Equity capital markets update –
2016 market review
December 22, 2016

Introduction

As year-end approaches, we wanted to reflect on key capital markets themes observed over the past twelve months, and offer a preliminary market and deal outlook for 2017. The past year has been filled with a variety of surprise outcomes—the US elections and Brexit in the political sphere, dark horse “Spotlight” winning Best Picture at the Academy Awards and the World Champion Chicago Cubs ending more than a century of futility to name a few—as such we make “projections” for 2017 with supportive data, but also a healthy amount of mainstream skepticism. That said, our outlook for the equity deal market is significantly more constructive than it was at this point last year for a variety of reasons. Below is a brief summary of our thoughts, which we expand on throughout this note.

- The 2016 IPO market was impaired by a volatile start to the year, and a complicated calendar in general:
  - Poor IPO price performance in 2015
  - A 10% market correction in January
  - Uncertain global growth, monetary policy, and oil price environment
  - US elections breaking up the fourth-quarter deal window

- However, the current market backdrop appears to be much more constructive for equity capital transactions heading into 2017:
  - More stable and optimistic economic and policy outlook
  - Expectations for a tax-friendly political bias
  - Positive data on recent equity fund flows
  - Strong aftermarket performance from 2016 transactions increasing investor appetite

- While market conditions appear positive, clients should also assume volatility will periodically emerge for any number of reasons that could include:
  - The US presidential transition, including policy vs. expectations
  - Broader global/geopolitical risks
  - Commodity (oil) prices
  - Overheated stock prices
  - Access to and pricing in the debt markets

- In summary we expect the capital markets deal environment to rebound in 2017, reverting to normalized levels of activity and volumes
  - We also expect windows to frequently open and close, rewarding issuers that are ready and aggressive

- Amidst active markets with expected volatility, being prepared and able to raise capital opportunistically has exceptional value to the issuer
2016 year-in-review

As anticipated, US IPO issuance volumes were challenged this year
- 87 transactions priced raising $21 billion (volume down 34% from 2015)
- Lowest number of transactions since the financial crisis of 2008-09
- Lowest amount of capital raised since the wake of the Internet boom in 2003
- Average transaction size was $236 million vs. $366 million in 2015

Entering 2016, investors were wary of IPOs given the poor performance of the 2015 IPO class, with 56% of the 2015 IPOs trading below issue price heading into 2016. Compounding this dynamic, broader indices started the year with a ~10% correction in January, further reducing investor appetite to add risk positions to their portfolios. Only six IPOs (all in the biotech space) priced in the first-quarter of 2016 raising $575 million, which represented less capital raised than during the first-quarter of 2009, when market and economic uncertainty were significantly higher.

As the year progressed, additional factors came into play. Periods of volatility and uncertainty surfaced at inopportune times during a calendar that already was condensed. While several large deals priced and traded successfully, the large, well-known, brand name issuer that can validate the IPO path on its own never really came to market. With many of the potential post-election 2016 issuers possessing strong balance sheets, the choppy deal environment wasn’t attractive enough to entice a traditional class of IPOs to execute in 2016. As such despite strong performance by the broader indices in the wake of the US elections, the actual timing of the election eliminated the traditional November IPO issuance window, effectively condensing any potential transactions into December, a month that typically is fairly slow from an IPO perspective.

On the public company financing side, capital raising volumes were also down, though not as sharply as IPOs. Follow-on equity issuance was $151 billion in 2016, down 17% from 2015, while convertible issuance of $19 billion was relatively unchanged from last year, up 2%. The marketing of these products involves less risk and requires significantly less time to market than an IPO, allowing issuers to navigate market volatility and tight issuance windows more easily. Public registrants also have flexibility to react quickly to market developments when launching and executing transactions. Marketed follow-ons and convertible debt deals are typically only in the market for one to three days, while equity block trades allow issuers to forego marketing, raise capital on an overnight basis (eliminating all market risk), and shift placement risk to the
underwriters. As such, block trades were 2x more prevalent in 2016 than they typically are executed (relative to marketed equity deals). Compare these processes to an IPO that requires 2 to 2.5 weeks of uninterrupted marketing to successfully price transactions. During times of heightened uncertainty, transaction mechanic flexibility is a valuable option and enhances deal activity for public companies.

