PILFOR
LENDING SOUNDNESS

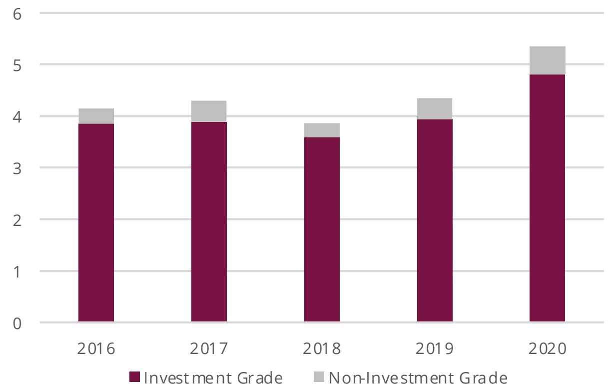
7 April 2021

5 Pillars of Capital Allocation

When the economy started to cough

To compare 2020 with a roller-coaster is like everything else than exaggerating to say the least. Economies took deep dives, companies witnessed sales and margins double-folding, social lives turned upside down and "home work" got a completely new meaning to millions of employees. Had it not been for unprecedented governmental and central bank measures implemented within record times following the outbreak of the pandemic, capital markets would have very likely taken a hefty and prolonged beating and companies relying on capital market access might have struggled to obtain liquidity life-lines. The aforementioned governmental and central bank measures such as short-term work, covid loans, opening the flood gates to the capital markets and softening requirements around insolvencies clearly masked the pandemic's toll on companies throughout most of 2020 and cradled many into turning a "blind eye" on the postponed, but unavoidable default rise. From a corporate view, 2020 proved to be a knife that parted the corporate landscape into the "haves" and "have not" by means of building up liquidity cushions lending an often direly needed helping hand in times when organic cash flows dried up. The comfort lent by central banks to capital markets and above all investors following firmly closed market windows in spring, ignited a firework of bond and loan issuance throughout a good part of 2020 topping USD 5tn and even USD 10tn if including governments and alike, setting a historical watermark as shown in Figure 1).

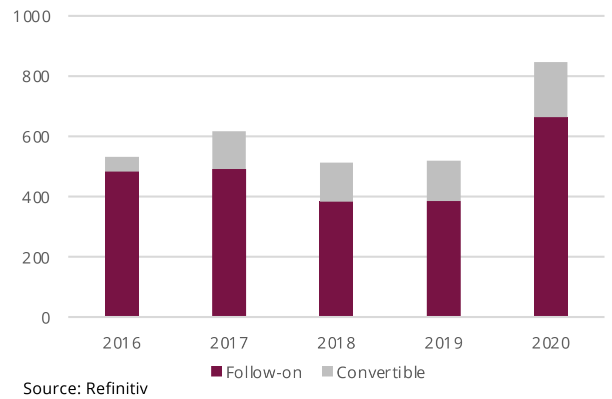
1) Global corporate bond market issuance 2016 – 2020 (USD tn)



Source: Refinitiv

Add another USD 5tn from loans and the likes, and 2020 has witnessed an overall debt increase north of USD 15tn across public-, corporate- and private debtors. According to IMF, global debt stood at around USD 280tn year end 2020, representing a debt to GDP ratio north of 360% calling it the "attack of the debt tsunami". 2020 clearly just accentuated the upward trend spurred since 2016 and totalling in excess of USD 50tn over the 5 year period. In advanced nations the ratio topped a stunning 430%, representing an increase of around 50% vs. 2019. Emerging nations, albeit at lower rates, witnessed their debt / GDP ratio hit 240%. Similar activity was also recorded on the equity capital market as companies sought to take advantage of prospering valuation levels and huge investor demand. Leaving IPO and SPAC issues aside, companies undertook a record USD 663bn of capital increases globally added with some additional funding by means of convertible issues reaching USD 183bn. Overall, global equity markets raised USD 846bn in 2020 as outlined in Figure 2), for companies seeking to bolster their balance sheets, fund acquisitions or, as was the case for an alarmingly growing number of battered companies, to ensure some kind of liquidity life-line in the wake of the pandemic and the looming uncertainties attached to it.

2) Global equity market issuance (USD bn)



Source: Refinitiv

As vaccine rollouts continue across a growing number of countries, 2020 results show the scars of the pandemic and signs of fragile or disrupted supply chains make their appearance, we believe that there will remain a high degree of uncertainty attached to the development of the pandemic and its economic effects. Widespread immunization stands at the forefront of many countries, possibly achievable by mid-2021 for some countries, will support paving the way for a return to somewhat more normal social and economic activity.

The pandemic has caused havoc across most facets of everyday life, hammering revenues, bashing margins, hitting employees, dismantling investment plans, and in a considerable number of cases necessitating emergency financing to ensure corporate solvency. It has resulted in a historical wave of negative rating actions during the course of 2020, with a massive share of ratings carrying negative outlooks heading into 2021. That being said, unprecedented central bank measures have triggered a wave of debt and equity issuance hitting record highs and flooding corporate liquidity pools, built to serve as a life-line just in case. As sales and margins face sunnier prospects as of 2021, executives will be facing the question of how to allocate their amassed liquidity across the 5 pillars: Capex, Debt Paydown, Dividends, Share Buybacks and M&A. Being a smart steward of capital got a new meaning after the pandemic.

Simply put, companies will have to do more with less and likely tread more cautiously in terms of not only creating value, but ensuring value is protected by means of crisis-proofing their business. The days of taking multiple trips to the candy store of investment choice belong to the past.

