CFO Survey Europe – Quarterly Report

DUKE THE FUQUA SCHOOL OF BUSINESS

TILBURG UNIVERSITY
Understanding Society

CFO Europe

Q1 2011

- *CFO Optimism Continues Positive Trend of 2010*
- *Leading to M&A Activity in 2011?*
- *Question Marks for Emergency Fund*

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Introduction

M&A part of the growth strategy again?

Hiring remains modest but job types indicate signs of possible economic recovery

European financial sector remains problem child

European CFOs' optimism on own country remains in the trail of the rest of the world

The first quarter of 2011 is characterized by increased optimism about the economy and own company. The positive sentiment during Q4 of 2010 may have proven to be substantial and persistent.

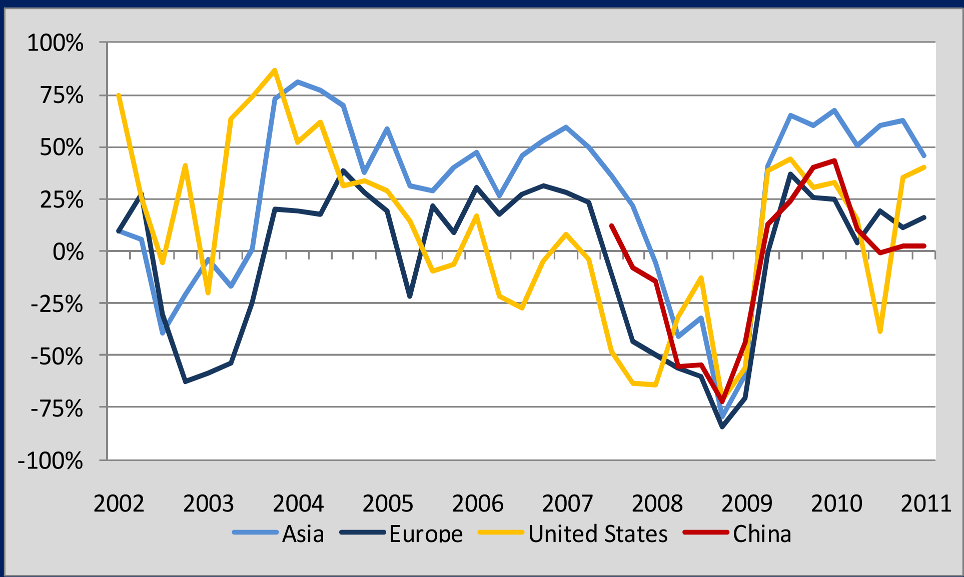
This may have contributed to the fact that M&A activities are gaining in popularity and are considered as the main driver of growth again. Although hiring remains modest, the job categories that are in strong demand (highly skilled jobs in Finance, IT, Marketing, Sales and Product Development) may possibly signal an upturn in the economy as well.

Notwithstanding these favorable sentiments, European CFOs also display a sense of prudence and caution when it comes to the European financial sector. The initiatives in the European Union to restore confidence in the market have been received with mixed feelings among the European CFOs. Many CFOs for example are of the opinion that the European Financial Stability Facility in its current format is not the proper instrument to bring about the necessary turnaround in the financial markets.

Moreover, a small majority of the CFOs believes that banks are in general over-leveraged. Most of them are also worried that the developments in the banking sector and possibly the political attention that it is given will stimulate institutions to shift risky activities to parts of the financial sector that are less regulated and less transparent. Around seventy percent of the CFOs believes there is a need for a Europe-wide bank oversight institution to oversee and regulate cross-border banks.

Almost one out of four CFOs perceives it as possible that one or more eurozone countries will leave the monetary union within the next five years.

Figure 1. Optimism index for CFOs in Asia, Europe, US and China



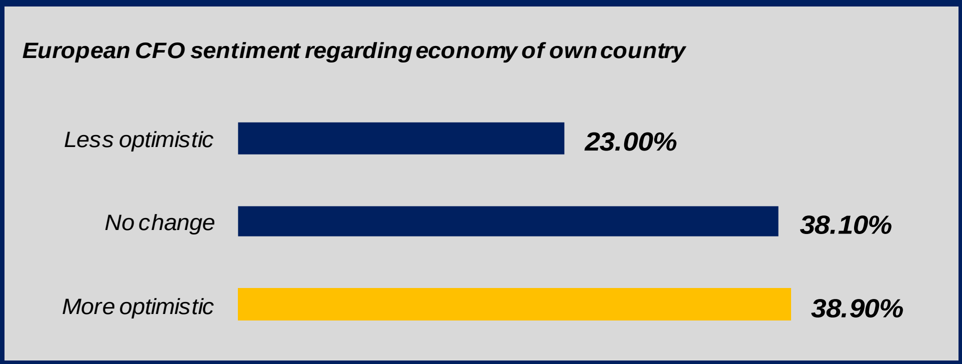
CFO optimism & sentiment

Economic sentiment is positive

In the first quarter of 2011, CFO's optimism about the own economy continues the trend of Q4 2010. With 38.9% of the European CFO's being more optimistic the average optimism index has increased to a level of 58.9 (on a scale of 0 to 100). 23% of the CFO's is less optimistic.