Current trends point to an improved market backdrop for 2017

We view last year’s limited IPO issuance as an anticipated product of volatility, uncertain growth and monetary policy, and a compromised deal calendar. Given last year’s inactivity, a more constructive macro-economic and growth outlook, the prospect of lower corporate taxes, and the perception of a business-friendly political environment for many sectors and businesses, we expect the 2017 deal calendar to revert to more normalized conditions and activity. We caveat this view with the obvious —if the last 12 months have taught us anything, it is to expect the unexpected. That said, if current conditions hold we anticipate a much more constructive IPO environment, in line with historical “recovery year” deal flow. There are a number of macro and market factors influencing this view:

- Aftermarket performance of the 2016 IPOs. Investors are currently eager to evaluate potential IPO investments given the outperformance of the asset class in 2016. IPOs over the past 12 months have outperformed the S&P 500 Index by an average of 27%, with returns relatively well distributed (77% of issuers still trading above issue price). Fund managers are constantly seeking opportunities to outperform the market; in a constructive transaction environment investing in new deals (IPOs and follow-ons) is a fairly common strategy to outperform the broader indices. Deals are typically priced at a discount to their estimated fair value to compensate for transaction risk, and to entice investment. All else being equal —shares in these securities typically appreciate to fair value in the aftermarket, which returns “alpha” to investors that purchased securities at the discount. As such, significant and broad outperformance of IPOs increases the appetite of investors to participate in these offerings to keep pace and outperform indices.

While the strong performance of the IPO asset class in 2016 theoretically could have driven more deal activity, a few issues worked against this. First, many of the better performing deals came in 3Q16, which gave issuers limited windows through year-end to access the market. Perhaps of even more relevance, many prospective issuers were not prepared to capitalize on the momentum of the IPO market late in the year. Given all of the issues highlighted earlier, plus the dearth of IPO activity in 1H16, most issuers were not in a “ready” state to move quickly and capitalize. Some had slowed their readiness processes, while others were just caught off guard by the deal market momentum. As such, the second half of 2016 demonstrated the true value of enterprise readiness and transaction optionality to prospective IPO candidates.

- Potential return of “unicorn” issuers. Media reports indicate that a number of unicorns have confidentially filed Form S-1’s and/or are working with advisors in anticipation of doing so in the first half of 2017. Generally speaking, these companies have developed for two to three years since their last financing, have grown into their valuations and achieved operating leverage. Additionally, private capital alternatives have cooled over the past 12 months. While there are still well-known investors with significant capacity to invest in these markets, others have pulled back, bringing valuations for new private capital into a more rational relationship with potential IPO values. All of these factors combined make an IPO track more palatable than in previous years, offsetting the complexities that accompany an IPO and operating as a public company.
The US macroeconomic outlook is stable. The economic data flow in 4Q16 paints a relatively constructive picture for the US economy. After a slow recovery from the financial crisis, the US has returned to “full employment,” with reported unemployment hovering around 5%. Recent data on wage and income growth supports this finding as well. Housing prices, as measured by the Case-Shiller Index, rose to levels not seen since before the 2008-09 financial crisis. While disparities remain on a regional basis, overall home-buying activity is relatively strong. Consumer spending has been the bulwark of the slow recovery, comprising ~70% of GDP growth, with the employment and wage growth data pointing to continued strength. Business investment has lagged up to this point in the economic recovery, but is expected to pick up given the perception of a business-favoring administration and policy bias. While these items all introduce inflation risk —and indeed expected inflation has increased by 10 bps since November 1 —the market views moderate inflation (below target of ~2%) as a positive.