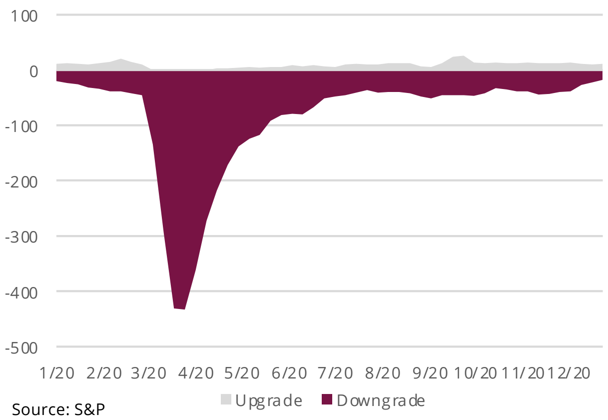
While governmental and central banks measures and helping hand were clearly more than needed and key to stabilizing economies to every extent possible, companies obviously didn't issue bonds, seek loans and raise equity for the fun of it. These actions were and continue to be driven by the collapse in visibility required to safely steer companies through the unknown storms, for many possible tidal-waves. As demand collapsed, supply chains fell apart and consumer patterns changed within days, revenues and margins deteriorated at a pace not seen to date. Contrary to any past crisis that in most cases proved rather local or regional, 2020 was set out to experience a global and pretty simultaneous crisis grabbing whatever it could, wherever and however. Only a relatively small number of companies in the technology, healthcare and food sector proofed to have pretty resistant business profiles. For most however, sales and EBITDAs headed south-bound (Figure 3).

3) Global nonfinancial corporate revenue & EBITDA growth

Source: Fitch, Moody's, S&P

When adding falling sales, collapsing margins, fragile capital structures a complete lack of visibility in terms of severity, duration and government installed lockdown measures and shaking these ingredients thoroughly, the result is a highly toxic mixture threatening the fundamentals of many a company, or measured in terms of their credit worthiness, nose-diving credit ratings. And this is precisely what happened within days, as the major rating agencies rolled back their sleeves and started to take a closer look into their crystal balls in an effort to gauge the pandemic's impact on assigned ratings. Needless to say, the task proved an unseen challenge for above reasons. On the other hand, the rating agencies – serving the interest of investors – had to reflect the exogenous shock the pandemic had caused more or less over night, globally and across pretty much every single sector imaginable. The result of these efforts being

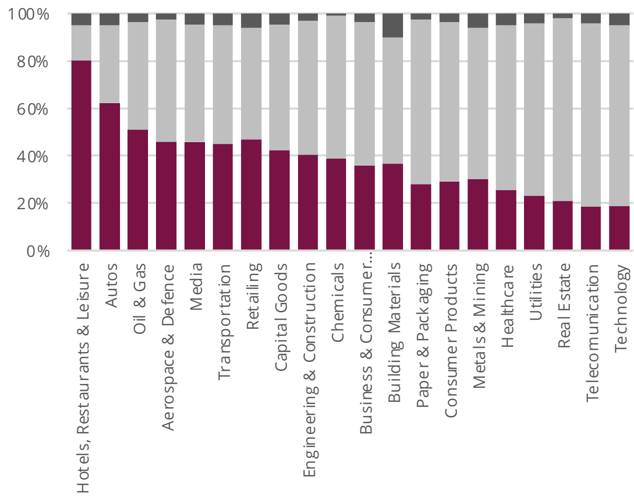
4) Wave of COVID-19 and recession related rating actions 2020



Source: S&P

historical records in terms of negative rating actions as shown in Figure 4), reflecting the rating actions S&P took during 2020. By year end 2020, there were more than 2'000 negative rating actions by S&P, in excess of 800 by Moody's and a couple of hindered by Fitch. The spike in rating activity was recorded in the second half of March, albeit lowering the negative action pace during the course of April and May. Besides the unexpected impact of the pandemic, the collapse in the oil price represented the other major driver of negative rating actions, concentrated however on a much smaller number of sectors. Figure 5) reflects the rating outlook across sectors at year-end 2020. Needless to say many of which were already thoroughly battered with rating cuts during the course of the year such as Hotels, Restaurants and Leisure, Autos, Oil & Gas, Aerospace & Defence, Media, Transportation and Retailing to name just a view.

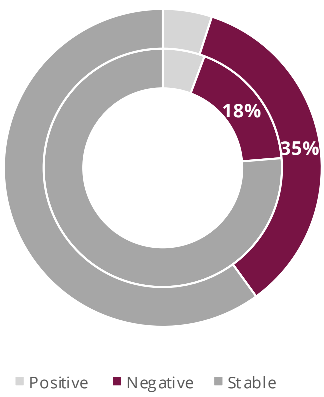
5) Global ratings outlook distribution by industry



Source: S&P

Despite increasing visibility on the recovery, roll-outs of vaccines and clearly positive forecasts for GDP growth in 2021, the global corporate landscape is far from being able to relax and take a break from the nightmare 2020 as highlighted in Figure 6). More than a third of all non-financial corporates – just to bring some clarity, many financial corporates are far from being spared from negative rating actions nor are their outlooks in good shape – had a negative outlook at year-end 2020, compared to 18% the year before. A lot therefore depends on the general economy and the pick-up in sales and margins on the one hand, and executives efforts to safeguard ratings. Else, ratings will dive further.

6) Global rating outlooks non-financial corporates 2020 / 2019

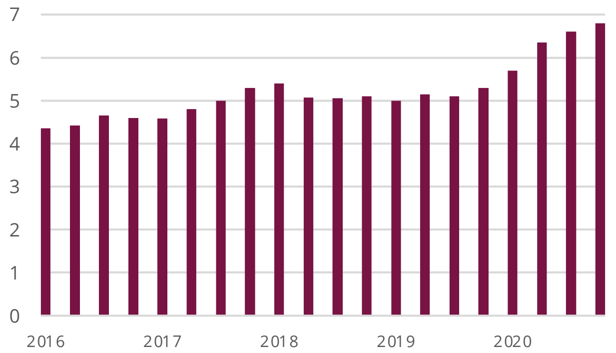


Source: Moody's, S&P (year end)

Cash in the centre of management focus 2020

Rarely has management faced the "Janus of finance" in the way outlined above. On the one hand operating cash flows were threatened to evaporate from tumbling revenues and collapsing margins dangerously limiting financial flexibility, while on the other hand, receiving open invitations to join the debt and equity issuance cocktail party at near zero costs. Not surprisingly the invitations were not left unanswered as outlined previously and brought many a company and management record high levels of cash waiting to be drawn if needed. The global non-financial companies rated by S&P alone are believed to sit on a cash pile just shy of USD 7tn, after having added some USD 1.5tn in 2020. (Figure 7).

