UNIVERSITY of VIRGINIA

DARDEN SCHOOL of BUSINESS

VIEWS FROM THE C-SUITE: *Market Activity*

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Views from the C-Suite

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The University of Virginia Darden School of Business Institute for Business in Society held its Strategic CFO Roundtable on 8 May 2018 in Arlington, Virginia.

Since 2009, these roundtables have provided a confidential forum for corporate financial leaders representing the varied industries of the Washington D.C. region to discuss global and U.S. economies as well as corporate financial strategies and performance.

In addition, each roundtable focuses on a Top of Mind (ToM) topic, a specific issue of immediate importance to the members. For the May 2018 roundtable, the ToM topic was, *Market Activity,* a look at the influence of market metrics upon CFOs' decision making.

THE ECONOMIC DISCUSSION

The May roundtable convened after a period of turmoil in the stock market. For 2017, the market returned in excess of 25% to investors and reached a number of record highs during the year. Since then:

- The Dow Jones Industrial Average continued to climb in 2018 until hitting a final record of 26,617 on 26 January.
- During February, March and April the market displayed high variability dipping below 24,000, then back above 25,500 before sliding back to a close of 24,360 on 8 May.
- Interest rates continued a slow rise as yields for 10-year Treasury bonds averaged 2.96% for the first week of May.

Following the exuberance of many at the passage of tax reform at the end of 2017, the market met several setbacks regarding White House economic policies. For example, the market's volatility increased when the president announced the imposition of trade tariffs on imports of steel and aluminum. The market vacillated between the positive impact for U.S. steel and aluminum manufacturers and immediate concerns of a trade war and production cost pressures for large industries such as automobiles, aircraft, heavy equipment, and construction.

Despite the headwinds created by policy changes, the roundtable CFOs continued to respond to our survey with high levels of optimism for the U.S. economy and for their own companies.

Darden Strategic CFO Roundtable Survey

Before each roundtable, the members participate in a survey designed to elicit insights into their business views relative to national counterparts. For a couple of key questions, we compare the CFO Roundtable member responses with those of the Duke University CFO Magazine Global Business Outlook Survey (the "national survey') which has polled senior finance executives nationwide over the past 88 quarters. The comparison of results serves to generate conversation regarding member expectations of the financial condition and outlook for the U.S. and global economies and their own companies.

Economic Outlook

Figure 1 depicts how the CFOs for the national survey and the Darden survey have rated their optimism regarding the U.S. economy on a scale of 0 – 100%, where 0% indicates "Not Optimistic" and 100% indicates "Extremely Optimistic." The May 2018 Darden Strategic CFO Roundtable Survey (dashed line) revealed a rebound from January of 6.1% in optimism regarding the U.S. economy: 69.3% for May and 63.2% for January. The national survey (solid line) reported an optimism level of 71.2% for Q1 2018, slightly lower than the 73.6% reported for Q4 2017. Both surveys have displayed a gradual rise in optimism over the past two to three years and have reached record or near-record levels.

Figure 1: Optimism for the U.S. Economy
(Scale of 0 – 100%)