Early in 2016 the specter of several and unpredictable Fed funds rate increases put pressure on equity prices. However, it was not until the week of December 12th that the Fed raised rates again (the second raise this year), with consensus for a further two to three raises in 2017. Investor sentiment has shifted to view this as a positive signal of economic activity. With all of this said, a shift in Fed signaling, or uncertainty with respect to the forward rate curve, could weigh on the market during parts of 2017 and beyond.

Fear of a slowdown in the Chinese economy also stoked global growth fears early in 2016. Policy actions taken by the Chinese government to re-prioritize growth appear to already be taking hold, with Q3 Chinese GDP growth of 1.6% beating consensus expectations. Commodity prices are recovering strongly with the CRB Index up 23% from its lows in February 2016. Manufacturing activity as measured by the Global Purchasing Managers Index (PMI) points to the return of global growth, with particularly strong readings in the largest economies—the United States, the Euro Zone, Japan and China.

While most of this macro news has been percolating since October, the market really only reflected the strength of the data after the uncertainty of the US presidential election passed. Since the election, US indices are up 5%-9%. The inverse correlation with bond yields has also broken down with 10-year treasuries up 68 bps over the same period. Momentum has clearly shifted with expectations for a positive macroeconomic environment in 2017. While it is critical to also consider the potential for headline risk across the geopolitical arena and otherwise, sentiment has clearly turned, with the news flow exhibiting a much more positive spin than over the previous year.

Equity fund flows are positive. Mutual funds and ETFs have experienced ~$81 billion of outflows year-to-date. A majority of the outflow occurred during periods of uncertainty—at the beginning of the year and leading up to the US election—when investors moved assets defensively into cash. Since the election, we have experienced a reversal of this trend as a result of the prevalent positive outlook. Equity fund flows have been positive over the past four weeks, with total equity fund assets exceeding $3.9 trillion. Combined with the recent run of indices to all-time highs, total assets are at their highest level of 2016. There are several reasons to believe this reversal to the positive can hold through 2017. The $81 billion outflow in 2016 is the second largest drawdown of the last 25 years, behind only the $130 billion outflow experienced in 2015. Similar to new issue activity, a reversion to the mean seems probable as underlying corporate and financial fundamentals are relatively strong. Recent index performance and broader optimism about the economic outlook for 2017 should continue to draw investment dollars to equities. In addition, a return of inflationary pressures and rising rates should drive investors to shift assets out of fixed income, likely also to the benefit of equities. And in turn, inflows force portfolio

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managers to identify new investment opportunities and are therefore a positive influence on new issue markets. Continued inflows would add to our already positive outlook for the new issue market in 2017.

Other market trends to monitor and expectations for 2017

• While the broader market outlook is constructive, expect intermittent bouts of weakness. Across the global geopolitical landscape, it seems inevitable that unpredictable events will spark periods of instability and volatility. 2017 elections in France, Germany and elsewhere across Europe will raise questions about the stability of the EU and its single currency. Stumbles in China's efforts to increase economic growth or a potential trade conflict could make equity and debt investors cautious at times. Flare-ups in the Middle East, or broader fears about the global impact of terrorism, could impact the oil markets and ripple uncertainty throughout the broader market. Of course, the causes of market volatility in 2017 may not emanate from any of these issues, but rather from another source currently not contemplated by market prognosticators. The equity market in recent years has shown tremendous resilience and the ability to process and recover from these types events on an accelerated timeline; however, the severity and length of volatile periods could impact 2017 equity issuance volumes.

• Tax reform: expectations and reality. The incoming Trump administration has suggested an extensive overhaul of corporate taxation, including the prioritization of a reduction in the corporate tax rate and a repatriation holiday for cash generated and held offshore. Given Republican control of both Houses of Congress, the market is pricing in reform that is favorable to corporate earnings and capital flexibility. Without specific policy details, the near-term impact on capital markets activity is currently speculative. A simplified tax code and lower rates could improve growth prospects over the long term. In theory a sustainable decrease in tax rates would increase earnings and therefore valuations, which could make IPOs a more attractive alternative and therefore increase deal activity. Expectations of financial upside will be reflected in the broader market and therefore could improve general IPO “sentiment” in 2017, despite the fact that reform will likely take significant time to legislate and longer still to implement.