7) Global corporate cash balances hit record highs (USD tn)



Source: Fitch, Moody's, S&P

Following the severe estimated 3.5% drop of the global GDP in 2020, IMF forecasts GDP to increase by 5.5% in 2021 and 4.2% in 2022, sending out positive signals and building hope. While the growing number of vaccinated people is a pre-requisite for a sustainable recovery, its path is likely to be bumpy and everything else than free of further uncertainties and set-backs in our view. Leaving this aside for the moment and turning back to the just revealed, one question is moving up the priority agenda of companies and a growing number of stakeholders. What do companies intend to do with their heaps of cash accumulated assuming returning post-COVID cash flows will do the trick of covering operational costs?

Solving the riddle of the 5 Capital Allocation Pillars

One lesson executives have learnt – and arguable there's a wealth of them learnt during 2020 – in the very recent past is just how fast pieces can fall apart. We would dare say a lot faster than all the perceived threats and opportunities digitalization, consumer trends and e-mobility bring to the table, just to name a couple. All the more so will executives have realized that some fundamental questions might be needed to raise on how to allocate capital. The days when executives could handle capital allocation like a trip to the candy shop pandering in strawberry, apple, peppermint and coke all at once belong to the past. The reality of the post-pandemic world will force corporate leaders to make challenging calls and take difficult decisions. Their creativity, determination and approach to risk will be closely followed under the watchful eyes of investors, peers, banks, rating agencies and the public. What will however remain, are the 5 Pillars of Capital Allocation:

- ☞ **Capex**
- ☞ **Dividends**
- ☞ **Debt Paydown**
- ☞ **Share Buybacks**
- ☞ **M&A**

In addition, executives will increasingly have to consider and measure their undertakings from the ESG sustainability perspective, focussing not only on shareholder value but also on the needs of a growing stakeholder base. Decisions will increasingly have to provide both financial and social returns to ensure the long-term flourishing of companies. To prosper in this kind of environment, companies require a capital allocation plan with straight-forward nucleus:

Make prudent capital allocations that will give the business competitive advantages in some 5 years down the road, focus on re-building strong capital structures and utilize cash in ways leading to applause and not wide-spread criticism.

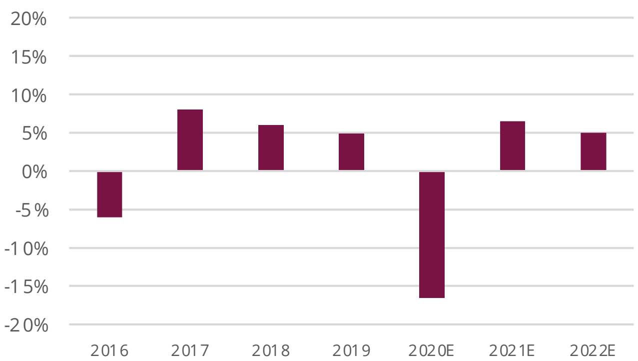
The ultimate goal companies will increasingly shift – be this willingly or by means of third-party pressure – towards not only creating value, but to preserve values and create value at the same time.

As the bruised economy is slowly finding its way back to growth and the crisis is easing, let us now turn back to the question of how the massive cash piles accumulated by many companies is likely to be deployed across the 5 Pillars of Capital Allocation and the implication these executive decisions have especially on shareholders and bondholders and their respective values.

The Capex Pillar

Companies have historically shown to follow an uneven investment or capex pattern not necessarily linked – contrary to what common sense suggests – to economic growth. Following a massive contraction of capex spending during the covid-battered 2020 with both maintenance and expansion investments being cut to a minimum, 2021 will likely record a considerable revival. This is all the more so the case for companies focused on growth markets such as China. But even for sectors affected to a lesser extent than many others still turning every penny in their pockets before investing it, appetite to rapidly expand investment capex seems to remain rather modest (Figure 5). According to S&P 2022 levels for globally rated non-financial companies are forecast to just fall short of 2019 levels for this group. The more pandemic-battered peers are set to clearly fall short of 2019 levels in 2022 by some 10%.

8) Global non-financial capex development 2016 – 2022E



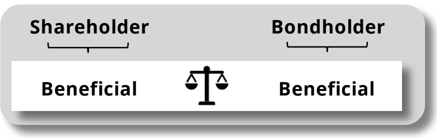
Source: Fitch, Moody's, S&P

Worth noting that a number of large sectors like Autos, Utilities, Technology and Capital Goods are already investing substantial amounts on investments to transform their businesses aligned to major market trends. Others are forced to invest to face disruptive developments such as Retail. This is less about consumer spending, but rather holding on to market position.

Other sectors that have trimmed capex to lows such as Metals & Mining, are contemplating capex spending to replace depleted reserves. The technology sector, mostly navigating well through the storms of the pandemic, spotting growth opportunities in regions such as Asia-Pacific, might also dive deeper into their capex pockets. However, a wide-spread capex boom seems unlikely at this point in time. According to S&P, the share of cash flow allocated for capex compared with that for other uses was the lowest in 2019 since 2007 for its globally rated non-financial companies. While maintenance capex will be a "conditio sine qua non", companies might have fundamentally started to shift their growth focus by means to expansionary capex towards M&A, possibly also some R&D. It could also mean that companies are finding it increasingly difficult to discover growth areas. One result is and will likely be a long-term structural reduction in money spent on more traditional forms of capex such as factories and equipment. As new services play an increasingly important role vs. manufacturing for many companies, and manufacturing tends to be outsourced, intellectual property accounts for a larger capex share.