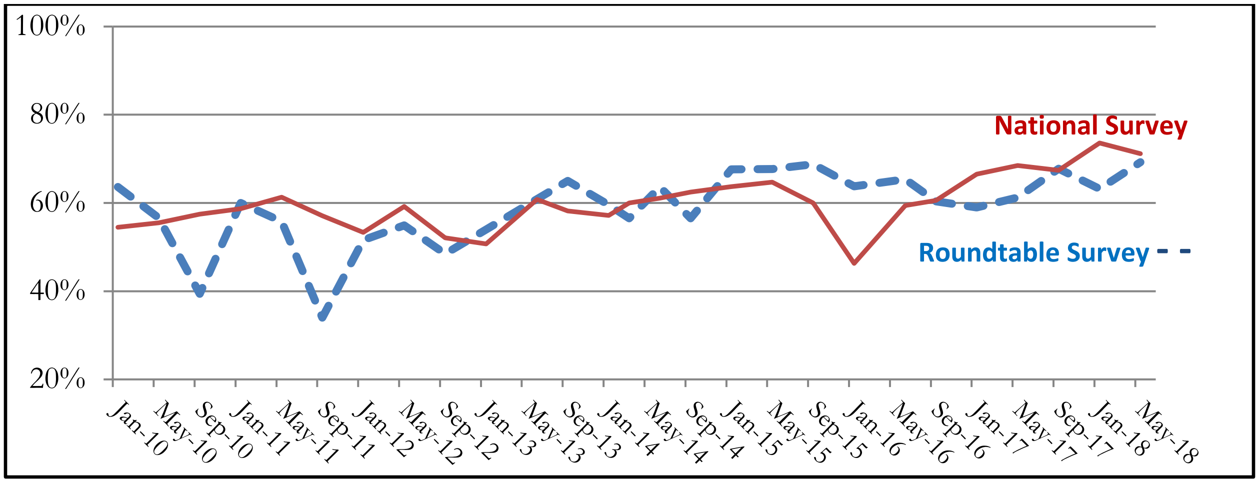
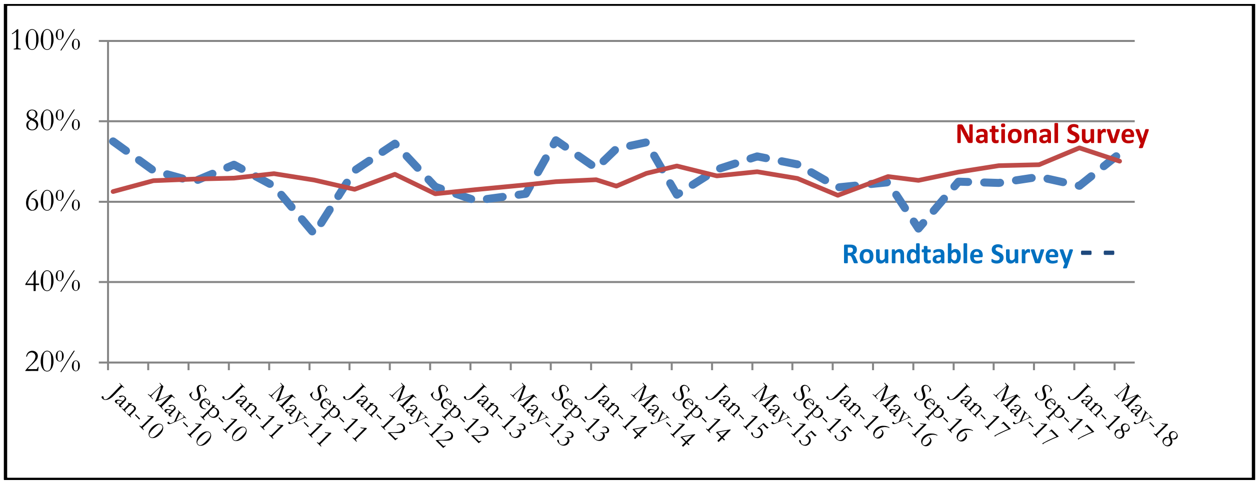


Figure 2 compares the Darden Strategic CFO Roundtable Survey with the national survey regarding optimism for the CFOs' own companies. Both surveys exhibited optimism levels for their own companies that were similar to those reported for the U.S. economy. For the national survey (solid line), optimism was reported as 70.1% and for the roundtable survey (dashed line), optimism was reported as 72.0%. As has been true for the past several quarters, these optimism levels are similar to those reported for the U.S. economy.

When we began the CFO Roundtable Survey in 2010, the tendency for both surveys was for the CFOs to have much higher levels of optimism for their own companies relative to the U.S. economy. For the period 2010 to 2018, the optimism responses to the national survey have averaged 5.9% higher optimism for their own company relative to the U.S. economy and 7.9% for the roundtable survey. Over the past four roundtables, however, the "own-company optimism premium" has fallen to only 0.2% for the national survey and 1.3% for the CFO Roundtable. If the own-company optimism premium is a leading indicator of the direction of optimism for the U.S. economy, we would expect that the current optimism levels are not likely to rise much higher going forward. (see Appendix for more information on the Darden Strategic CFO Roundtable Survey).