Regarding the potential impact of a repatriation holiday —looking to past experience as a guide, the market will anticipate elevated M&A and share repurchase activity similar to the 2004 repatriation tax holiday. Over $3 trillion of US corporate profits are currently estimated to be parked in overseas accounts, the bulk of which —perhaps over half —sits with the largest 50 companies in the S&P 500 Index. Given the profile of many of these companies, capital return to shareholders (i.e., dividends and share repurchases) would seem to be the most logical near-term use of available funds. Certain issuers may also look to deploy their repatriated funds to debt retirement, as bond prices decline with expected rising rates.

An additional scenario to keep in mind is if the direction and impact of new tax policy (corporate and individual) underperforms current market expectations. There is clear momentum in the market, much of which is tangibly linked to the perception of a business-friendly administration expected to prioritize tax reform. Policy changes that appear less aggressive than initially anticipated could introduce volatility into the market and thus impact the new issuance calendar. Obviously the flipside could also occur, where new tax policy is better-than-anticipated and stocks rally further. Either way, tax reform will be in focus in 2017 and may impact the new issue markets one way or another. As such, it is critical for companies evaluating the IPO market in 2017 or beyond to make tax planning a core task in their IPO preparedness journey.
Oil prices and potential impact on the broader market. At the beginning of 2016, oil prices were under pressure as demand from developing economies weakened and supply exceeded demand. In the first-quarter of 2016, West Texas Intermediate (WTI) fell to the mid-$30s and market experts questioned if prices could fall even further. As an important input across industries, oil price uncertainty significantly contributed to the general malaise in the equity markets. The fall in prices obviously also has a direct negative impact on earnings for oil and gas companies, creating challenging year-over-year growth comparisons. Energy is among the largest sectors in the S&P 500, so the optics for overall market earnings growth were challenged.

The environment stabilized into the second half of 2016, with prices rising and largely trading in a range of $42-$52/barrel. In November and December, strengthening economic data from China, as well as the potential for an OPEC agreement to limit supply, drove WTI prices to the high end of that range, which the market is broadly viewing as positive.

Despite this momentum and apparent price stability, it is important to consider the potential impact of deteriorating oil prices on capital markets conditions. The correlation between the stock market’s recovery in 1H16 and stability in oil prices is not merely coincidental. And the uptick in oil prices over the past 6-10 weeks is also not an immaterial component of markets reaching new highs. Given the strength of this correlation, commodity price instability certainly has the potential to roil markets, and in turn the IPO environment, even for industries away from the energy sector.

The public company fundraising environment remains constructive. We anticipate investor interest in follow-on equity offerings to continue. Sponsor portfolio monetization was a primary driver of activity in 2016, and that process will continue for portfolio companies that have completed an IPO over the past several years. Re-offer discounts over the past three years have been extremely tight, averaging 2%-4% which demonstrates the continued willingness of investors to increase their exposure to in successful public companies. While volatility may periodically impact market access, receptivity to opportunistic financings and monetizations is likely to remain high.

As has been the case for several years, investor demand for the convertible product also remains strong. Of 54 convertible transactions in 2016, 94% priced within or better than the marketing range on either coupon or premium. Despite this positive trend, volume remained relatively low at $18.8 billion in 2016 (compared to $18.5 billion in 2015 and $39.6 billion in 2014). Convertible volumes have been limited in part due to the historically attractive interest rates available to issuers in the bank and bond markets. With continued Fed funds rate increases expected in 2017, combined with visions of expansionary fiscal policy under the Trump administration, access to historically low coupon straight debt may be impacted. While rising rates also influence convertible pricing, the impact is felt to a lesser extent, and terms are expected to remain issuer-friendly for the foreseeable future. The rate environment, in combination with rising share prices, will likely buoy convertible volumes in 2017.