What does this development and re-weighting away from the Capex Pillar mean for shareholders and bondholders? First of all capex in its basic form is key to sustaining production and forms the counterpart of depreciation. It was and will play a key role in a company's sustained cash flow generation capacity. It would be difficult to find a finance professional and business leader willing to set organic growth targets without capex budgets serving as engines for the aspired growth targets. As such, both shareholders and bond / debt holders benefit from adequate capex spending as outlined in Figure 6) for future cash flows, allowing to distribute parts thereof in form of dividends or to pay interest and paydown debt.

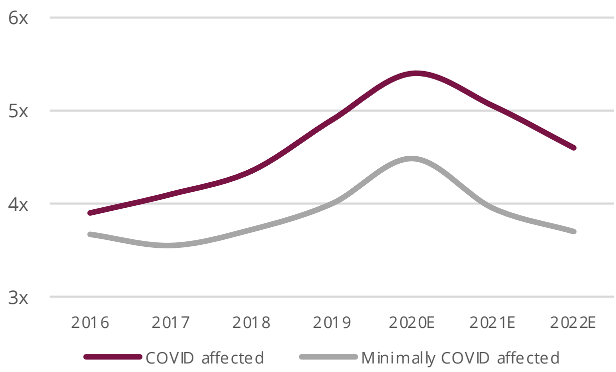
Capex Allocation Pillar



The Debt Paydown Pillar

Global debt has increased north of USD 50tn since 2016, with 2020 contributing a stunning USD 15bn. Not surprisingly corporate balance sheets have shouldered more leverage, often without the corresponding EBITDA and Cash Flow to hold key credit metrics in balance. A sudden slump in sales and margins unmasked the hefty debt loads in spring 2020, causing leverage ratios to balloon. The increased fragility of capital structures fed since 2008 and especially over the last five to six years is reason for concern and should cause warning lights on executives priority agendas. However, while the focus on top-line and margin growth is cast in stone for all companies and receives utter most attention, balance sheet and leverage development often find themselves being turned "a blind eye" on. Figure 10) shows the development of leverage for non-financial corporates rated by S&P.

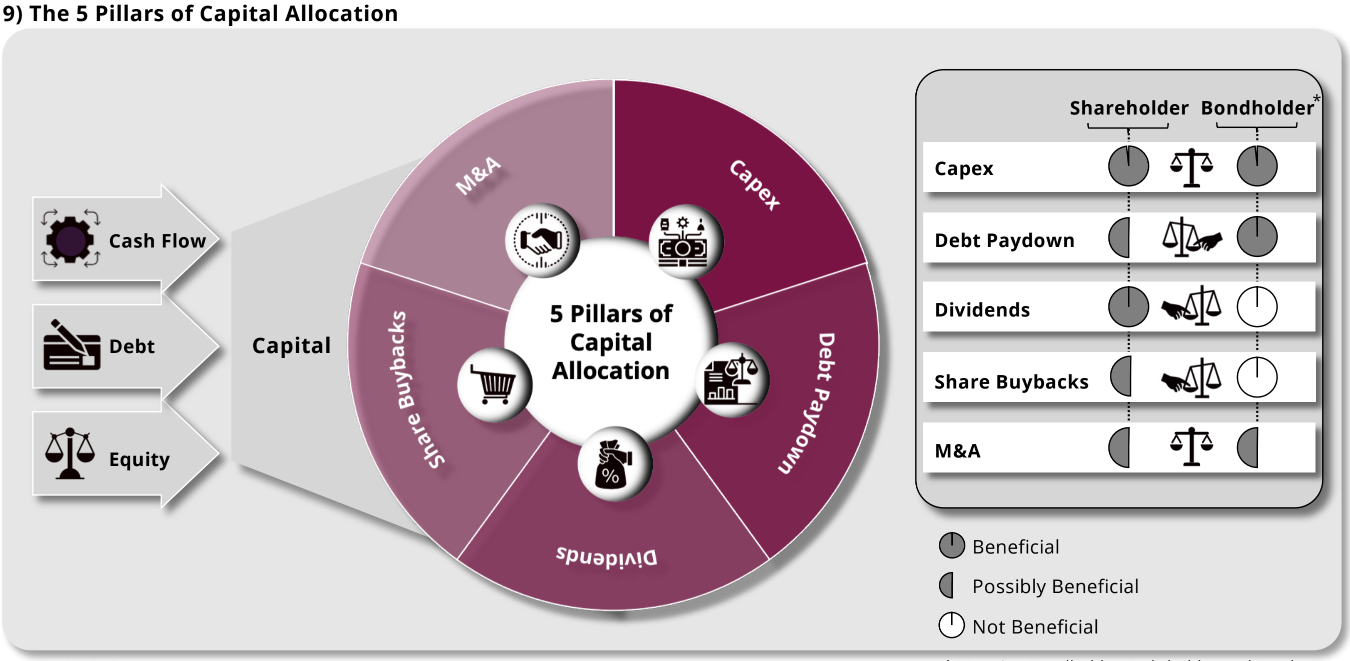
10) Global median Debt/EBITDA for non-financials 2016 – 2022E



Source: Fitch, Moody's, S&P

A return to pre-pandemic levels is forecast to take some time, assuming things go smooth on the path of recovery and executives prioritize debt paydown during the time horizon. Any hick-ups either from faltering revenues, weakening margins or a lack of attention to reduce debt will cause a prolonging of leverage reduction and maintain rather fragile capital structure far from being able to weather unforeseeable storms. However, appetite for debt paydown