Figure 2. European CFO sentiment regarding economy of own country

Favorable outlook is shared among larger group of optimists

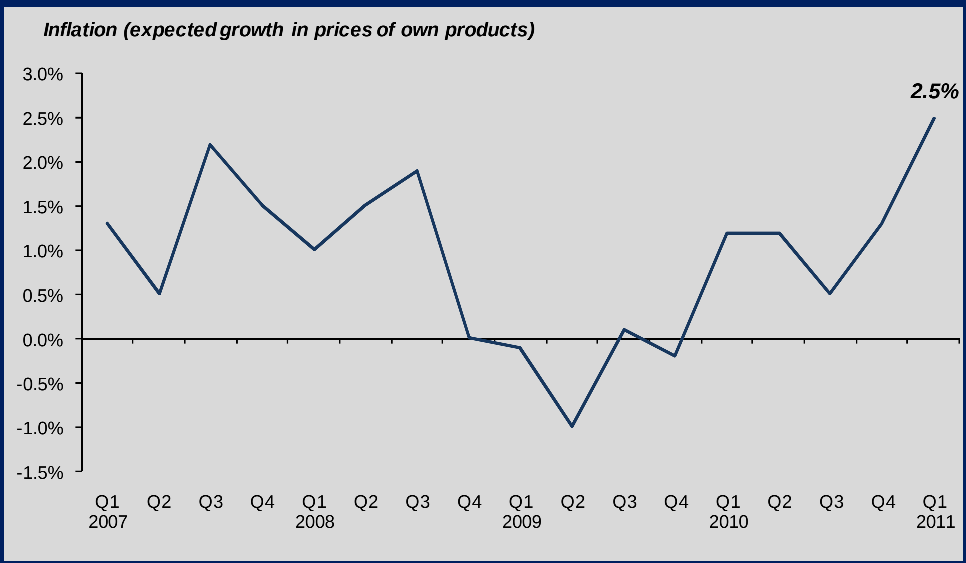


Consumer demand and price pressure are top concerns of CFOs

Similar to Q4 2010, primary concerns include consumer demand and price pressure. European companies expect prices of their products to increase by 2.5% during the next 12 months, indicating moderate price pressure in the near term. The expected increase in prices for this quarter has also reached its highest point since the beginning of 2007 and has been on a steady incline for the last three quarters.

Figure 3. Inflation expectations measured by price increase of companies' own products

Expected growth in prices of own products steadily increasing….



….Instigated by rising commodity prices

Inflation has begun to worry CFOs as fuel and commodity price inflation are among the top six corporate concerns. The cost of fuel is therefore likely to be closely monitored by many CFOs this quarter. With the current unrest in some Middle Eastern countries and the risk of spill-over effects to other major oil producing states, the energy intensive industries have good reasons for concern.

Figure 4. Oil price development OPEC, non-OPEC, and Brent (2007 to date)

Source: EIA statistics

However, the uptick in oil price levels should not be attributed to an increase of the (geopolitical) risk premium alone. Fundamentals such as supply and demand continue to have a central role. With the global economy slowly improving, it is only natural that demand for oil picks up and inventories fall back to their normal levels. This will have an upward effect on the oil prices. Moreover, the huge "financialization" of the oil market that has taken place in the last decade may possibly exacerbate these price movements. Speculation through futures trading in the oil market is regarded by many as one of the primary reasons for the 2008 spike in oil price levels.

Rising capacity utilization may signal longer term inflation

Exacerbating the inflationary concerns, the capacity utilization (a measure of actual output versus potential output) of manufacturing firms will increase during 2011 to more than 80%, up 5% from last year's level according to the data provided by the CFOs.

The (global) financial instability is a top concern to CFOs

The stability of the finance and banking system also remains another top concern for European CFOs. In reaction to the financial crisis and its implications on countries such as Greece and Ireland, the eurozone member states have created the European Financial Stability Facility (EFSF) in May 2010. However, the larger part of European CFOs (more than 70%) is of the opinion that the EFSF is either entirely inadequate or has insufficient funds and/or powers allocated to it.

The EFSF as answer to the financial crisis in Europe but deemed inappropriate in its current form

- 13% of the CFOs believe the EFSF is by all means an inadequate instrument.
- More than 30% of the respondents feel that the facility should be allowed to buy government bonds and recapitalize banks directly. In short, the mandate should be expanded with more powers.
- Another 13% believe that the EFSF should be allocated more funds.

- More than 13% is of the opinion that the facility has the potential to regain the stability in the Euro area if only the mandate would be expanded with more powers and the allocated funding (currently EUR 440 billion) would increase.

EFSF should facilitate debt restructuring and economic reform

As the EFSF primarily targets the symptoms of the crisis, its effectiveness is contingent on its ability to force (failing) euro-countries to restructure their debt and implement structural economic reform (aimed at the root of the problem). Would this not be the case, then the over-indebted countries have an incentive to continue and repeat their traditional policies of indebtedness at the expense of the EU-countries funding the EFSF. A case could be made that the facility is therefore an insufficient instrument as it does not provide states with a direct incentive to pursue the necessary reform. Instead it keeps over-indebted countries artificially solvent and thus merely redistributes taxpayers' money from solvent states to creditors of insolvent states[1].

EU leaders also not unanimous yet on design of EFSF

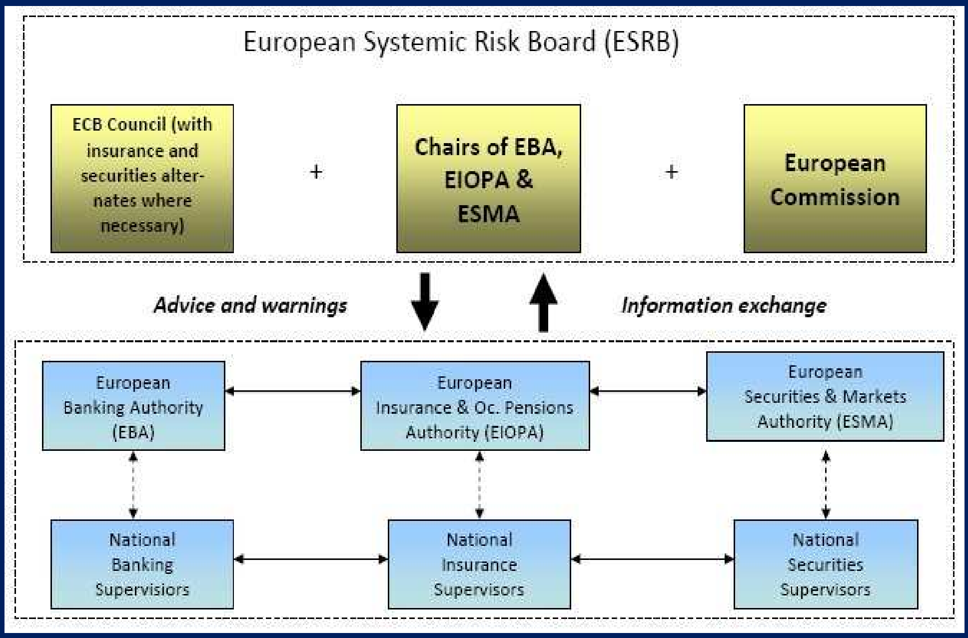
Nevertheless, EU leaders are in the process of negotiating reforms of the EFSF targeted at:

