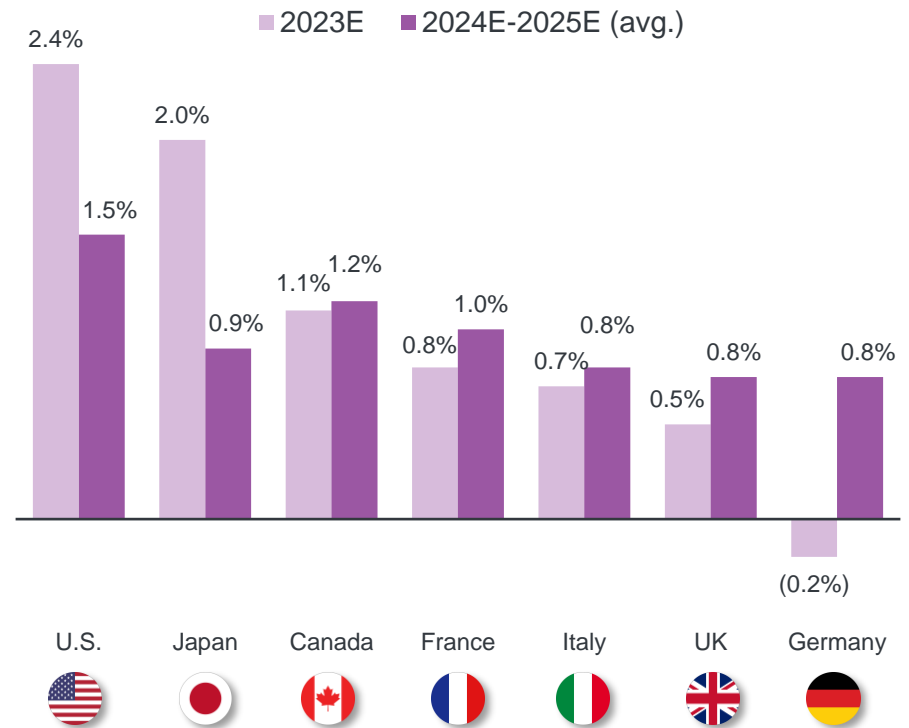
Source: FactSet; ¹ December 2023 actuals based on latest available data as of 12/31/2023; GDP based on 2023E, CPI and Unemployment based on Q4 2023E, 10-yr UST as of year-end actuals

2 U.S. economic strength is a global bright spot as balance of trade shifts

SHARE OF TOTAL U.S. IMPORTS¹



REAL GDP PROJECTIONS²



Mexico overtook China as the source of the largest share of U.S. imports in 2023

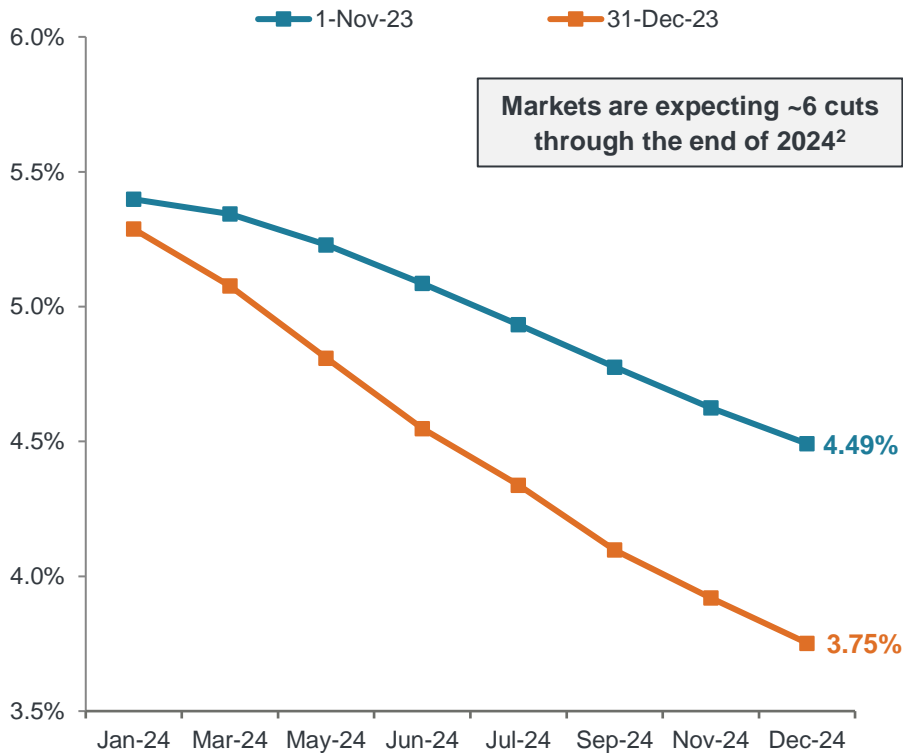
Why it matters?

- Geopolitics and a focus on supply chain resiliency are driving an increase in reshoring (U.S. sourcing), nearshoring (geographically close countries), and friendshoring (geopolitically aligned countries), but also increasing the risk of prolonged inflationary trends
- U.S. economic strength underpinned by resilient consumer spending, a surprising uptick in worker productivity, and supportive policy measures (Inflation Reduction Act, CHIPS act, etc.)

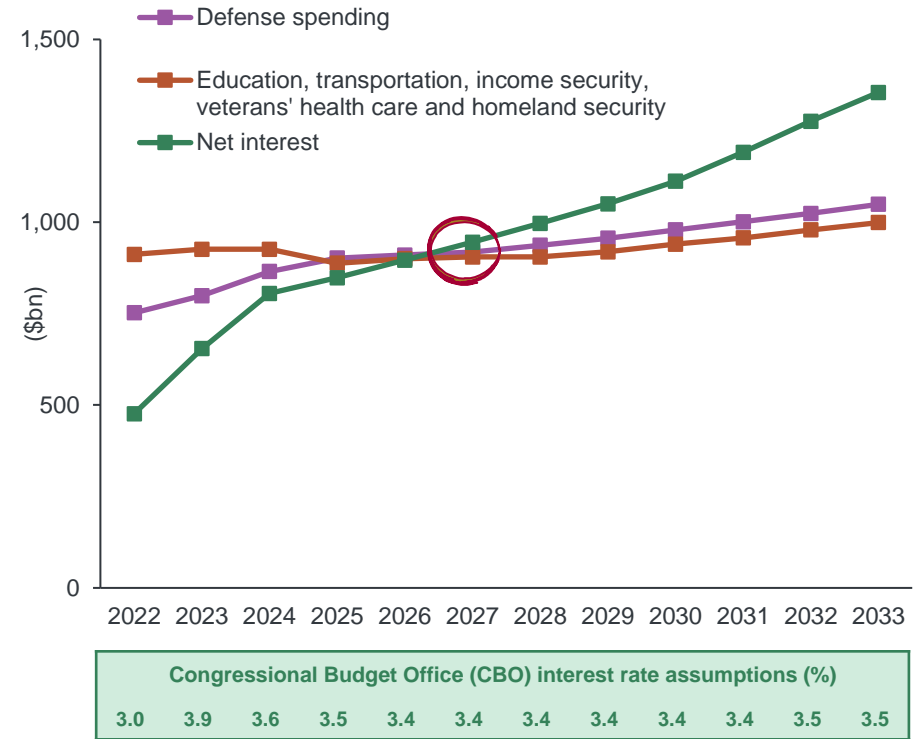
Note: ¹ US Census Bureau latest data as of October 2023; % of total US imports, seasonally adjusted; ² FactSet as of 12/31/23