9) The 5 Pillars of Capital Allocation

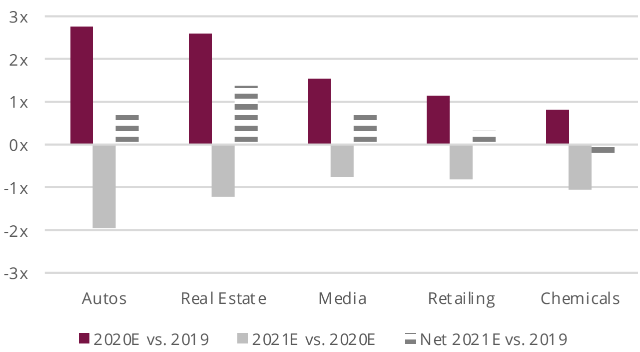


Source: PILFOR

* Meaning Bondholder, Debtholder and Lender

appears very small. The prospect for sustained low to near zero interest rates and funding costs is to tempting for many an executive and their Boards of Directors. As long as these circumstances hold, there does not seem to be much incentive to pay high attention in the majority of cases. Executives seem content to all leverage ratios to improve through a forecasted growth in EBITDA, despite regaining pre-pandemic levels possibly posing a longer journey than expected. Figure 8) offers some insight into median Debt/EBTIDA leverage ratios of rated speculative companies across some sectors covering a forecast period up to 2022. While some sectors are bound to record metrics in-line with 2019 levels, a considerable number will struggle to obtain these within a reasonable time horizon, posing further risks.

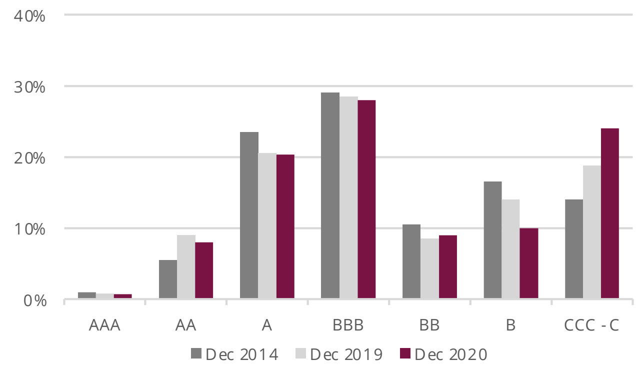
11) Change median sector Debt/EBITDA - speculative grade



Source: Moody's, S&P (only rated non-financial speculative grade issuers)

With increasing confidence in terms of an economic rebound being near, executives seem content to allow Debt/EBTIDA metrics to return to pre-pandemic levels through improving EBITDAs rather than measures addressed at paying down debt. Higher levels of debt, respectively risk, are set to remain, making the return from the pandemic installed recession different from the past. Leverage levels will undoubtably improve, albeit at varying degrees and over longer time horizons.

12) Deteriorating ratings of European issuers



Sources: Fitch, Moody's, S&P

Higher rated companies with considerably more financial leeway are likely to re-position their target rating levels aligned with their overall strategy. In a number of cases this will therefore be of a more permanent nature.

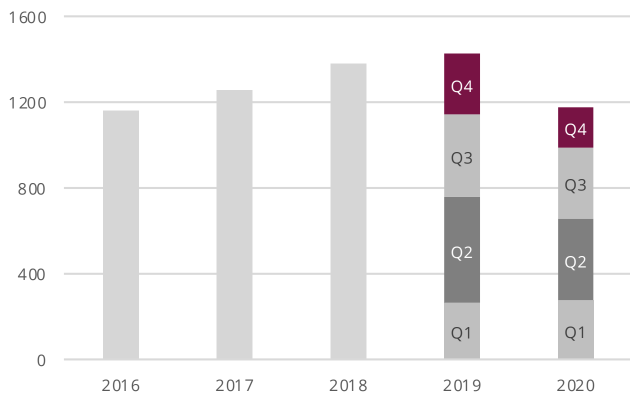
Debt Paydown Pillar

Shareholder		Bondholder
Possibly Beneficial		Beneficial

The Dividend Pillar

Global dividends hit a new record in 2019 with USD 1.43tn, up 3.5% YoY. Key drivers were once again the US with emerging markets and Japan adding to the rise. Records were also recorded in Canada, Russia, and France according to Janus Henderson. From a sector view, the highest growth was witnessed in the oil sector, while Telecoms saw dividends decline. 2009 to 2019 has seen a very high growth in dividends, albeit from a low base starting in 2009. Dividend payouts have in fact nearly doubled during the period, filling the pockets of dividend investors nearly an additional USD 700bn in 2019 vs. 2009. The total dividends distributed during the ten years reached a breath taking USD 11.4tn overall. Not surprisingly 2020 recorded a decline in global dividends with Q1 still holding up well YoY reaching north of USD 275bn. However as the pandemic spread and uncertainty mounted, dividends were partially put on the back burner declining from USD 480bn in Q2 2019 to USD 382bn in Q2 2020, the lowest second quarter since 2012. More than a quarter of Q2 dividend payers (27%) cut their dividends, more than half cancelled them outright. Dividends fell in every part of the world, except North America, where Canada proved very resilient.

