Can Anyone Solve the Euro Woes?

By Ramona Dzinkowski

Almost every day there's more unsettling news about the eurozone's financial crisis. Will the countries involved ever agree on a possible solution? Will the member states stay together? And what, if anything, will happen now that the European Union (EU) received the Nobel Peace Prize?

A Look at the Issues

The eurozone is the world's largest economy with 20% of the global gross domestic product (GDP). It's composed of the 17 European Union (EU) member states that have adopted the euro as their official currency and some non-EU countries that have adopted the euro. Companies around the globe are connected to the region through trade, finance, and foreign direct investment. But the past two years of problems with credit liquidity, the sovereign debt crisis, and political uncertainty have called into question the future of the EU and, more specifically, how much global companies can rely on it as a source of growth going forward. The International Monetary Fund (IMF) predicts that annual growth in Europe will be 0.25% in 2012, considerably weaker than the 2% growth rate of the previous year. Growth estimates for the region are 0.7% in 2013. Huge growth imbalances also exist between countries, with very tough prolonged recessions expected for some—particularly Portugal, Greece, Spain, Ireland, and Italy. (Italy is one of the largest U.S. trading partners in the region.)

Companies that depend on the EU for a large portion of their sales are cringing at the region's prospects for the remainder of 2012. According to the U.S. Department of Commerce, the value of U.S. goods exported to Europe was $268.4 billion in 2011, or roughly 20% of total U.S. merchandise exports for the year. Year-to-date figures for August show that the first eight months of 2012 will see a mere 2.8% increase in U.S. exports to Europe over the same time last year. This compares with a 16% increase in second quarter figures between 2010 and 2011.

Companies with the largest exposure to the downturn in the EU are chemical manufacturers and makers of transportation equipment, computer and electronic products, and machinery.

Meanwhile, ongoing political instability within the region is creating havoc for investors around the world as they watch share prices plummet from one day to the next. For example, when the news hit about a new anti-austerity socialist government in France, coupled by the "hung" parliament in Greece, global equity markets dropped suddenly during the first week of May, wiping out most of the gains made in the first part of 2012. In turn, this sort of market volatility has shaken investor confidence and has the potential to create downward pressure on domestic demand in countries around the world.

More recent political uncertainty in Italy with questions around who will be the next prime minister is straining Italy's attempt to distance itself from other eurozone crises centers like Spain. The extent to what the markets will bear and for how long around this issue remains to be seen.

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Possible Catastrophic Results

Though many financial experts are hopeful that Europe will pull through its economic and political woes in the long term, others caution companies to prepare for some short-term pain. "I myself think that the euro is at very significant risk of breaking up," William Langdon, president of Canadian think tank the C.D. Howe Institute, says. "I'm a bit surprised that the baseline forecast that people are using continues to imagine that Europe's going to muddle through somehow," he adds. "The arithmetic is against them. The more time the EU buys, the worse things get. I think any realistic risk assessment has to at least envision that Greece, particularly, exits the euro simply because the agony of staying in will become too much after a year or two or three. That clearly exposes North

America to some problems, particularly through the financial sector because it will be messy. If it were Greece, for example, that were to reintroduce the drachma, there will be some unilateral rewriting of contracts because that's what the new currency will effectively do, right across the board. And then the additional fallout from that will be a lot of speculation around whether other peripheral countries are also going to exit the euro, which means flights of capital and credit crunches," Langdon explains.

Adrian Cooper, CEO and chief economist at Oxford Economics, a global economic consultancy based in the U.K. and New York City, says that, on a macro level, the possible "breakup" scenario of the eurozone will have catastrophic results reminiscent of 2008. "If the eurozone does fracture, then I think for Europe we're talking about a recession that is at least as deep as the downturn that we saw during the post-Lehman Brothers crisis—a very steep recession," he notes. "At the same time, the knock-on effect will be very large for countries with significant risk exposures. In the United States, for example, they'll be sufficient to generate an outright recession. Furthermore, we're likely to see a very big selloff in equity markets in Europe, and that's likely to be reflected in a big selloff in equity markets in the U.S. also."