- Increasing the lending capacity
- Renegotiating interest rates and repayment schedules of EU/IMF bailouts
- Closer economic government through: debt brakes which limit the size of structural debt; a common euro area public sector retirement age; adoption of a common corporate tax rate
- Expanding the mandate to purchase government bonds (The ECB is already doing this)

On 22 September 2010, the European Parliament voted through a new supervisory framework for financial regulation in Europe that came into force in January 2011.

The new European Financial Supervisory Framework aims at consolidation and concentration of oversight and coordination of the financial sector in the European Union

Figure 5. New European Financial Supervisory Framework



[1] See Plenum der Ökonomen (http://www.wiso.uni-hamburg.de/lucke) or The plenum of German economists on the European debt crisis (http://www.voxeu.org)

As part of this framework, the European Banking Authority (EBA) came into effect on January 1st this year. The primary objective of the EBA is to ensure common regulatory and supervisory standards throughout the European Union. The integrated financial market of the EU has allowed cross border banks to act as a catalyst in spreading the crisis. The fragmented (decentralized) national supervisory structures on the other hand, have proven to be inadequate in dealing with this crisis in its full breadth. Nor were they able to effectively work in concert with each other.

Centralizing oversight and regulation of the banking sector to enhance a safer and more effective system is considered by most CFOs as desirable

To adequately deal with the systemic risks that large (cross-border) banks and financial institutions pose, centralization of oversight and regulation may turn out to be desirable. 72% of the European CFOs is of the opinion that a European institution engaged in such centralized activities would indeed contribute to a safer and effective European banking sector. 17% however, believes that supervision and regulation is a national affair and should therefore remain the responsibility of that nation.

At the moment the EBA functions through a relatively high level of decentralization with a focus on harmonization by enforcing cooperation between the national supervisors. Whether the EBA turns out to be effective in its current format and capacity remains to be seen. As the EBA is also created to bring back confidence in the European financial market its credibility is already heavily tested in the coming period as it coordinates the EU-wide stress tests for 88 banks.

Banks perceived as overleveraged

The tests are aimed at assessing the solvency of the banks and the sufficiency of their capital base. 57% of the European CFOs believes that banks, in general, are overleveraged.

But not only banks pose a threat to the financial system

As the banking sector is now under heavy scrutiny a small majority of CFOs (53.5%) perceives it somewhat likely to very likely that risk-taking activities will be shifted to less regulated financial sectors and companies.

Unclear whether risk-taking will shift to less regulated parts of the financial sector as the EU is also poised to increase regulation in those parts out of the EBA's scope

The EU is however very keen on extending regulation and oversight to those parts of the financial sector which have traditionally been less transparent and considered as opaque. The European Securities and Markets Authority (ESMA) for instance, takes a central role in regulating and monitoring a large part of the securities and investment markets, including alternative funds. Regulations require hedge funds, private-equity funds and commodity funds to:

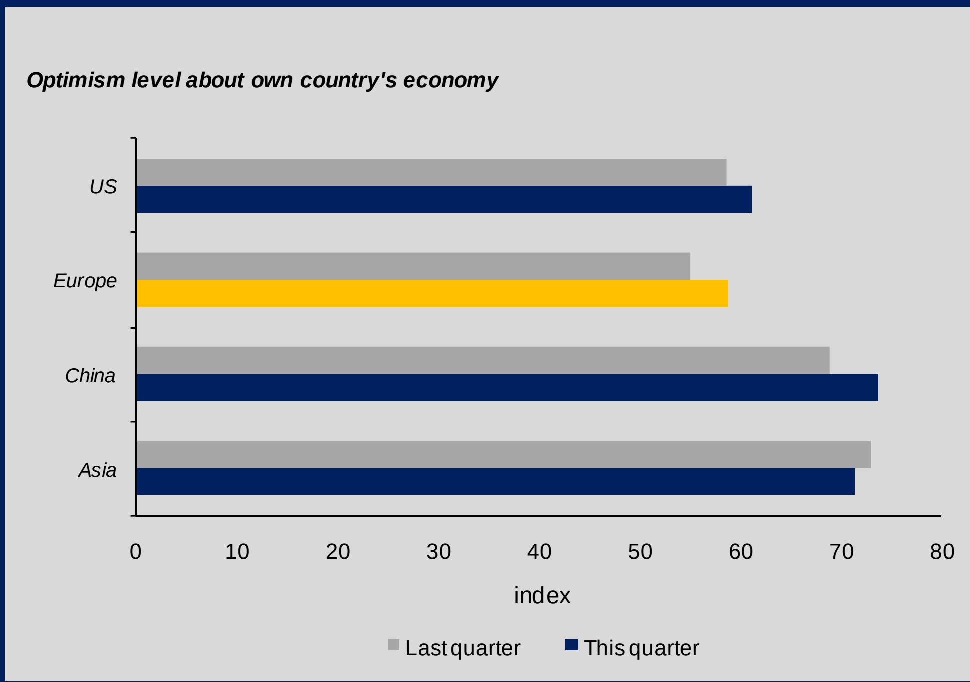
- inform regulators and investors about their activities
- retain capital to protect themselves from default
- use depository banks to safeguard their investors' money

However, as member states have until 2013 to implement these into national law it will take some time before it is clear whether the new regulations are effective, sufficient and properly designed.

The persistence of the financial crisis and the uncertainty about the effectiveness of the just recently established EU-wide financial supervisory framework might therefore explain the fact that the optimism level in Europe still trails that of other parts in the world. Overall, we can conclude that the CFO's optimism about his or her own economy is gaining momentum again.