13) Global annual dividend payouts 2016 – 2020 (USD bn)



Source: Janus Henderson, Reuters

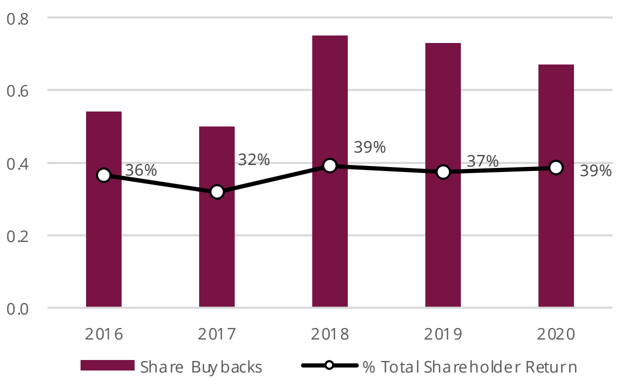
The worst affected region was Europe, where payouts fell by some 40%. In terms of sectors, Healthcare and Communications held up rather well, while Financials and Consumer Discretionary payouts retrenched considerably. For the whole of 2020, the impact of the pandemic on the dividend capacity meant a decline of 17.5% YoY, just slightly north of the 2016 payout level. Contrary to most sectors, the banking sector faced bans in the US and Europe on dividend payouts by banking supervisors in spring, requesting them to only pay fractional amounts of the initially intended. This was due to the looming economic uncertainties and related risks gauged by regulators as serious enough to request banks to hold on to their capital until the dust of the pandemic had settled somewhat. The bans where withdrawn in autumn, while still maintaining certain restrictions going forward, just in case the de-masking of the pandemic's toll on borrowers would reveal an uglier face than expected. That being said and considering the stark rise in dividend payouts over the last couple of years, executives might be well advised to consider the balance between shareholder renumeration by means of rapidly increasing dividends, often prompted by growing heightened payout ratios in terms of net profit vs. an effective increase thereof, and the debtholder renumeration during the same time period. Low to near zero interest rates have helped companies to issue spitting cheap debt, while at the same time often accepting higher leverage levels. For a considerable number of companies this occurred on the back of their debtholders, that witnessed balance sheet being loaded with debt, just to see it being passed on to fund shareholder renumeration. As such the and in the interest of financial sustainability, a company's retained cash flow should – in the absence of extraordinary investments or acquisitions – at least make it to zero. Executives and text books might argue that a constant and slightly rising dividend stream is a strong signal towards shareholders, who hold the riskiest piece of the capital structure, and thus past developments are the right thing to do. Keeping in mind that rising leverage levels, reduced financial flexibility and exogenous shocks like a pandemic can pose severe risks to both shareholders and debtholders, installed dividend policies might be worth revisiting in the interest of longer-term value creation. However, considering the dividend trend and executive's aim to not fall short on payouts compared to peers or sectors, the ongoing highly attractive cost of debt with rates likely to remain historically low for the time being, combined with a general shareholder call for attractive dividend yielding stocks, a more moderate payout pace is difficult to foresee at this point in time.

Dividend Pillar

The Share Buyback Pillar

Share buybacks have increasingly become en vogue over the last couple of years, as the seem to be a good way to enhance value for shareholders. By reducing the number of shares outstanding, executives can boost their earnings per share and inflate share price. Supporters of these measures can undoubtedly be found by means of hedge funds and other short-term focused investors. The trend towards share-based compensation for top executives has not fell short of identifying yet another group of supporters, who are allocated considerable proportions of their pay through stock-based instruments and bonuses driven by a rise in share price.

14) Global nonfinancial corporate share buybacks* (USD tn)



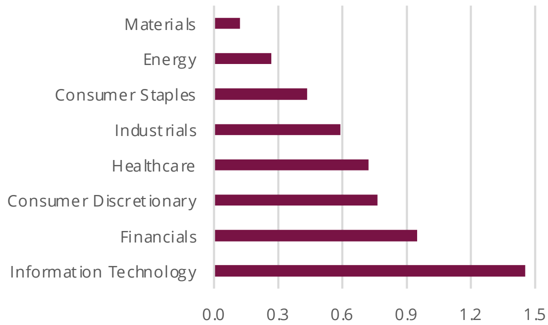
Source: S&P / * Rated by S&P and excluding real estate

Share buybacks face some key criticisms: In an environment of falling earnings - like 2020 – their impact on shareholder returns is considerably lower and they invite massive scrutiny. Companies too reliant on share buybacks risk a pronounced backlash, as a number of airlines have already witnessed. As long as companies remain fundamentally healthy, longer-term oriented investors may have no problem with this. However, what if the money spent on buybacks is money that would otherwise have been invested in R&D, capacity renewals or growth investments? Or even worse, what if the money used for buybacks is borrowed? A study by INSEAD covered north of 1'800 US companies over a five year timeline. Findings were, that the money allocated to share buybacks reduced the company's likelihood of growing over the long-term. Further the study also showed, that buybacks do not lead to an increase in market value, but are strongly correlated to a declining market value. In an interview 2018, the well known investor Warren Buffet said:

"Can you imagine somebody going out and saying, we're going to by a business and we don't care what the price is? You know, we're going to spend USD 5 billion this year buying a business, we don't care what the price is, But that's what companies do when they don't attach some kind of a metric to what they're doing on their buybacks."

In hindsight a number of well-known global companies might have a second thought on undertaking massive share buybacks over the years instead of investing the money into R&D and growth. To say the least, evidence does not suggest buybacks are good for long-term growth and value creation. In fact, far from suggesting that buybacks are a sign of confidence in the future of the company by top executives and boards. Quite the opposite is the case: Buybacks are a way of disinvesting in a way that rewards short-sightedness at the cost of a company's fundamental strength, its employees and pensioners. Considering the current share buyback programs running or announced, a longer-lasting decline in share buyback activity seems to be off the table for a considerable number of companies and their executives.

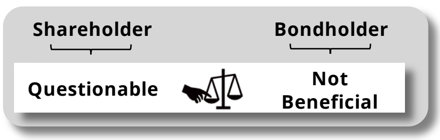
15) Sector overview share buybacks 2010 – 2019 (USD tn)



Source: Dow Jones Indices

Some of the largest buybacks in recent history were undertaken by Apple with USD 76.6bn, Bank of America with USD 29.2bn, JPMorgan Chase with USD 25.4bn, Alphabet with USD 24bn, Wells Fargo with USD 23.5bn, Microsoft with USD 21.8bn, with others such as Nestlé (CHF 20 bn) or Novartis (CHF 10 bn) to run in the near future.