3 Markets are “all in” on lower rates, but significant risks persist

MARKET IMPLIED EFFECTIVE FED FUNDS FORWARD CURVE¹



PROJECTED U.S. FEDERAL SPENDING³



Interest expense on U.S. debt is expected to overtake defense spending within the next four years

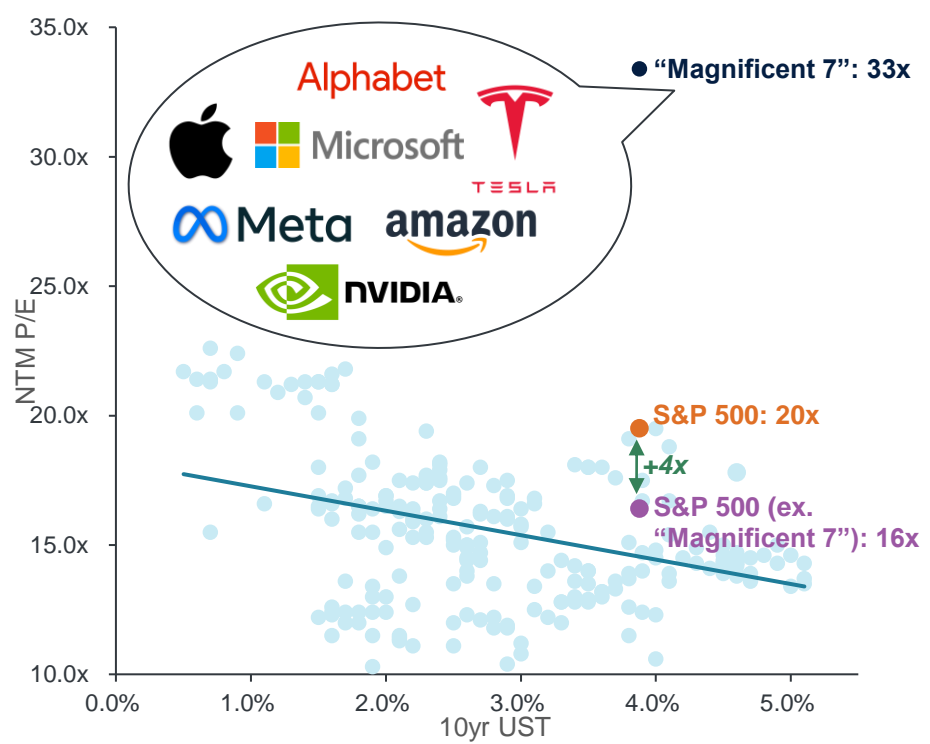
Why it matters?

- Markets are now pricing in six 25 bps cuts to the Fed Funds rate in 2024, up from three at the beginning of November
- Even if market expectations come to fruition, U.S. government leverage continues to increase, and investors may increasingly demand a higher return to compensate for the added risk especially given less demand from rate insensitive buyers of Treasuries (Central Banks and commercial banks) keeping yields higher
- Proactive risk management remains key given rate uncertainty

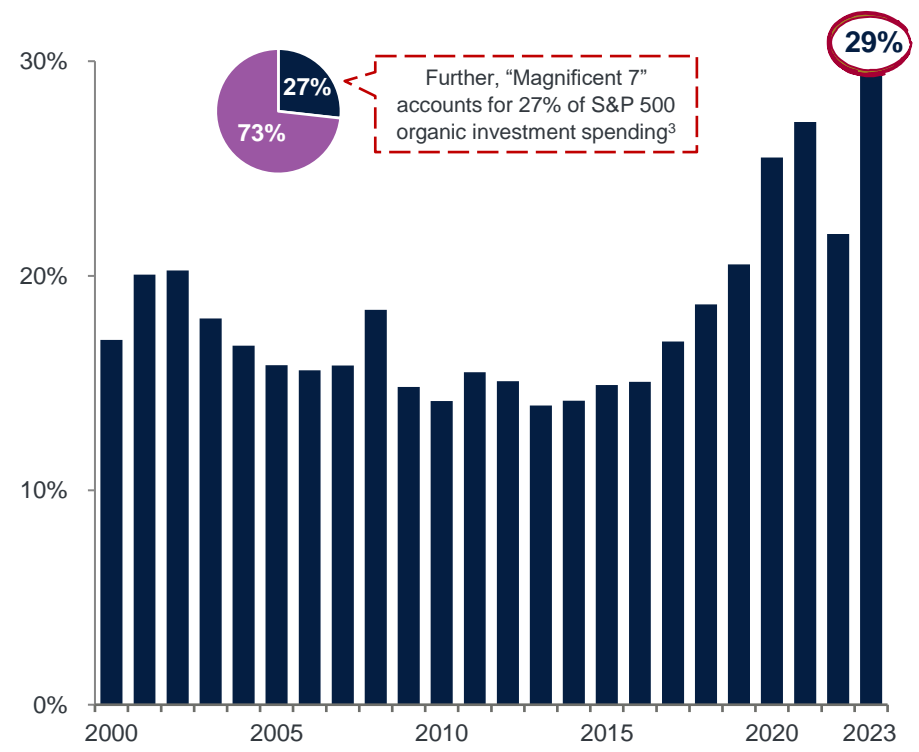
Source: Eikon, FactSet, CBO, FRED economic data; ¹ Based on Fed Funds futures implied effective rate at 2024 year-end; ² As of 12/31/23; ³ Budget of the U.S. Government for Fiscal Year 2024, forecasts from CBO

4 Equity markets flirt with all-time highs, but driven by a record concentration amongst a select few ultra-mega-cap firms