Optimism level about the economy in European countries back on track but still trailing the rest of the world

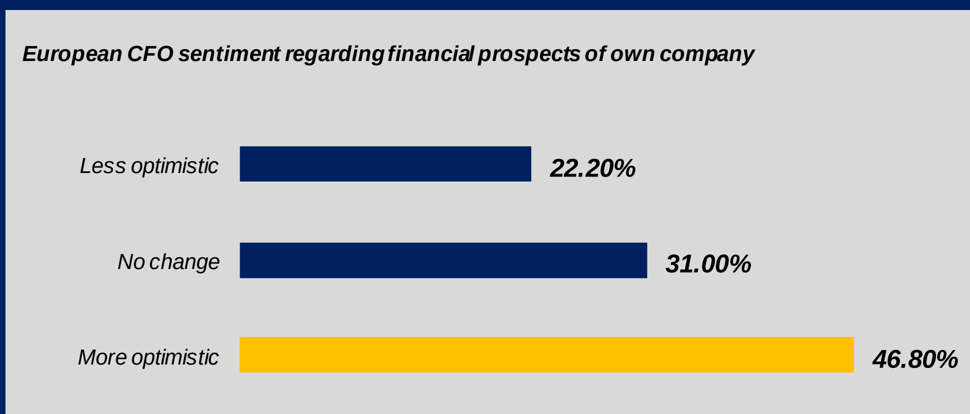
Figure 6. CFOs' optimism level compared to last quarter



Also during Q1 2011 CFOs are (on average) more optimistic about the financial prospects of their own company then they are on the economy. Roughly 47% of the respondents are more optimistic about their own company when compared to last quarter. Although this group of optimists has slightly decreased in number from 50% in Q4 2010, the average level of optimism has increased to 64.2, a level which has not been observed since 2008.

On average, CFOs remain more optimistic about their own company than they are about the economy of their own country

Figure 7. European CFO sentiment regarding financial prospects of own company



Around 22% of the CFOs are less optimistic about the financial prospects of their own organization. The fact that the ability to

But maintaining (profit) margins is a pre-condition which has now come under pressure

maintain margins and to forecast results are considered as primary internal concerns by most CFOs may provide explanation for this. In addition, borrowing conditions haven't improved for most companies, possibly exacerbating the pessimistic view of these CFOs.

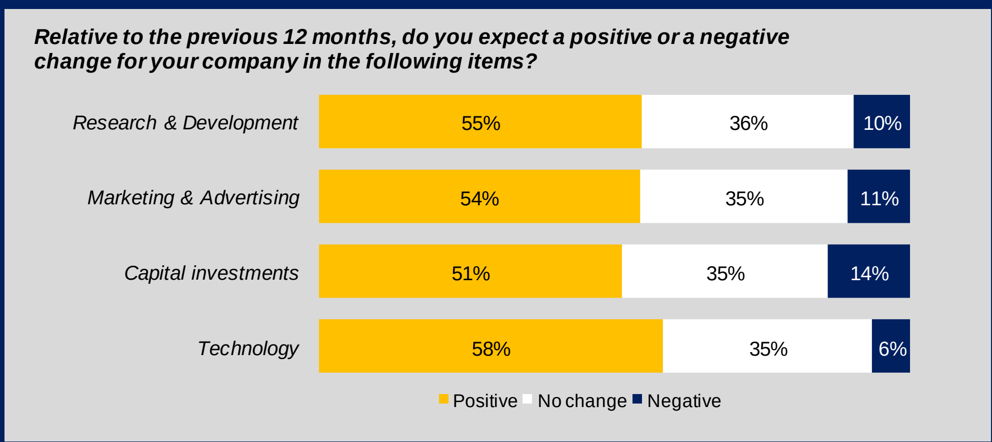
Nevertheless, optimism about the own company has reached its highest level since 2008

Figure 8. European CFO level of optimism regarding financial prospects of own company

The positive outlook during Q4 2010 on corporate spending is continued during the first quarter of 2011. Comparable to last quarter, more than half of the CFOs expect increased spending across the board.

Corporate spending on major business drivers is expected to continue last quarter's trend….

Figure 9. Breakdown of CFOs' responses to questions regarding corporate spending



Expectations on actual spending are a bit tempered though in comparison with the fourth quarter of last year:

- CFOs in Europe expect that capital spending and investments will grow with 4.3% compared to an expected growth rate of 6.8% during the previous quarter.

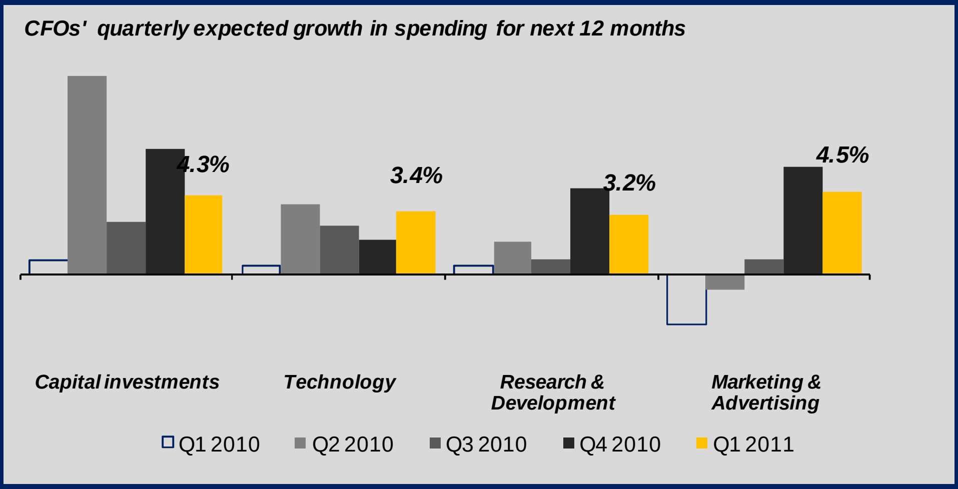
- R&D expenditure is expected to increase by 3.2%. Although not as high as the 4.6% of last quarter, the trend is continued in a positive fashion

- Corporate spending on advertising and marketing is estimated at 4.5% compared to last quarter's growth rate of 5.8%.