Paul Wirth, deputy CFO of Morgan Stanley, echoes these sentiments, pointing to the contagion in financial markets that could again worsen liquidity worldwide in the near term. "While the actual consequences of the European financial crisis have been limited thus far," he says, "they loom heavy on the horizon for global organizations. Worries that Europe's crisis could worsen and spread are spooking investors and consumers and, in particular, could further slow the U.S. economy, which is already impacted by slow growth, weak hiring, stagnant pay, high energy costs, a wide trade deficit, and an uncertain political environment." Meanwhile, banks worldwide are cutting lending and creating excess liquidity reserves for what's expected to be a protracted negative environment. "Continuing diminished confidence," Wirth notes, "could freeze lending and shock the global economy further."

Rethinking Risk Strategy

What does all this mean for global companies that rely on Europe as a major export market or that have operations within the region? With the European double-dip recession well under way and the threat of the EU breakup still at hand, many senior finance executives around the world are in the process of rethinking their risk exposures on all

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fronts, under various alternative eurozone outcomes while their companies look to alternative markets in order to maintain revenues.

As Bill Murphy, national leader, Financial Risk and Regulatory Management at KPMG LLP (Canada), explains, the current euro environment is having two critical management impacts on companies with interest in the region. "First," he says, "it's leading companies to reconsider their areas of concentration and whether they should be shifting toward emerging markets and away from the more established western markets, particularly Europe. Second, it has increased management's emphasis on risk management. More specifically, companies are looking beyond their own credit facilities to those of their customers and suppliers. If there's one phrase that you hear being spoken about most significantly in all of these discussions that are taking place in the management ranks and boardrooms of both European companies and multinationals, it's credit risk."

On the credit-risk side, Murphy explains, in terms of outstanding accounts receivable for shipments, companies are making sure they understand who has the ultimate obligation for amounts that are being borrowed. "For example, if they're selling to a European manufacturer, they're beginning to look at who that company's customers are in terms of where the cash will originate to determine whether there's an indirect credit risk further down the chain that would limit their customers' ability to pay."

He adds, "Companies are also trying to get a better sense of whether European banks will be reducing their credit facilities to European businesses, which, again, could have an impact on their customers' ability to pay. At the same time, European suppliers are a significant concern to businesses both in Europe and globally, and that again requires a deeper understanding of the supplier's financial situation. That's kind of understanding credit risk beyond your own organization."

Minimizing Exposure to a Downturn

Clearwater Seafoods is a North American seafood company with a large international fishing fleet and processing plants. With 38% of its annual sales coming from the EU, the company is redoubling its efforts to minimize its exposure to a potential downturn in sales should the worst-case scenario in the region unfold.

First, risks associated with foreign exchange are partially mitigated by strategies to diversify sales internationally, which will reduce the impact of any country-specific economic risks on its business. Says Tyrone Cotie, treasurer at Clearwater, "What diversification has meant to us over the last year and will mean in the next five years is to move more into China. We've seen some big growth last year and this year in our Chinese sales. Over the next five years, I expect we'll also be dipping our toe into India. Second, Clearwater is executing on pricing strategies by limiting the majority of sales to short-term contracts—typically less than six months—that provide a margin for exchange rate fluctuations."

At the same time, understanding markups on the way to market is critical, Cotie adds. "It's knowing the profitability through the whole chain, so when we price products we understand how much Clearwater is making, how much the distributor is making, and how much the retailer is making so that we get our fair share of the profit pie."

Finally, Clearwater uses conservative exchange estimates in business plans coupled with a targeted foreign exchange program based on using forward contracts up to $175 million in nominal value, which is approximately 75% of its annual net foreign exchange exposure. "In this way," Cotie says, "the program enables Clearwater to lock in exchange rates up to 12 months for key sales currencies (the U.S. dollar, euro, yen, and sterling), thereby lowering the potential volatility in cash flows from derivative contracts." In terms of ensuring its customers are liquid, Clearwater regularly monitors credit availability in the EU, insures receivables, or obtains cash advances on sales.

A Natural Insulator

For other companies, the nature of their products is helping to act as a natural insulator against a dramatic downturn in the EU. Take TransCanada Turbines (TCT), for example. It's the world's largest licensed repair and overhaul facility for the industrial gas turbine engines manufactured by Rolls-Royce and General Electric (GE) that are used in the power generation and oil/gas transmission markets around the globe.