Figure 2: Optimism for Their Own Company
(Scale of 0 – 100%)



The discussion around the table surfaced plenty of evidence to support the optimism reported in the surveys. After completing their first quarter under the new tax law, one CFO reflected on the impact of the lower tax rate:

> We have money now for capital allocation. It's the same job that it was, but maybe with a little more. We haven't done any special bonuses. We're going to buy shares back for different reasons, not because we happen to have a little bit of a lower tax rate. Our [tax] rate was 24% in the first quarter; it's normally around 35-38%, so it's meaningfully lower. I think in general it's good news for investors and shareholders from a cash standpoint.

Another CFO discussed the hypothesis that the growth stimulus from the tax change would create more jobs. The belief remained the same as from the January roundtable, just after the tax law had been passed, that lower tax rates would not spur higher wages:

> The number of people we hire is based on the demand for our products. Maybe if there was some overall economic growth because of the tax rate and it created more demand for our products, we would hire more people, but we pay wages based on the market and on what we need to pay to attract and retain people. Maybe if some of the companies, the 30% who are using some of their tax savings to increases wages, make the market more competitive, then we have to do it. It's more of a secondary effect than a primary effect.

As we went around the table and the CFOs gave updates on their companies, a number of positive developments were announced:

> We just raised $78 million in a series B equity issuance, which was oversubscribed and we didn't use a banker. . . We are expanding rapidly and looking at going into multiple countries and will keep these funds in the bank for potential small acquisition, perhaps.

> We had an activist investor in January of 2017 who had a thesis that our company would be better as a private investment, as oftentimes activists do, so our board decided to put the company up for sale. I am now CFO of a private company, which is a new experience for me.

> We just sold one of our businesses with a contract that allows either party to exit under certain conditions.

> We released earnings last Wednesday, beat consensus, raised the bottom end of our guidance, had double-digit growth for the quarter, and industry leading organic growth.

As the discussion about the U.S. economy and their own companies was closing, the roundtable members considered the survey results regarding expectations of changes in their income statement, balance sheet and cash balance. Consistent with the overall optimism, all of the expectations continued to range from "neutral" to "higher." For example, all or almost all of the respondents expected an improved income statement, balance sheet and cash balance for the next four quarters (see Appendix, question 8). Expectations of an acquisition were also much higher than prior surveys.

THE TOP OF MIND TOPIC

For May 2018, the Top of Mind (ToM) Topic, *Market Activity,* focused on market metrics upon which the CFOs relied to make strategic and tactical decisions. The survey included three questions related to Market Activity (see Appendix, questions 10, 11, 12).

Common Metrics Used to Assess Market and Economic Strength

Initially, we discussed the economic and financial metrics that CFOs used to assess strength of the stock market and economy. Everyone answering the survey selected GDP growth and most (75%) look at the Federal Reserve's actions and/or stated strategy, and stock market performance. Half the respondents review mergers and acquisitions (M&A) activity and stock market level (e.g., S&P P/E level).

Surprisingly, no one answering the survey looked at stock market volatility (e.g. Volatility Index (VIX)) to determine market and/or economic strength. As Ken Eades noted, the Volatility Index (VIX) "is forward looking, it's not backward looking, so it's actually a pretty scientific measure of how markets are thinking about basic statistical risk going forward." Looking at the VIX at "just about the time of the tariffs . . . that kind of put things in a tailspin and we had a lot of volatility."

Perhaps one of the reasons that the members did not select the VIX as a metric for market and economic strength is that "everybody [answering the survey] said [the volatility] is average." (See Appendix, question 11).

A Good Time to Add Risk

The final question had the members characterize their views on whether the current market is a good environment to add risk to the balance sheet (see Appendix, question 12). More than 75% of the respondents saw it as a good time to add risk.