Although these growth rates are not spectacular they do indicate that the positive development in corporate spending, which picked up in 2010, might be of a structural nature as conditions for companies and the economy as a whole are slowly improving.

….but will translate into slightly lower budgets compared to Q4 2010

Figure 10. Expectations on corporate spending.

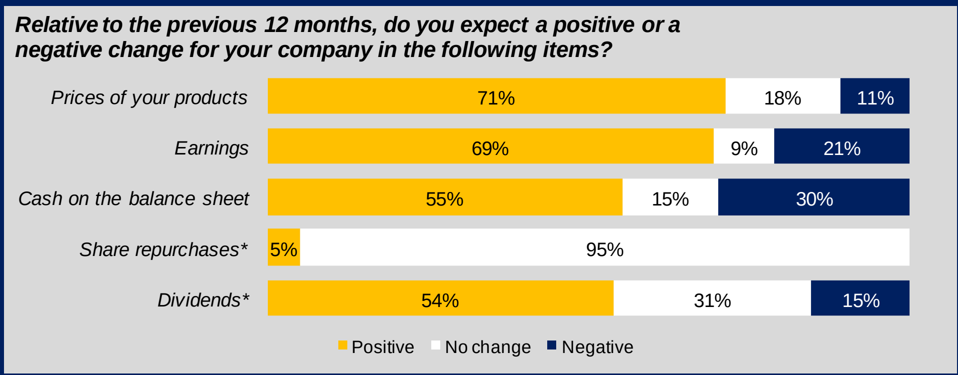


Finance & capital

The optimistic sentiment among European CFOs is supported by the earnings data

The overall optimistic sentiment among European CFOs is also reflected in their expectations with regard to balance sheet and income statement components. A significant number of CFOs believe that the prices of their products will increase. Whereas last quarter only 57% of the respondents were expecting a positive price development, this quarter almost three out of four CFOs expect that prices will experience an upward trend. The larger part of companies foresees positive changes in earnings and cash reserves. 54% of the CFOs also expect dividends to pickup momentum this quarter.

Figure 11. Breakdown of CFOs' responses to questions regarding finances

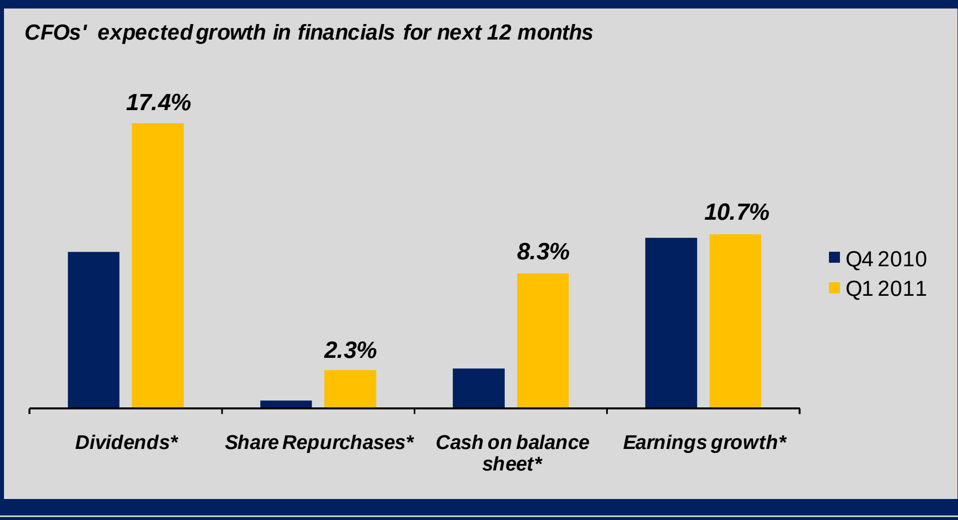


Publicly listed companies are leading the way with expectations improving quarter on quarter. For the next twelve months CFOs anticipate growth in:

- Corporate earnings of almost 11%
- Cash on balance sheet of 8.3%
- Dividends distribution at an extraordinary 17.4%
- Share repurchases of 2.3%

Publicly listed companies exhibit extraordinary growth expectations

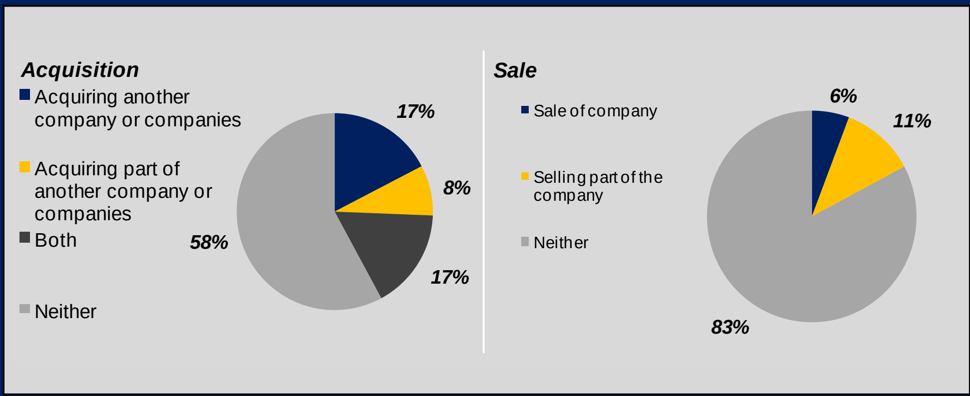
Figure 12. CFOs' expected growth in financials (publicly listed companies only)



Will cash reserves finally be deployed for M&A purposes in 2011?