S&P 500 VALUATIONS VS. INTEREST RATES (SINCE 2005)¹



TOP 7 S&P 500 FIRMS MARKET CAP AS A % OF INDEX TOTAL²



Seven firms are driving S&P 500 P/E multiples 4x turns higher

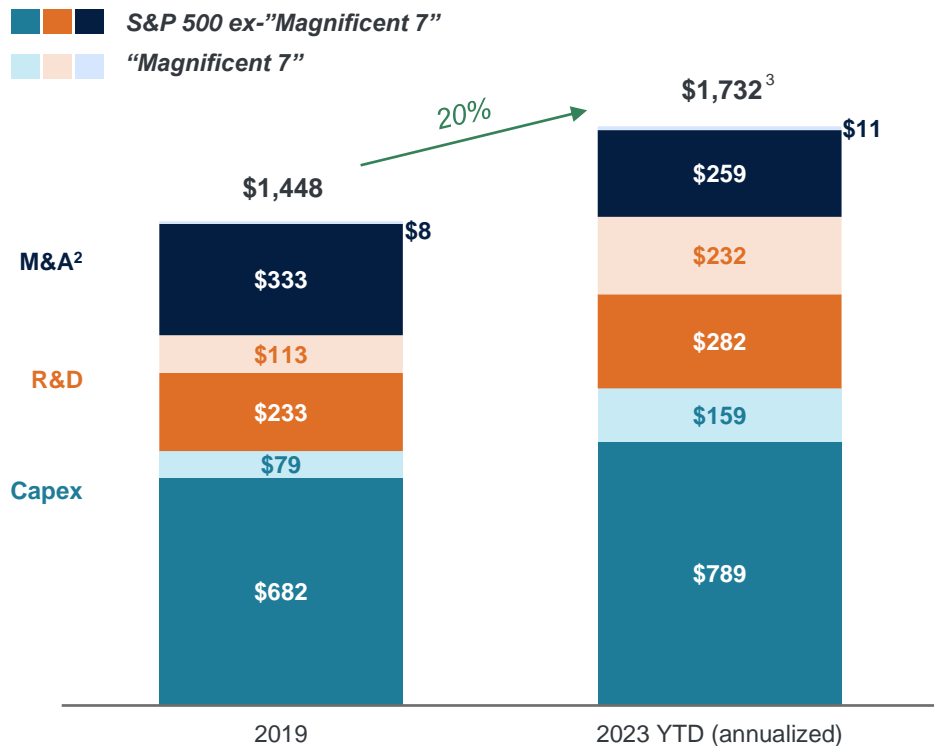
Why it matters?

- S&P 500 multiples appear divorced from higher interest rates but the exclusion of the largest seven companies in the index indicate the rest of the market is directionally aligned with the typical rate/value trends
- While tempting to suggest this value concentration is driven solely by extraordinary expectations for unsubstantiated future profitability, these seven firms have also become the investment engine of the U.S. economy, representing roughly the same proportion of market-wide capex and R&D as suggested by their lofty valuations

Source: FactSet as of 12/31/23; ¹ Monthly NTM P/E and 10yr UST observations since 2005; S&P 500 (ex. "magnificent 7") P/E calculated as median of individual S&P 500 (ex. "magnificent 7") firms' P/E ratio; R-squared=12%; ² As of 12/31 of each year; ³ YTD 2023 (data up to Q3 2023)

5 Growth investments across the market have been driven by the “Magnificent 7”

ORGANIC & INORGANIC INVESTMENTS FOR S&P 500 FIRMS (\$BN)¹



	Growth vs. 2019
S&P 500	
① Capex	+25%
① R&D	+48%
M&A	(21%)
S&P 500 ex-“Magnificent 7”	
Capex	+16%
② R&D	+21%
M&A	(22%)
③ “Magnificent 7”	
Capex	+102%
R&D	+105%
M&A	+42%

COMMENTARY¹

- ① Firms across the market are prioritizing innovation, with increases in R&D spending outpacing capex
- ② The S&P 500 ex-Magnificent 7 has increased organic growth investments over time, though at a level barely above inflation⁴
- ③ The Magnificent 7 have put the most capital to work with all 7 spending within cash flow⁵

2/3 of the increase in investment across the market has been driven by the “Magnificent 7”

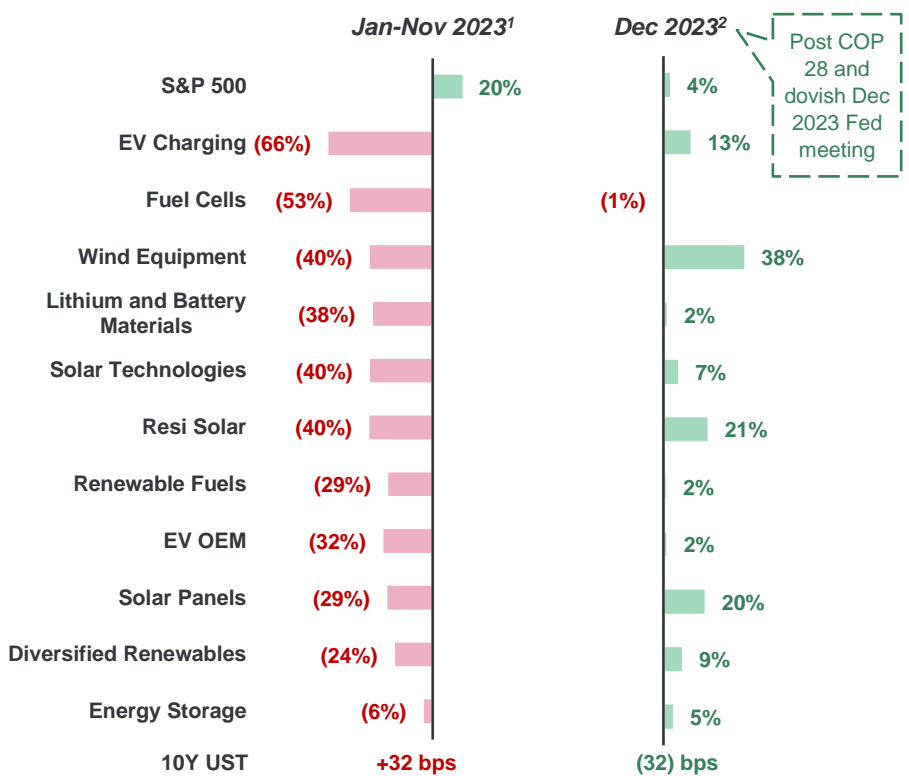
Why it matters?