> We're under-leveraged . . . we're interested in deals that work well. So, we have more cash and marketable securities than we do debt, a couple hundred million, but it's just finding the right deals . . . we would love to be in a position to do some more transactions, take on a little bit more risk - it's just finding the right deals. Valuations are quite high.
>
> We see this as a good time to do bigger things.
>
> The tax rate being lower does have an impact on how we're looking at things too.
>
> Being on the private side, [there is] more of an indirect influence. Indirect in that its impact is on what we have already invested in or what we may invest in. So levering up, it's not really going to impact that decision very much from our standpoint. We're equity investors so we use equity to

> make the investment and . . . we have limits on the amount of leverage we can have. . . So, then it's a question of the investment itself and does the leverage profile change for those investments, and that's sort of unique. There's not a broad brush that I think we could apply to that.

Turning their attention to M&A activity, and looking at statistics over the past five years, most members felt that the level of activity would continue:

> I think M&A is going to continue to be strong, because . . . the [private equity] firms are pretty healthy. When you look at companies, they're looking for ways to grow and money is still, historically, pretty cheap. Why wouldn't it, unless we have something to send the market off track? And valuations are high, so if you're a seller, this is a good time to sell.

> It's hard to draw seasonality out of this because it's all over the place, but I think . . . companies are looking for growth, but it's hard to come by, so a lot of growth is inorganic at this point. And, you've got a lot of capital sitting around. . . So that's all on the positive side. On the negative side is valuations, those are the kind of things that are counterbalancing.

> We're bringing some companies to market, so we hope that it stays strong.

With regard to IPO activity, the members felt that the number of IPOs were inflated by the number of spin-offs that are still happening. They felt a more informative view would be to look at net exit dollars versus numbers of IPOs.

> If you put the private deals on this last three years, this chart looks very different.

> You ought to look at liquidity in that . . . his is actually now in the mid-market, just the total minority. There are easily 3-4 private deals being done of this magnitude for every IPO.

> Looking at net numbers [of IPOs] . . . a lot of those spin-offs stay as a spin-off for a year or two and then go private . . . [because] after two years usually, you can reap the tax benefit.

> It's interesting, you've seen in a lot of the hospitality businesses there's been a lot of spin-offs over the last number of years to . . . separate the operating businesses from the real estate components.

> You saw that with Hilton. . . Hilton created three companies out of one. . . When Marriott bought Starwood, Starwood spun-off its timeshare business, which is the company . . . taken public . . . in 1997 . . . then it got bought by Starwood and then they spun it back out and then last week Marriott announced . . . Marriott Vacations bought the spin-off and Marriott Vacations was itself spun off of Marriott. There's a lot of activity.
>
> But, don't forget the trend says bypass the banks.

Outcomes of Recent Market Activity

Beyond the market metrics, the roundtable members provided updates on their own activities related to market actions, reactions and opportunities.

Obstacles that limit corporate growth include those hurdles created through government regulations. While the CFOs have been encouraged that the Republican administration is reducing federal regulations as part of being business-friendly, several members recognized continuing regulatory challenges:

> In general, the environment seems a little less predatory, or . . . you feel like maybe there aren't as many things lurking around the corner -but our industry [higher education] is heavily regulated. There has been a bit of a break from that if you want to call it that, but two years from now . . . who knows what will happen. . . Healthcare is the other industry . . . that's a heavily regulated world and that's not going to change, so I don't think we see that much difference from a regulatory standpoint.
>
> As a public company, there are some advantages and disadvantages. It's kind of interesting to think that we're still in an environment that is discouraging people from going public. Overall, there are a lot of negative things associated with it. Even [section] 162(m) of the new tax law has limitations so that any of the top five people with over $1 million of compensation become non-deductible. So, there's an incentive not to be public.
>
> [There are so many] things that are designed to be shareholder friendly: [i.e.,] more visibility into the financial statements, more transparency, segment reporting . . . all the things you have to disclose, proxy access rights . . . all the new accounting regulations to

bring more clarity. [However,] I think they bring more confusion. All these things that are supposed to be shareholder friendly, but they add costs to companies and they discourage companies from going public, which is taking them out of the ability for shareholders to even own them. So, it's the unintended consequences of not taking the company public. . . All of these great investment opportunities are no longer available to public shareholders because these things that are supposed to make companies safer investments for public shareholders [actually] make it harder.