In last quarter's survey more than halve of the CFOs expressed their intentions on deploying the cash reserves of their respective companies for the purpose of capital investments, debt repayment and financing of mergers and acquisitions. This quarter seems to underline this again as mergers and acquisitions are expected to experience an uptick in 2011. More than 42% of the European CFOs indicate that their company plans to acquire another company, part of another company or both. 83% of the CFOs have no plans in the pipeline that include selling the company or parts of the company, indirectly evidencing that the overall (intended) M&A activity is aimed at growth.

Figure 13. M&A planning (acquisition and sale)



Data indicates an appetite for mergers and acquisitions

Combined with the modest expectations with respect to growth in capital investments, technology spending, R&D, and marketing and advertising this could very well be a prelude of a shift in the growth strategy of companies. Whereas companies may have put emphasis on organic growth in recent years, growth by means of mergers and acquisitions may become the dominating strategy again whereby focus is put on:

Predominantly as part of the business growth strategy

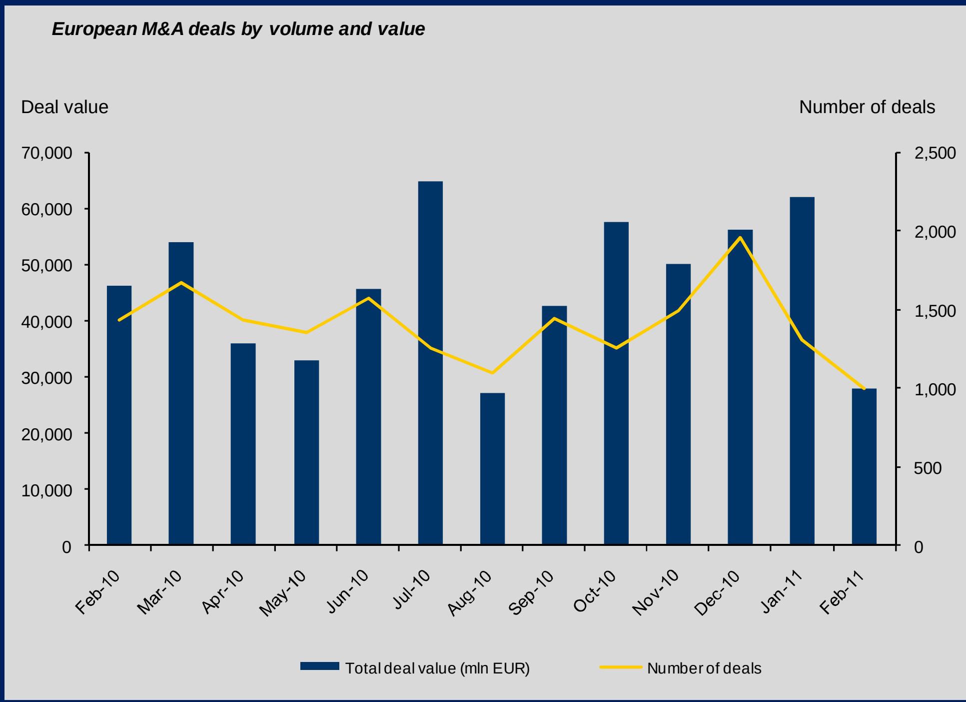
- Gaining market share in existing market(s)
- Expanding geographical presence
- Acquiring high-growth business
- Cutting costs via economies of scale
- Expand scope of product offerings

At the moment, there is no evidence yet of a strong uptick in the M&A market. Data shows that during the start of 2011, actual deal volumes and deal values have been relatively low when compared to 2010. However, other surveys also report expectations on growth in the M&A market. The Thomson Reuter survey (2011 Outlook for investment banking services) projects an overall growth of 36% with the financial sector and real estate in the lead.

With increasing cash reserves, publicly listed companies in better position to explore potential deals

Publicly listed companies in particular seem to be in the right position to engage in M&A activities. From mid 2010 onwards, CFOs from listed companies already had very favorable prognoses regarding earnings growth. Their expected growth in earnings has remained above the 10% ever since. This does not only seem to be translated into opportunities for share buybacks (with an expected growth of 2.3% this quarter) or dividend payments (an extraordinary expected growth of 17.4% this quarter) but also into expected growth of cash reserves (8.3%), the primary means to finance M&A activity.

Figure 14. Overview of M&A deals in Europe (2010-to date)



Source: Zephyr published by BvD

Actual M&A activity still very limited though in the first two months of 2011

In general, the business landscape seems to support M&A activity as several major drivers seem to be moving in the right direction. As confidence in future earnings grows firms are more prone to make acquisitions to keep up with competition. Moreover, the global crisis has also created opportunities for those companies that survived. Availability of high quality assets which are typically undervalued as a result of the crisis makes an attractive investment case. This could explain why we can observe M&A activity across a diverse set of sectors.

Figure 15. M&A deals by volume in top five target sectors

Top five target sectors for M&A activity indicate deal potential is present in every industry

Target sector	Jan-11	Feb-11
Other services	473	377
Wholesale & retail trade	135	96
Machinery, equipment, furniture, recycling	140	92
Banks	82	73
Primary sector	71	53

Source: Zephyr published by BvD

Figure 16. M&A deals by value in top five target sectors

Consolidated industries leading the M&A deals by value possibly indicating that individual deal size is significant

Target sector (EUR mln)	Jan-11	Feb-11
Chemicals, rubber, plastics, non-metallic products	4,521	6,038
Banks	12,927	4,897
Other services	5,839	4,088
Primary sector	6,903	3,371
Metals & metal products	556	2,023