- A select few firms are now driving growth in investment across the market thanks to their scale, low cost of capital, and strong cash flow generation
- This trend demonstrates the importance of deploying capital on growth to remain competitive, while managing capital allocation conservatively enough to remain resilient and opportunistic through-cycle

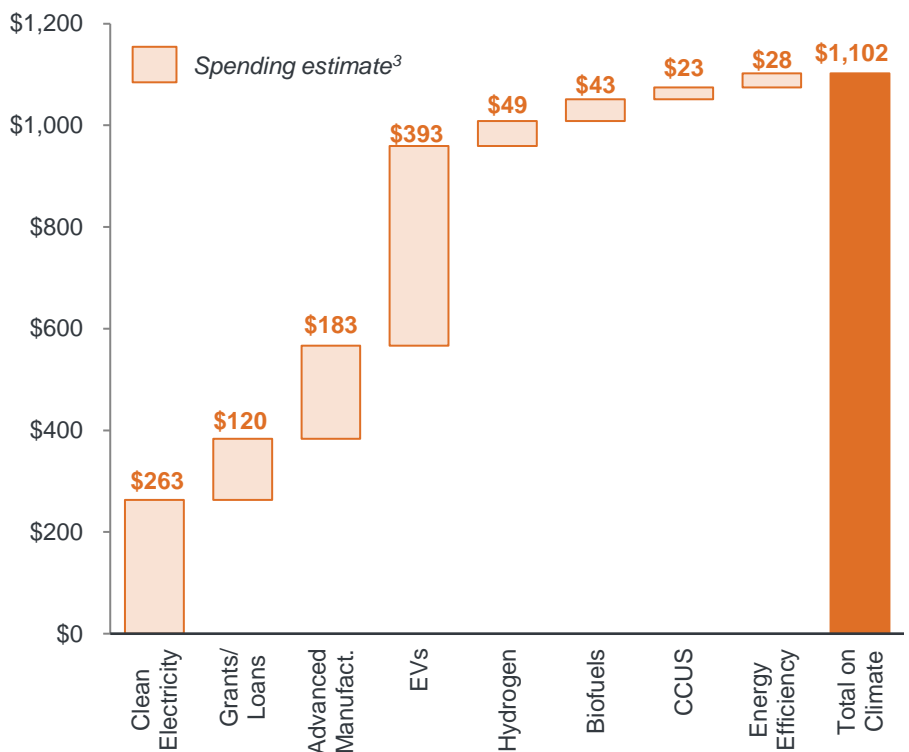
Source: FactSet as of Q3 2023 (firms that have reported quarter ending 9/30/2023 earnings as of 11/15/2023); Members as of 12/31 of a given year end ; Note: ¹ “Magnificent 7” defined as Nvidia, Apple, Amazon, Tesla, Meta Platforms, Microsoft, Alphabet; ² M&A figures represent cash spent on acquisitions; ³ Annualized basis; ⁴ Calculated by adjusting 2023 YTD values by the change from Q3 2019 to Q3 2023 CPI (19.9%); ⁵ YTD as of Q3 2023

6 Energy transition valuations highlight the challenge of capital-intensive investment in a higher rate environment, even with policy support

MEDIAN INDUSTRY PRICE PERFORMANCE IN 2023



ESTIMATE OF IRA SPENDING OVER THE NEXT DECADE (\$BN)



Energy transition equity valuations are down significantly as firms recalibrate to a higher cost of capital environment, despite more than \$1trn of potential spending upside in the IRA

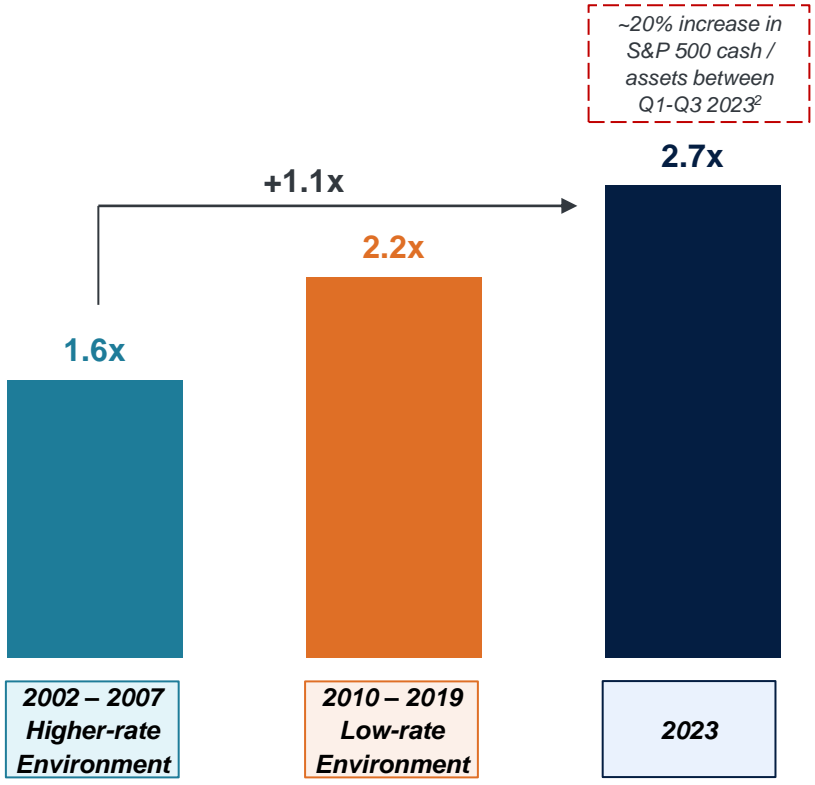
Why it matters?

- The energy transition sector exemplifies a capital-intensive and capital-markets reliant sector caught by high interest rates
- Policy tailwinds such as the Inflation Reduction Act (“IRA”) support upside potential for those taking longer term views in the industry, but plans need to be revisited to reflect the current cost of capital reality

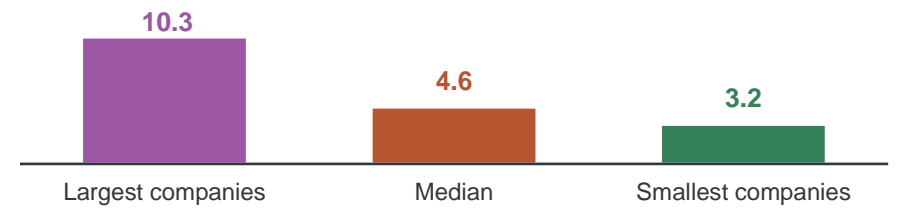
Source: FactSet; ¹ Data from 01/01/2023 to 12/01/23; constituents per JPMorgan; ² Data from 12/01/2023 to 12/31/2023; constituents per JPMorgan; ³ Congressional Budget Office estimate and Senate Estimate as of 08/16/2022 + Upside modeled by Penn Wharton Budget Model, 'Budgetary Cost of Climate and energy provisions in the Inflation Reduction Act', April 2023