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As CFO Bev Stewart says, the company is somewhat recession proof. "We're fortunate that we're in a high-demand industry, regardless of what's happening," she explains. "People still need power, and our clients still need the engines maintained and repaired in order to generate that power. What we do see, though, is a trend in Europe and internationally that power companies will defer maintenance, do the bare minimum, and take the risk that they can tide over the engines until their cash flow situation improves. What they're doing is waiting until the engine actually breaks. And then, of course, it costs them a lot more. That also helps our business."

At the same time, TCT can see bad news coming a long way off. "In 2009, when most companies were very badly affected by the financial crises, our business did very, very well," Stewart adds. "It wasn't until 2010, when everybody else was going into recovery, that we saw an impact." What TCT did to mitigate that was to refocus its efforts in other parts of the world. "For example," Stewart notes, "We're spending a lot of time opening up new markets in places like Africa (Nigeria), Guyana, China, and the Middle East. Not often the best in terms of political stability and commercial stability, but when some of our traditional markets are affected we have to look elsewhere."

Meanwhile, TCT has instituted a staged payment program in order to minimize default risk. "When these engines come in to be fixed, they're usually here for between two weeks and three months, and we'll be getting probably 80% of that paid before the engine even leaves the shop," Stewart says. "Since the downturn in the EU, it's been much easier to ask for staged payments. Ten years ago, staged payments in this industry were unheard of. Now it's almost standard. The other thing we also do now to reduce our risk is always deal in U.S. dollars. Very few contracts are accepted in euros nowadays."

Diversification Is Key

Estée Lauder, a global cosmetics company that manufactures and sells skincare, makeup, fragrance, and hair care products in 140 countries, manages its exposure to a downturn in the EU through diversification and by the nature of its products.

As Karen Mann, executive director at Estée Lauder, explains, luxury products generally have a pretty solid future as the number of affluent people around the world increases. "The key to that, however," she says, "is balancing those revenue streams in terms of the global markets and product diversification to meet regional needs. We've actually focused on other regions to carry some of that weight that's pulled us down in the EU."

Bombardier, based in Montreal, Canada, is one of the world's largest makers of airplanes and trains. With a 47% revenue exposure in Europe, it's also looking elsewhere around the world for new sources of demand and ways to cut overhead. According to Bombardier CFO Pierre Alary, though the rail transportation side of the business has held its ground in the EU, orders for aircraft have been very low. Consequently, the go-to markets are the BRIC (Brazil, Russia, India, and China) countries. "We have two different approaches there," he says. "For example, in China we have a manufacturing site that is a 50-50 joint venture with a Chinese partner where we actually manufacture trains for the Chinese market. That's on the transportation side. On the aerospace side, we have different agreements with state-owned Chinese companies where we have some collaboration. For example, for the Q400 series plane, the fuselage is being made in China."

In terms of cost reduction, moving from high-cost centers to lower-cost ones has meant Bombardier has also looked south of the border to Mexico. "Since the downturn in the commercial aircraft market in Europe and in the U.S., we've had to adjust our North American production downward," he notes. "But opening up a manufacturing site in Mexico for some subassembly work has allowed Bombardier to be more competitive, and, at the end of the day, has directly helped to preserve jobs overall."

Good or Bad?

As for what could happen to Greece if it leaves the euro, it isn't all bad news, says C.D. Howe President and CEO Bill Robson. "It might be a helpful thing over a longer time horizon for Greece and maybe another peripheral European country or two to leave the euro. I think that the alternative of staying in is a very prolonged recession, austerity, and a lost decade scenario. Companies that have operations in parts of Europe that might be negatively affected by the event itself would probably find themselves going forward in a somewhat better situation. It's not at all inconceivable that 18 months later the Greek economy would be growing, employment would be growing, demand would be up. There's clearly the short-run risk for companies exposed to the region, but they might find that the economics of the situation are actually better afterwards."

At the same time, should Europe pull through this current crisis, it could be all good news for international companies looking to make a play in the region at this time. According to KPMG's Bill Murphy, "If there is a solution to a stabilized eurozone, and the risks are being overstated, that might present an opportunity to run to acquire companies and facilities in Europe at bargain prices. Industry players as well as institutional investors, particularly pension plans, might think it's a good time to buy active business in the EU or real estate and infrastructure assets as well."

Meanwhile, the risk management folks will continue to sharpen their pencils to determine the possible collateral damage if the EU and eurozone remain on shaky ground. **SF**

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