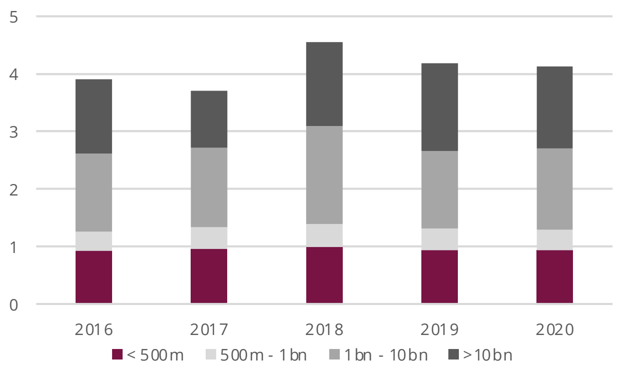
Share Buyback Pillar



The M&A Pillar

Seldom did M&A record a roller coaster like in 2020, when only thanks to a flurry of big deals in the last couple of weeks saved M&A from what looked like a lost year due to the pandemic and the uncertainties it caused. Global M&A volume reached USD 3.6 tn, down only 5% from 2019 levels according to refinitiv. USD 2.3 tn was booked in H2 2020, representing an increase of 88% vs. H1 2020. Activity for both Q3 and Q4 stood north of USD 1 tn, marking only the second time since 2008 where dealmaking surpassed that level in consecutive quarters. As the likelihood of successful vaccines rose, testing spread and political certainty materialised, deals started to shoot out of the ground like mushrooms as shown in Figure 16).

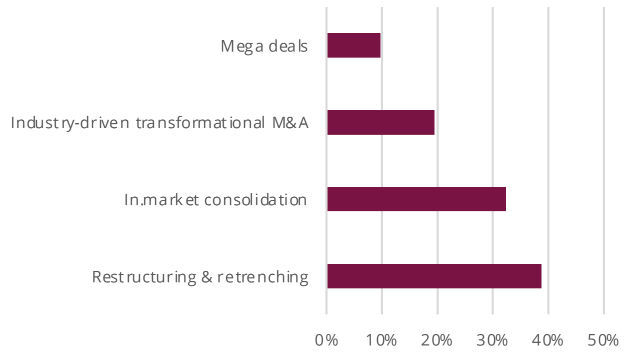
16) Global M&A by volume and deal size 2016 – 2020 (USD tn)



Source: Dealogic, Refinitiv

The environment – leaving the pandemic aside – proofed very good for dealmaking, with high equity markets, low interest rates and investors willing to pay for growth. Some of the largest deals included S&P Global's USD 44 bn deal to acquire analytics group IHS Markit, AMD's USD 35 bn acquisition of Xilinx and AstraZeneca's USD 39 bn takeover of Alexion. In each of the mentioned deals the acquirer used its own shares as the main acquisition currency, taking advantage of the sky-high stock markets. Some deal activity was spurred by companies' desire to diversify their portfolios to reach a certain scale and larger balance sheets to be able to focus on growth opportunities ahead. Another factor helping to spur activity can be found in a growing number of cash-rich companies wanting to put part of their cash to work by means of bolt-on acquisitions or – in some cases – for targets having been hit by the crisis and are now trading at attractive valuation levels. Overall M&A activity is likely to remain solid across the US, Europe and also for cross-border deals according to advisors such as Goldman Sachs and Morgan Stanley. Shares as the key acquisition currency will likely play a role for US companies to undertake cross-border transactions given continued gaps of PE ratios of US companies vs. for example European companies. As stock markets continue to bid up the price of some assets, it will become harder for strategic acquirers to compete with the increasingly active and deep-pocket known private equity investors. Companies seem to have increasingly taken the stance to look out for and acquire growth externally as compared to invest in organic growth as aforementioned in the part "The Capex Pillar". For example, auto manufacturers and suppliers will closely evaluate consolidation and partnership possibilities to share the burden of product development in a rapidly changing and evolving industry. The semiconductor industry will also likely further drive consolidation fuelled by increasing R&D and economies of scale benefits. In its most recent survey, refinitiv shows the the key drivers for M&A activity dealmakers see and expect for 2021 as outlined in Figure 17).

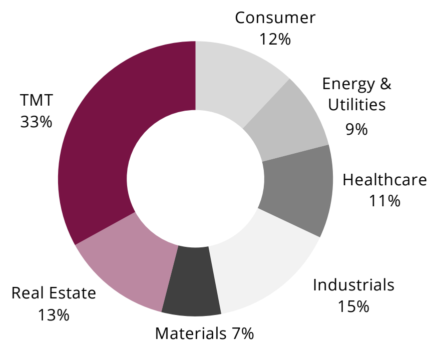
17) Drivers of M&A activity expected for 2021



Source: Refinitiv

Because of the severe disruption to daily commercial activity, it can prove challenging to identify emerging market trends. The certainly holds true for M&A activity, especially heading into 2021. In light of practical difficulties related to an M&A process such as due diligence during lockdown, it is very likely that executives postponed a good number of M&A deals rather than cancelling them outright.

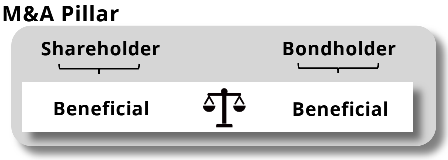
18) Global non-financial corporate M&A sector share 2020



Source: Dealogic, Refinitiv

Another trigger as outlined in Figure 14) for M&A activity in 2021 is expected to be the sheer number of distressed assets in need of a well-heeled acquirer. It would be fair to assume that many companies will become more vulnerable to takeover approaches once government support starts to wane. And lastly, the accelerated digital transformation is likely to further fuel M&A activity and attract the attention of a number of executives evaluating how to be develop and prepare their companies. Artificial intelligence and subsets like machine learning, AI-based innovation are just some examples affecting a considerable number of industries rushing to find ways of working, producing and handling changing consumer patterns. Especially in these cases, it is often more convenient, cost-efficient and faster to dive into the M&A opportunity ocean than to pursue internal paths. Provided Acquisitions are not overpaid for and don't endanger the acquirer's financial standing, M&A should benefit both shareholders and debtholders.