7 Companies are more levered coming out of the low-rate environment, with smaller companies most impacted

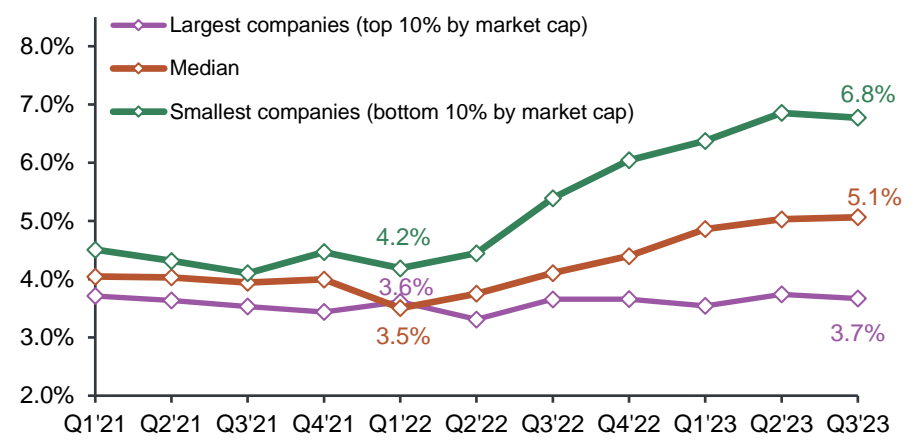
S&P 500 (EX-FIN) GROSS LEVERAGE¹



WEIGHTED AVERAGE YEARS UNTIL MATURITY – S&P 1500³



EFFECTIVE NET INTEREST RATE OVER TIME – S&P 1500⁴



Typical large-caps maintain >1x more leverage today vs. during the last higher-rate environment

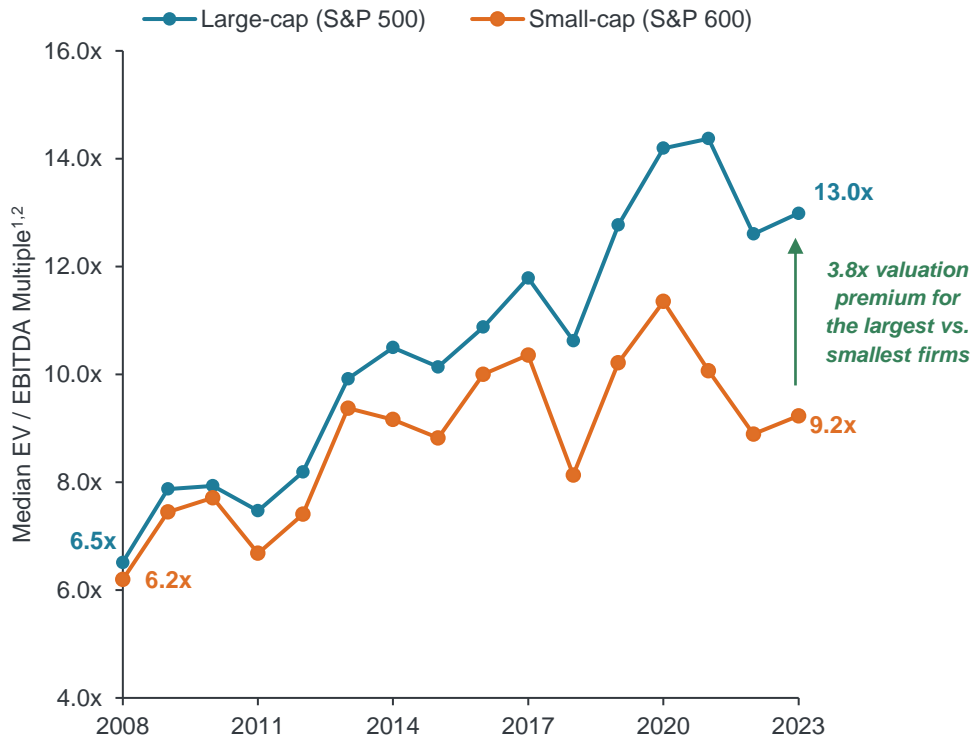
Why it matters?

- Smaller companies typically have lower ratings, shorter maturities and more organic floating rate exposure, so have seen an immediate impact in cash interest paid
- COVID-era issuances will come to term in the near-future, creating a need to refinance in a potentially much higher rate environment driving many to build cash in anticipation of paying off debt at maturity

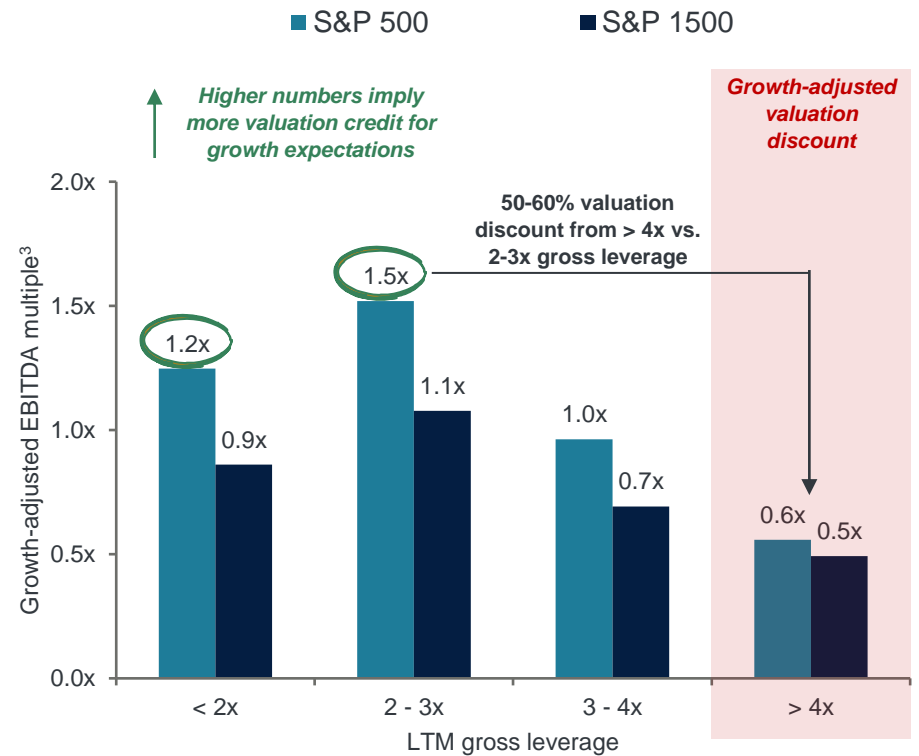
Source: FactSet, Market date as of Q3 2023; ¹ Average leverage during each period; ² As of Q3 2023, based on change in median S&P 500 cash / assets from Q1 2023 – Q3 2023; ³ Represents weighted average maturity of bonds, loans and municipals; Largest and smallest companies defined as top and bottom decile of the S&P 1500 by market cap; ⁴ Reflects index constituents as of 12/31 for each respective year; excludes Financials; calculated as quarterly interest expense net of quarterly income earned from interest annualized, divided by net debt, excludes companies with no debt or a negative net debt balance; largest firms represents top decile of companies by market cap and smallest firms represent bottom decile of companies by market cap each year

8 Scale and capital structure conservatism help offset higher interest rates and cost of capital

SCALE VS. VALUATION (S&P 500 VS. S&P 600 MEDIAN EV / EBITDA)