We're looking to refinance some debt and we've usually done that with public, but we're going to do a 144A offering. We always kind of liked having all of the information out there and just doing a normal, conservative, public debt offering. The 144A is the same buyers really, but it all has to do with the work associated with the public debt offering. It's just tougher. There are a couple of things you have to do that are painful. It's another little thing with respect to debt offerings that, again, going public is just costlier and more complex.

For all [we have to] do with the SEC filings, in my twelve years of [being a] public company CFO, I have never had anybody - an analyst, an investor, anyone - call with a question after the Q or K was filed. Never. I don't even know if they're reading them.

The Darden Strategic CFO Roundtable meets again in September 2018.

About the Authors

Kenneth M. Eades, Professor of Business Administration, is the Chairman of the Darden Finance Department and Associated Faculty with the Institute for Business in Society. The author of numerous academic articles, more than 70 Darden cases and three books, Ken has received both research and teaching awards.

Jane-Scott Cantus, Managing Principal and General Counsel of The ILEX Group, has worked with and advises Board and C-Suite members on strategy, culture, organizational design, leadership and talent for over 25 years. She co-founded the Strategic CFO Roundtable with Professor Eades and is a Fellow with the Institute for Business in Society.

About the Darden Strategic CFO Roundtable

The Darden Strategic CFO Roundtable is an invitation-only peer-to-peer forum for leading chief financial officers in the Washington D.C. metropolitan area. The roundtable members discuss, debate and share best practices surrounding the strategic role of the CFO. Representing a collective 300+ years of strategic, financial and leadership experience, the roundtable members share their views on the challenges and opportunities facing their companies and themselves. They discuss the lessons learned from triumphs and trials that led to their becoming recognized as strategic CFOs. Founded in 2009 by Darden Professor Kenneth M. Eades and Jane-Scott Cantus of The ILEX Group, the Strategic CFO Roundtable became a branded initiative of the Institute for Business in Society at the Darden School of Business of the University of Virginia in 2013.

About the Institute for Business in Society at the UVA Darden School

The Institute for Business in Society is a Center of Excellence at the University of Virginia Darden School of Business. Its mission is to be a leading global catalyst and convener of thought, information and action at the convergence of business and society. To achieve that mission, the institute unites leaders in business education with top industry executives, regulators and other thought leaders in discourse on the role and responsibility of business to make lasting positive impact to better an increasingly complex global society.

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Appendix

Darden Strategic CFO Roundtable Survey Results, May 2018

	N = 5 CFO RT May 2018		N = 5 CFO RT Jan 2018		N = 6 CFO RT Sept 2017		N = 9 CFO RT May 2017		N=244 National Q1 18		N=259 (56) National Q4 17		N=354 National Q2 17	
	Average	Median	Average	Median	Average	Median	Average	Median	Average	Median	Average	Median	Average	Median
1. Compared to last quarter, are you more or less optimistic regarding:-**U.S. economy** (Less =1, More = 3)	**2.3**	**2.0**	2.6	3.0	2.0	2.0	2.3	2.0	2.4	3.0	2.5	3.0	2.2	2.0
1. Compared to last quarter, are you more or less optimistic regarding:-Financial prospects for **your own company** (Less =1, More = 3)	**2.5**	**2.5**	2.6	3.0	2.2	2.0	2.4	2.0	2.4	3.0	2.4	3.0	2.3	2.0
2. Rate your optimism regarding: (Drag the slider to assign a number.)- **U.S. economy**	**69.3**	**71.0**	63.2	60.0	67.8	70.0	61.2	60.0	71.2	75.0	73.6	75.0	67.4	70.0
2. Rate your optimism regarding: (Drag the slider to assign a number.)-Financial prospects for **your own company**	**72.0**	**68.5**	64.0	58.0	66.2	60.0	64.7	60.0	70.1	75.0	73.4	75.0	69.2	75.0
5. How would you rate...-Your **employees' morale level**? (Poor =1, Satisfactory =3, Excellent = 5)	**3.8**	**4.0**	3.0	3.0	3.7	4.0	3.0	3.0						

The national survey is conducted by Duke University's Fuqua School of Business and CFO magazine.