Source: Zephyr published by BvD

Employment

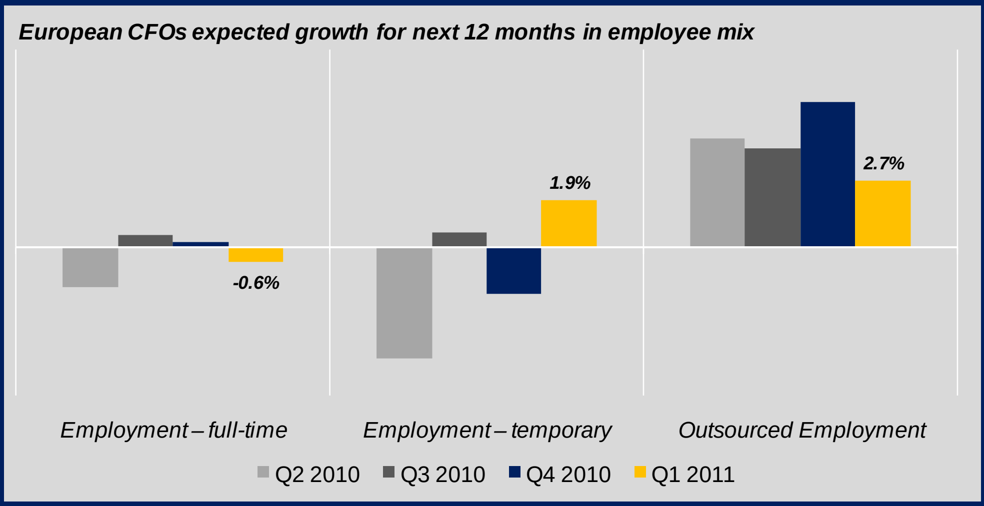
Full time employment is expected to decline….

and possibly substituted by temporary employment and outsourcing.….

having an upward effect on expenses for wages and salaries

The outlook on the labor market remains modest. The optimism has not been translated into significant hiring yet. Full-time domestic employment will decrease by 0.6%. An increase of 1.9% in temporary employment and an increase of 2.7% in outsourced employment indicate that the trend of last quarter is persistent (outsourced employment outweighs full-time and temporary employment for the fifth consecutive quarter). The fact that temporary employment is expected to increase and full time employment to decrease could also explain why 80% of the European CFOs expect wages and salary expenses to increase.

Figure 17. Expected growth in employment



The severity of the financial crisis is evident:

Some companies find it unlikely to return to pre-recession employment levels

Others will need an increase of 20+% in revenues to return to prerecession levels

The structural shift in the employee mix, where companies refrain from engaging in long term contract with their employees, is a sign that uncertainty about whether or not the economy will maintain its momentum still prevails. When asked what it would take for employment to return to pre-recession levels, one out of four CFOs indicated that they do not expect to return to pre-recession levels at all. 40% of the companies is already back on track with employment levels similar to those in 2007.

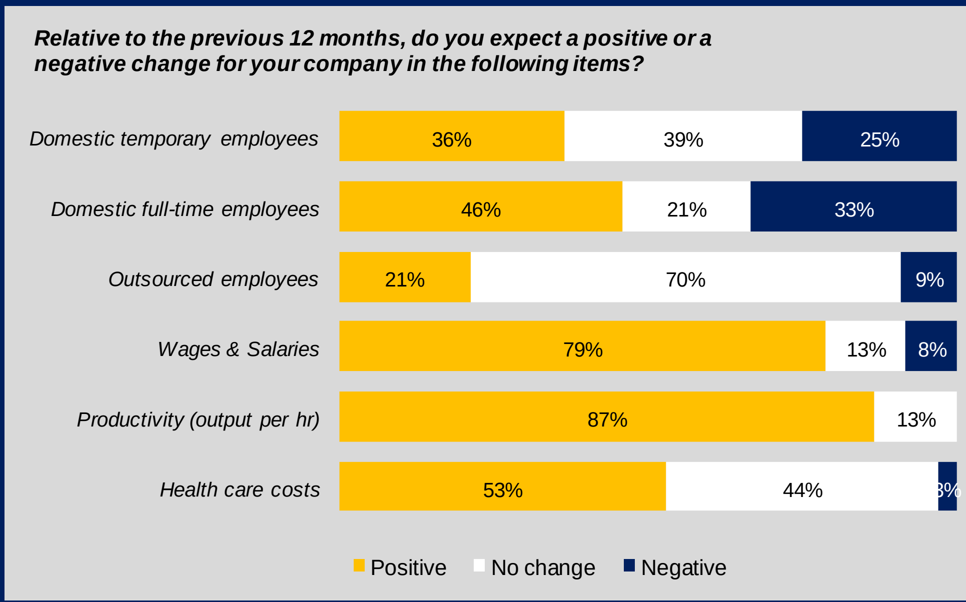
Another 35% however, is convinced that pre-recession levels can only be obtained with significant increases in revenue. This group has indicated that they will need (on average) an increase of around 22% in gross returns exhibiting once more the severity of the financial crisis.

Though 87% of the CFOs expect productivity to increase (at an average rate of 3.7%), one of their top concerns includes difficulty in attracting skilled employees. Among those firms that are hiring, it is

Those companies that are hiring have a strong demand for highly skilled and trained professionals

interesting to see that they have a very strong need for skilled and specialized labor and professional staff. Besides marketing, finance and IT staff, demand is greatest for sales staff and engineers/product developers. The fact that the latter two top the list of most needed job functions (38% and 35% respectively) could provide evidence that confidence in the economy is improving.