GROWTH-ADJUSTED EBITDA MULTIPLE VS. LEVERAGE³



Conservatively capitalized firms receive 2-3x more credit for growth

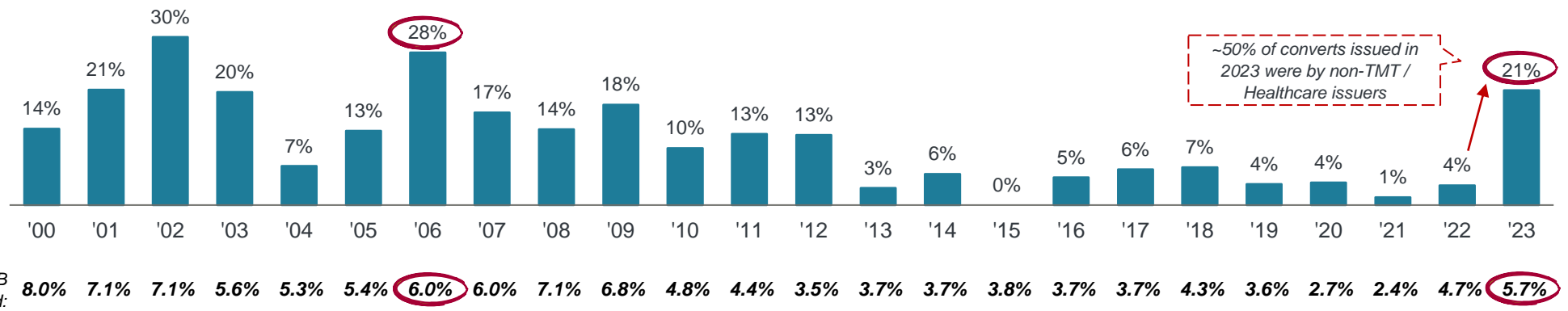
Why it matters?

- Higher interest rates amplify the relative ability of larger, more conservatively leveraged firms (typically investment grade) to pursue their growth plans
- Financial conservatism can help promote less volatile / risky equity and earnings accretion through reduced interest expense, spurring valuation two-fold

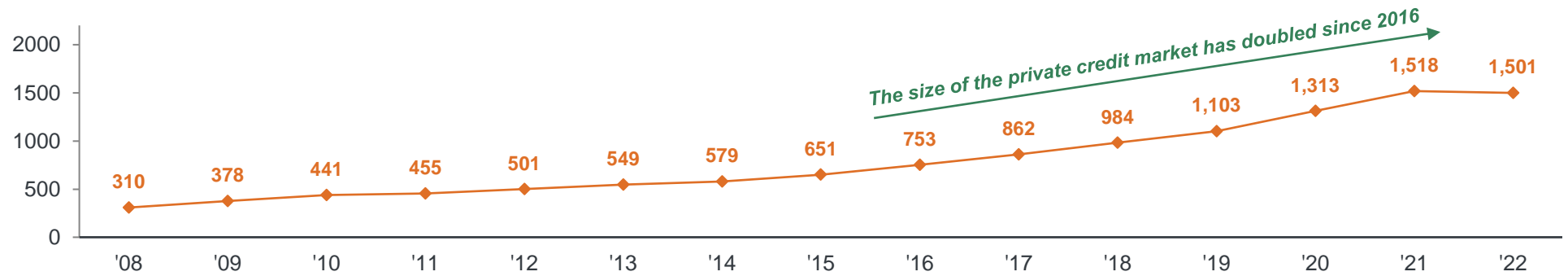
Source: FactSet, S&P CapIQ; Market date as of 12/31/2023; Note: ¹ Excludes Financials; ² EV / NTM EBITDA as of specific year end; ³ Multiple defined as NTM EV / EBITDA multiple divided by 2-year forward EBITDA CAGR; Excludes Real Estate, Financials, and Utilities

9 Higher rates are driving firms to consider alternative means of financing

IG CONVERT ISSUANCE OVER TIME¹



GLOBAL PRIVATE DEBT INSTITUTIONAL FUND AUM (\$BN)²



Convert issuances by IG firms are at the highest levels in two decades

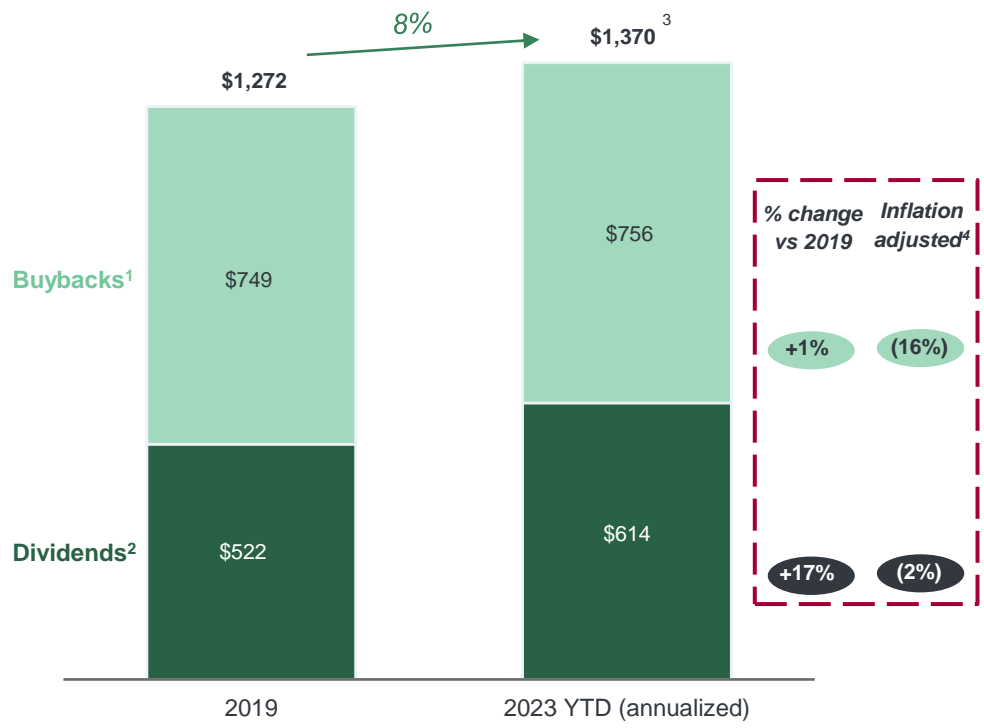
Why it matters?