	N = 5		N = 5		N = 6		N = 9	
	CFO RT May 2018		CFO RT Jan 2018		CFO RT Sept 2017		CFO RT May 2017	
(Weaker =1, No change = 2 Stronger = 3)	Average	Median	Average	Median	Average	Median	Average	Median
6. Recent quarter's financial results **vs. previous quarter: -Income Statement**	**2.3**	**2.0**	2.2	2.0	2.5	2.5	2.3	2.0
6. Recent quarter's financial results vs. previous quarter: - **Balance Sheet**	**2.0**	**2.0**	2.0	2.0	2.0	2.0	2.4	2.0
6. Recent quarter's financial results vs. previous quarter: - **Cash Balance**	**2.0**	**2.0**	2.0	2.0	1.8	2.0	2.3	2.0
8. **Expected change** over the next 4 quarters vs. last 4 quarters: **-Income Statement**	**3.0**	**3.0**	2.5	2.5	2.2	2.0	2.6	3.0
8. Expected change over the next 4 quarters vs. last 4 quarters: - **Balance Sheet**	**2.8**	**3.0**	2.3	2.5	2.0	2.0	2.5	3.0
8. Expected change over the next 4 quarters vs. last 4 quarters: - **Cash**	**2.8**	**3.0**	2.3	2.5	2.0	2.0	2.5	3.0
(Reduced =1, No change = 2, Higher = 3)								
9. **Expected change** over the next 4 quarters vs. last 4 quarters: - **Headcount**	**2.3**	**2.0**	2.4	3.0	2.0	2.0	2.1	2.0
9. Expected change over the next 4 quarters vs. last 4 quarters: - **Capital Spending**	**2.3**	**2.0**	2.0	2.0	2.0	2.0	2.1	2.0
9. Expected change over the next 4 quarters vs. last 4 quarters: - **Compensation**	**2.0**	**2.0**	2.2	2.0	2.0	2.0	1.9	2.0
9. Expected change over the next 4 quarters vs. last 4 quarters: - **Pro develop/training**	**2.5**	**2.5**	2.0	2.0	1.8	2.0	2.3	2.0
9. Expected change over the next 4 quarters vs. last 4 quarters: - **Prob (new mkt/product)**	**2.5**	**2.5**	2.3	2.0	2.5	2.5	2.5	3.0
9. Expected change over the next 4 quarters vs. last 4 quarters: - **Prob (Acquisition)**	**2.8**	**3.0**	2.3	2.0	2.2	2.0	2.3	2.0

10. Which economic and financial metrics do you use to assess the strength and robustness of the stock market and the economy? Check all that apply:

	Percent Selected
GDP growth	100
The Fed's actions and/or stated strategy	75
Consumer Price Index (level and changes)	25
Stock market level (e.g., S&P P/E level)	50
Stock market performance (e.g., S&P recent returns)	75
Stock market volatility (e.g., VIX level and changes)	0
IPO activity	25
M&A activity	50

11. Beginning in February the stock market volatility index (VIX) has been higher than the prior 12 months. How does the general level of uncertainty faced by your company today compare to the prior uncertainty levels you have experienced in your career?

	Percent Selected
Below Average	0
Average	100
Above Average	0

12. How would you characterize your view on whether this market/economy is a good environment to add risk to your balance sheet?

	Percent Selected
Uncertainty is too high, so we will wait.	0
Neither good nor bad time to add risk.	25
We see opportunities that make this a good time to add risk.	75