One last thought on the prospects for IPOs in 2017 ...

While the 2016 IPO market is generally (and reasonably) viewed as a down year, the past two to three quarters exhibited encouraging trends that while not immediately visible in deal volumes, help support the prospects for increased transaction activity in 2017 and perhaps beyond. The second-quarter of 2016 demonstrated that even with limited recent precedent, investors will engage and invest in IPOs at “the right price.” The third-quarter capitalized on 2Q16 deal success, shook off the Brexit market shock in June, and produced some of the higher profile and better performing deals of the year. 3Q16 was also the most active
quarter of the year for IPOs, despite the traditional August slowdown breaking up the quarter. Closing out the year, companies raised more IPO proceeds in Q416 than in any other quarter of 2016. Beyond actual transaction pricings, we have seen increased activity from companies at various stages of IPO preparation. In other words, there are concrete data points on pricings and activity that increase our confidence in the positive trends for 2017 discussed above.

Leading practices for issuers in this environment

- Plan and prepare well in advance. The unpredictable nature of market risk increases the value of readiness in this environment. On the IPO side, it is increasingly important to evaluate readiness, take action and be prepared to access the markets efficiently when the opportunity arises. While certain preparations can often be completed over the course of several months, our experience shows that planning 12-18 months in advance of a contemplated IPO positions companies for success in the market, and reduces deal and public company market risk. The JOBS and FAST Acts have significantly decreased the amount of time an Emerging Growth Company (EGC) is exposed with a public filing. With the ability to file confidentially, issuers are incented to begin a process earlier than they might otherwise to create optionality across multiple market windows. Our Equity Capital Markets (ECM) group provides prospective issuers with an independent perspective on IPO prospects, helps devise optimal strategies and assists with transaction execution.

Though the execution time frames are much shorter for public company capital raises, preparedness also leads to more efficient execution in the follow-on and convertible markets. Independent advice on transaction size and timing—from an advisor not incentivized along those vectors—positions management teams to make the best decisions about funding growth and preserving appropriate liquidity. Understanding convertible terms, market conditions and accounting is complicated, and as such the appropriate time investment should be made upfront to allow for opportunistic and accelerated market access.

- For prospective IPO candidates, begin acting like a public company as soon as practical. The transition from private to public company reporting is major, and practicing the roll-up of reporting and projection processes for several quarters in advance of the initial post-IPO earnings call is advised. While many management teams have experience with the cadence of public company disclosure, training a new organization on this process is critical.

When comfortable and prepared, developing relationships with Wall Street (bankers, analysts and potentially investors) in advance of the IPO process can have significant benefits. This begins with presenting a consistent story with respect to the company’s business and positioning, and highlighting a set of key metrics that drive the business model and in turn, valuation. Articulating a clear understanding of the strategy and demonstrating credibility in advance of the IPO can build a community of support that is invaluable when refining the investment thesis for the IPO, and just as importantly as the company operates in the public market post the deal. As such, beginning this dialogue and these relationships well in advance of the IPO can create trust that translates directly to value.

- Form a holistic view of capital alternatives. As mentioned, investor receptivity to equity and equity-linked products appears strong headed into 2017. As our Debt Capital Markets colleagues point out, access in their market also remains strong despite the prospect of rising sovereign rates. With this backdrop, issuers have the enviable position of alternatives across the capital markets security spectrum. Evaluating these options in a holistic manner requires a deep understanding of the benefits and
considerations of each, layered across the company’s specific situation. For many issuers this means getting up to speed on the convertible product that has evolved significantly. Call spreads and other structural enhancements allow issuers to tailor a security to best fit their capital structure and corporate finance goals and should continue to gain in prominence. However, the structuring exercise can be complex and unique to each issuer, making independent, expert advice advisable, and a holistic approach critical.

We are bullish about the prospects for issuance across the equity markets in the coming year, and the experience of the EY Equity Capital Markets team can help issuers define their capital markets objectives and achieve efficient execution. Please feel free to reach out with any questions or concerns.
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