- Convertible debt can serve as an attractive and less earnings dilutive means to finance growth and strategic initiatives in a prolonged high-rate environment
- Flexibility and demand of private credit with higher rates leads to an increasing supply of money into direct lenders
 - Private credit as a % of total financing (bank syndicated) for non-LBO leveraged transactions is now 54%
- Firms should be prudent to take advantage of creative ways to finance deal activity and growth amidst today's high-rate environment

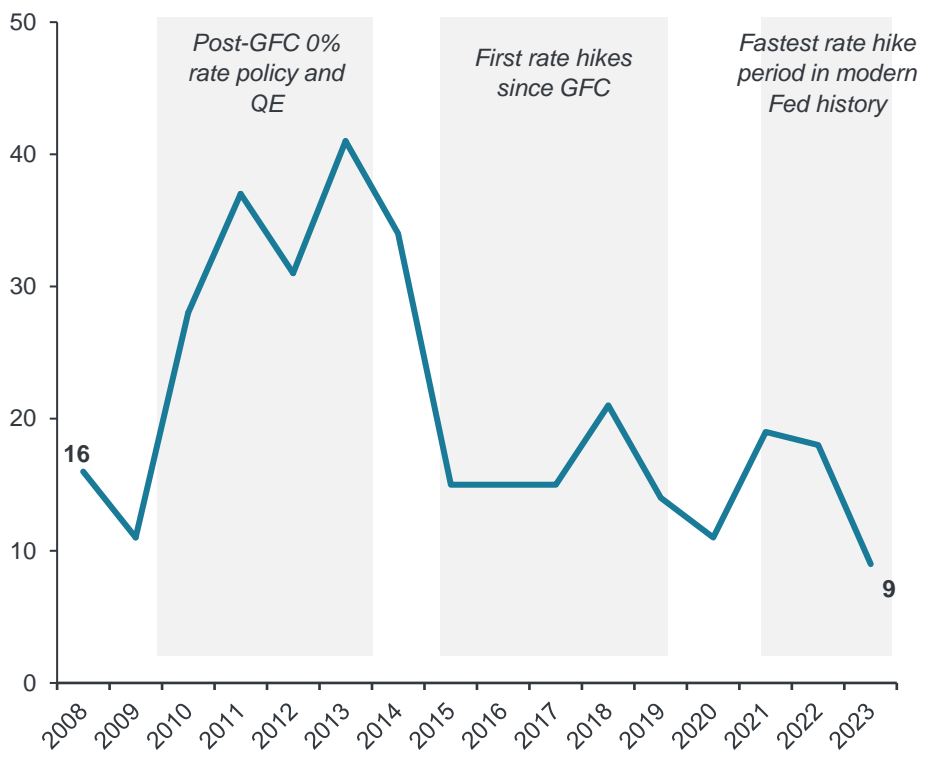
Source: JPMorgan, Morgan Markets, Pitchbook; Data as of 12/31/2023; Note: ¹ Sample set includes cash pay convertible debt issued by US-listed issuers; as a % of all cash pay convertible debt issued by US issuers; ² Data sourced from Pitchbook

10 Re-thinking the growth-vs.-shareholder return paradigm

SHAREHOLDER DISTRIBUTIONS FOR S&P 500 FIRMS (\$BN)



FREQUENCY OF DIVIDEND INITIATIONS BY RUSSELL 1000 COMPANIES⁵



Dividend initiations are at the lowest level post-Great Financial Crisis as overall payout trends moderate

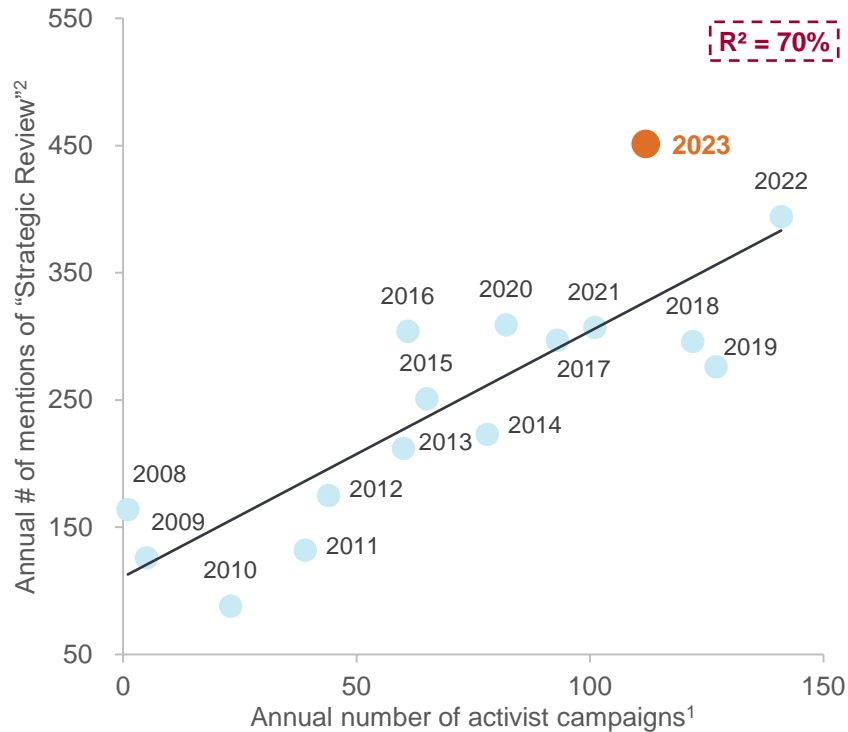
Why it matters?

- Rising rates reduce the appeal of dividends on stocks as alternative low-risk investments (e.g., money market funds) offer better yield
 - Dividend initiation levels and yield lowest in the past 15 years as firms re-assess investor dividend demand
- Buyback activity remains robust but is still only running flat to 2019 levels (down ~19% vs. 2022)

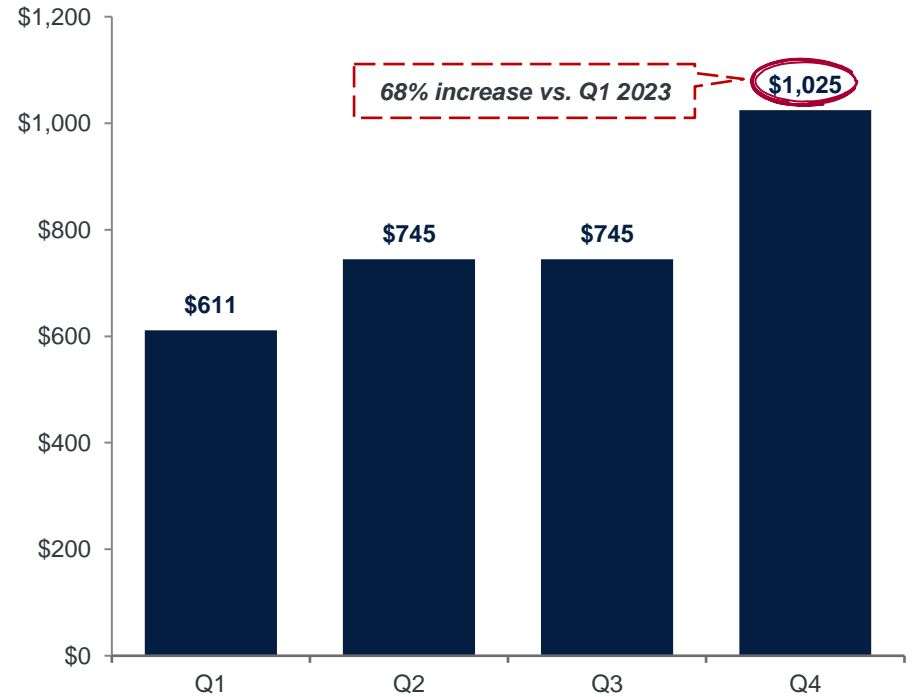
Source: FactSet as of Q3 2023 (firms that have reported quarter ending 9/30/2023 earnings as of 11/15/2023); Members as of 12/31 of a given year end ; Note: ¹ Represents actual value of shares repurchased; ² Represents all cash dividends paid; ³ Q3 2023 YTD Annualized basis; ⁴ Calculated by adjusting 2023 YTD values by the change from Q3 2019 to Q3 2023 CPI (19.9%); ⁵ Measured as number of firms that initiated / reinitiated a quarterly dividend in the given calendar year