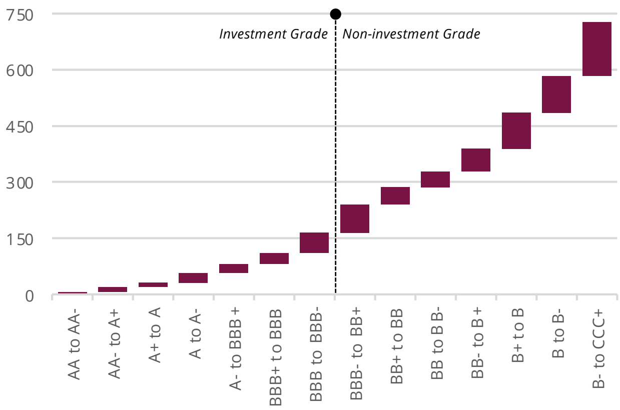
M&A Pillar



Conclusion

Understandably anyone will be hard pressed to find executives of a company wanting to turn back the time and wander the pandemic-masked paths of 2020 once again. Only as the FY 2020 results keep rolling in is the toll the pandemic took across sectors and companies visible, with sales diving double-digit and margins hitting new lows in some cases. Hopes for a healthy and marked rebound in 2021 are high, anything else would shutter confidence lastingly. On the other hand most companies – as already mentioned previously – were presented with a gift in form of liquidity shielded by the immensely large helping hands of central banks and governments. While debt has risen globally, to be fair, in many cases so has liquidity. A rebound of cash flows will allow companies to resume spending, gradually to pre-pandemic levels. Adding the extra loaded cash on hand gives executives even more options, while requiring them to take a prudent approach on how to allocate the liquidity across the 5 pillars of capital. Now might be a good time to invest back in the business. If previous downturns serve as a guide, the next couple of years will see ground-breaking innovations. Executives are well advised not to get left behind. Investments to safeguard employees, communities, supply chains and customer trust. In times where stock markets appears to have de-coupled from the real economy, shareholders will support spending on innovation and favour those companies that bear realistic growth prospects. Maintaining a sound and sustainable balance of the capital structure should also stand at the forefront of the "to do list". While 2020 was clearly unexpected and not part of anybody's wildest dreams, chances are history will repeat itself sooner or later. There goes the saying "better safe than sorry" is a lesson to be learned going forward. And for the advocates pursuing maximal leverage levels in an effort to maximise company value by minimizing the cost of capital, rest assured, debt has and will increasingly have a cost as following Figure 19) shows:

19) The cost of a notch across the rating ladder (bps)



Source: S&P

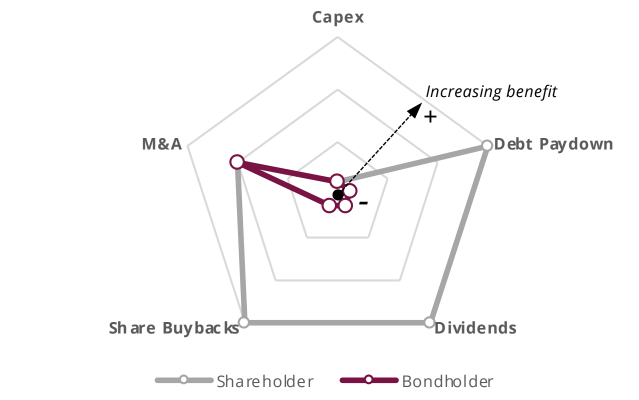
S&P analysed the incremental cost of debt between 2009 and 2019 in the US debt market across the rating ladder starting from AA and reducing the steps by one notch down, CCC+ being the lowest.

While the incremental costs were relatively small across the AA to A range, a clear step-up was visible from A to A- and yet another – marked even more – from BBB to BBB-, BBB- to BB+ and B+ to B. Keeping in mind that the global corporate landscape has witnessed a fundamental shift towards the BBB category within the investment grade, and towards the B category within the non-investment grade territory. Needless to say, the incremental costs are considerable and have often proved to weigh heavily on a company's cash flow, sometimes even tilting the needle towards the question of "to be or not to be". In times of near-zero interest rates and abundant liquidity adding debt is very tempting and might make sense in a number of cases. However, what looks like a sunny opportunity and prove very tempting, might turn into an accumulation of clouds and even worse once liquidity starts to withdraw and rates rise to more normalized levels. Debt, contrary to equity, has a fixed term and the historic issuance wave of 2020 is set to hit its refinancing walls in the not to long future. Finding a sustainable and "storm-proof" capital structure should make the "Debt Paydown Pillar" a candidate to keep a close eye on by executives. In his letter to investors in 1987, Warren Buffet made the following observation:

> ***"the heads of many companies are not skilled in capital allocation, and... it is not surprising because most bosses rise to the top because they have excelled in an area such as marketing, production, engineering, administration or, sometimes, institutional politics."***

Let's hope in the interest of companies and there various stakeholders depending on the long-term success and value generation, that capital allocation has worked its way up on the agenda of executive teams and boards sufficiently in the meantime. Which financial stakeholders do we project to benefit most from the capital allocation trend? Figure 20) offers an indication, implying a continued capital structure deterioration across the corporate landscape:

20) Who will likely benefit from the capital allocation trend?



Source: Refinitiv, S&P

And finally, being a smart steward of capital got a new meaning after the pandemic. Simply put, companies will have to do more with less. The days of taking multiple trips to the candy store of investment choice belong to the past.

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