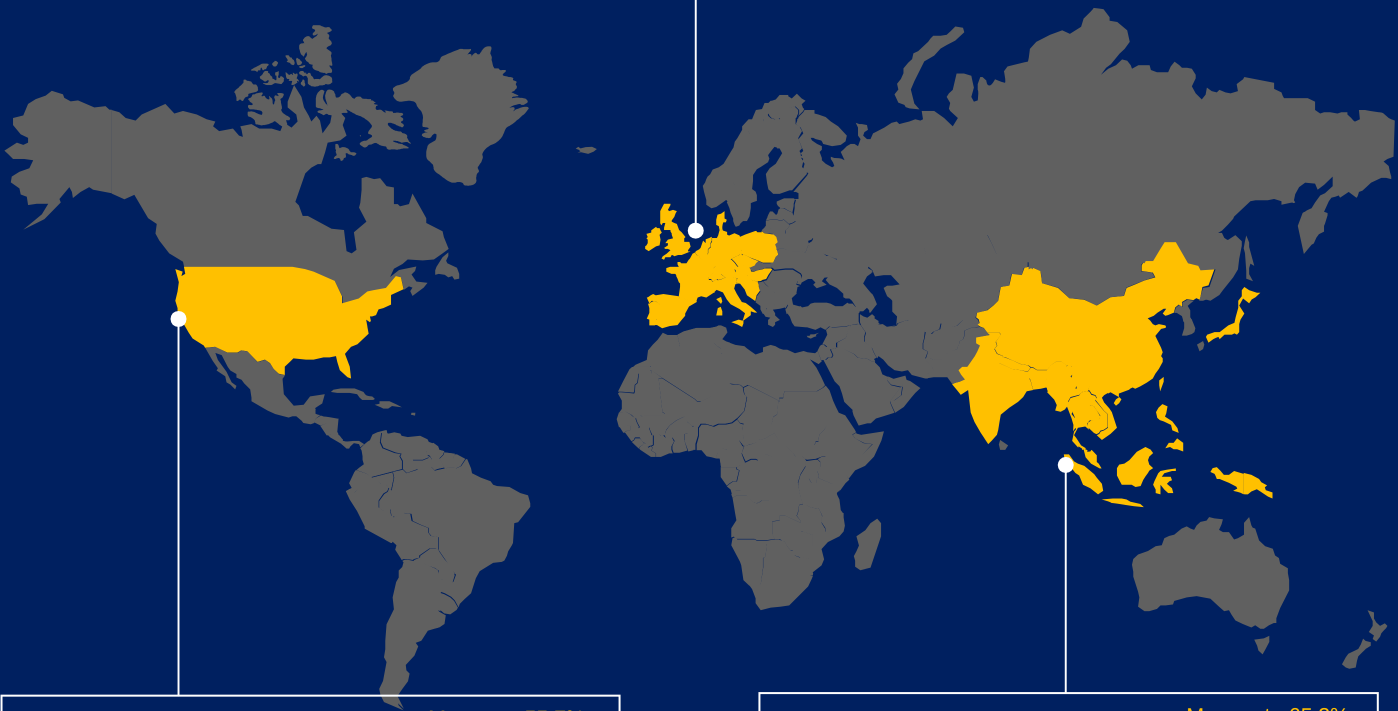
Figure 18. CFOs' anticipated developments in employee hiring, productivity and wages



Key results CFO Survey – Europe, US and Asia

Optimism about the country's economy	More opt: 38.9% Less opt: 23.0% No chg: 38.1%
Country optimism level	58.9
Optimism about own company	More opt: 46.8% Less opt: 22.2% No chg: 31.0%
Own company optimism level	64.2
Capital spending	4.3%
Technology spending	3.4%
R&D spending	3.2%
Advertising and marketing spending	4.5%

Employment – full-time	-0.6%
Employment – temporary	1.9%
Outsourced Employment	2.7%
Wages and Salaries	2.1%
Productivity	3.7%
Inflation (own-firm products)	2.5%
Earnings growth*	10.7%
Dividends*	17.4%
Share Repurchases*	2.3%
Cash on balance sheet*	8.3%
Mergers and Acquisitions	43.1% buy side 17.1% sell side



Optimism about the U.S. economy	More opt: 55.7% Less opt: 15.6% No chg: 28.7%
U. S. optimism level (0 to 100)	61.3
Optimism about own company	More opt: 52.1% Less opt: 19.1% No chg: 28.8%
Own company optimism level	67
Capital spending	12.1%
Technology spending	5.5%
R&D spending	4.1%
Advertising and marketing spending	3.7%
Employment – full-time	1.2%
Employment – temporary	0.3%
Outsourced Employment	3.0%
Wages and Salaries	2.8%
Productivity	2.9%
Inflation (own-firm products)	2.3%
Earnings growth*	18.1%
Dividends*	14.4%
Share Repurchases*	2.5%
Cash on balance sheet*	6.4%
Mergers and Acquisitions	35.9% buy side 13.7 sell side

Optimism about the country's economy	More opt: 65.2% Less opt: 19.7% No chg: 15.2%
Country optimism level	71.5
Optimism about own company	More opt: 66.4% Less opt: 16.0% No chg: 17.6%
Own company optimism level	77
Capital spending	14.6%
Technology spending	6.7%
R&D spending	6.1%
Advertising and marketing spending	8.8%
Employment – full-time	9.3%
Employment – temporary	4.2%
Outsourced Employment	3.0%
Wages and Salaries	8.0%
Productivity	6.8%
Inflation (own-firm products)	3.8%
Earnings growth*	8.8%
Dividends*	4.5%
Share Repurchases*	0.0%
Cash on balance sheet*	-2.1%
Mergers and Acquisitions	34.4% buy side 15.1% sell side

Percentages indicate this quarter's expected growth rates for the next twelve months
** Indicates public firms only*

About CFO Survey

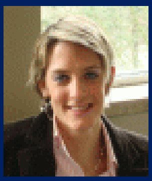
All the figures quoted above are taken from the Global CFO Survey for the first quarter of 2011. The survey concluded March 3, 2011. Every quarter, CFOs in Europe, the US, Asia and China are questioned about their economic expectations. Current records go back 60 quarters. The CFO Survey is conducted jointly by Tilburg University, Duke University (Durham, North Carolina) and CFO Magazine.

Note for the Press

The full results, including summary tables and previous editions of the CFO Survey can be found at www.cfosurveyeurope.org. For further information, please contact Reggy Peters, Tilburg School of Economics and Management, tel. +31-(0)13-4662993 or e-mail: r.p.peters@uvt.nl.

CFO Survey Europe team

Kees Koedijk
Professor Financial Management
Dean Tilburg School of Economics & Management



Reggy Peters (contactperson)
Science Communication & Press Officer
r.p.peters@uvt.nl
+31-(0)13-4662993

Christian Staupe
Research and Policy Officer
c.p.staupe@uvt.nl
+31-(0)13-4668902