11 Activism likely to spur continued strategic reviews...and actions

RELATIONSHIP BETWEEN ACTIVISM AND STRATEGIC REVIEWS^{1,2}



GLOBAL M&A QUARTERLY ANNOUNCED VOLUMES IN 2023 (\$BN)



Elevated shareholder activism activity and record high references to strategic reviews suggest increased strategic activity may be ahead

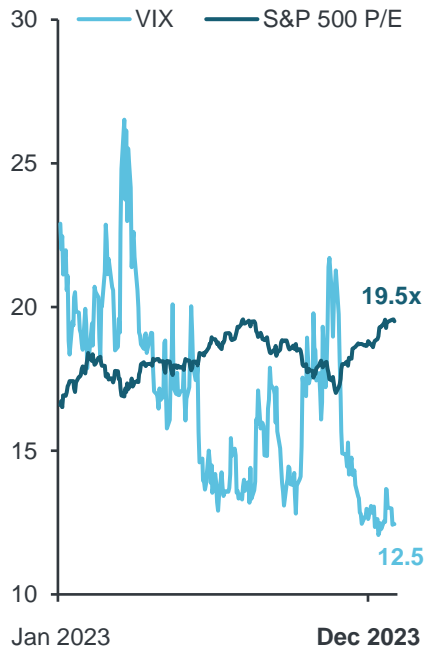
Why it matters?

- Strategic reviews often result in strategic actions, whether a sale, separation, or significant shift in capital allocation
- Prevalent activist campaign activity requires companies to be their own activists
- Even as overall M&A activity has been down in 2023, this trend suggests an increase in activity into 2024 as M&A momentum increased through 2023

Source: Dealogic, FactSet as of 12/31/2023; ¹ Campaigns for U.S. companies with market cap >\$1bn; ² Based on S&P 500 constituents as of 12/31/2022 and excluding non-public constituents as of 01/01/2008, mentions of "strategic review" in transcripts, press releases, investor slides and news

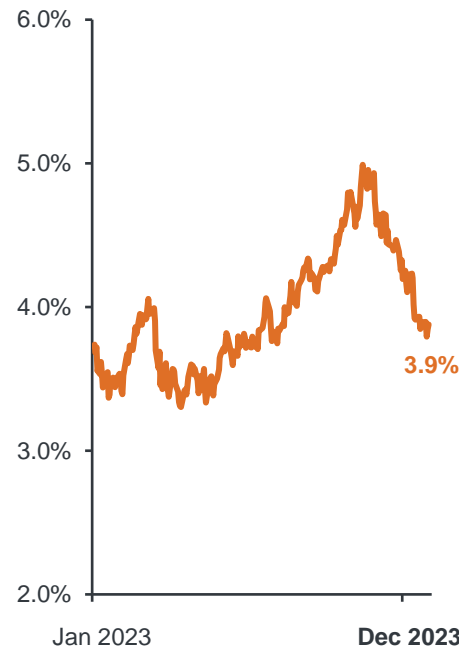
12 Capital markets are primed for action in 2024

EQUITIES (S&P 500 P/E & VIX)



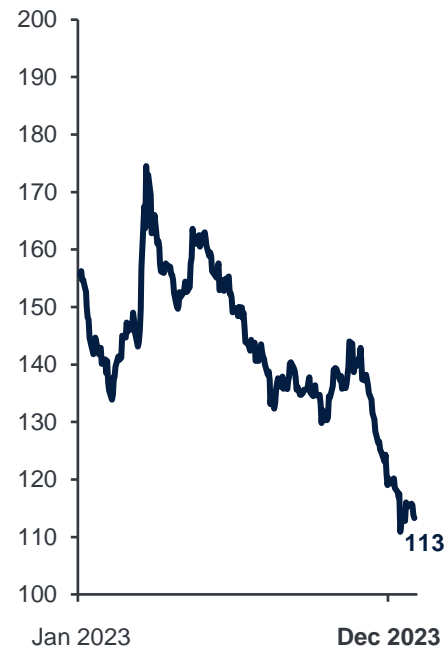
Last at current level:
S&P 500 – Jul 2023 / VIX – Jan 2020

RATES (10Y U.S. TREASURY)



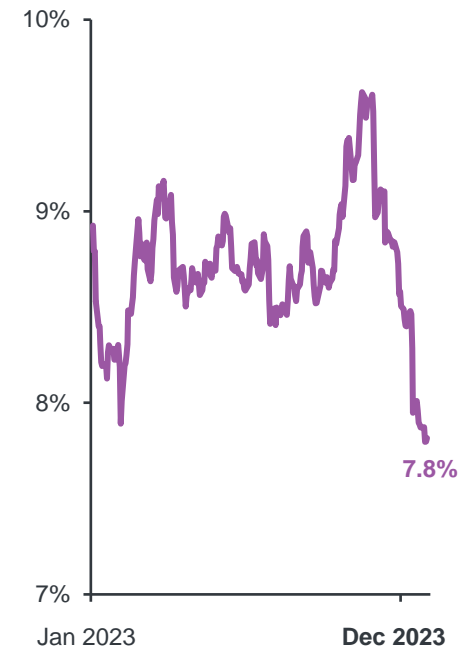
Last at current level: Jul 2023

INVESTMENT GRADE SPREADS¹



Last at current level: Jan 2022

HIGH YIELD ALL-IN-YIELD²



Last at current level: Aug 2022

Best market for issuers in 18-24 months

Why it matters?

- Robust valuations and declining equity volatility expected to drive more IPO / follow-on equity issuances in 2024
- IG and HY debt issuance at the most attractive level in recent years, given the pullback in rates, compression in spreads, and upcoming maturity towers
- Companies have the opportunity to de-risk capital needs early in a year still filled with uncertainty

Source: FactSet as of 12/31/23; ¹ JULI IG Spreads; ² JPM HY Bond Index Yield to Worst

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