CFO Survey Europe – Quarterly Report

DUKE THE FUQUA SCHOOL OF BUSINESS

TILBURG UNIVERSITY

Understanding Society

CFO Europe

Q2 2011

- *Decline in CFO Optimism*
- *The Greek Tragedy at its Climax?*
- *Significant Shift in Employee Mix Expected*

Contents

Introduction

European debt crisis continues to worry CFOs

Shaky prospects for the economy and the unrelenting severity of the debt crisis in Europe have dampened positive spirits over the last quarter. Two thirds of Europe's CFOs regard restructuring of Greece's national debt as inevitable.

European CFOs' optimism about their own company's fortunes remains steady, evidenced by rising investment and more staff on permanent contracts.

CFO sentiment has dropped to last year's level

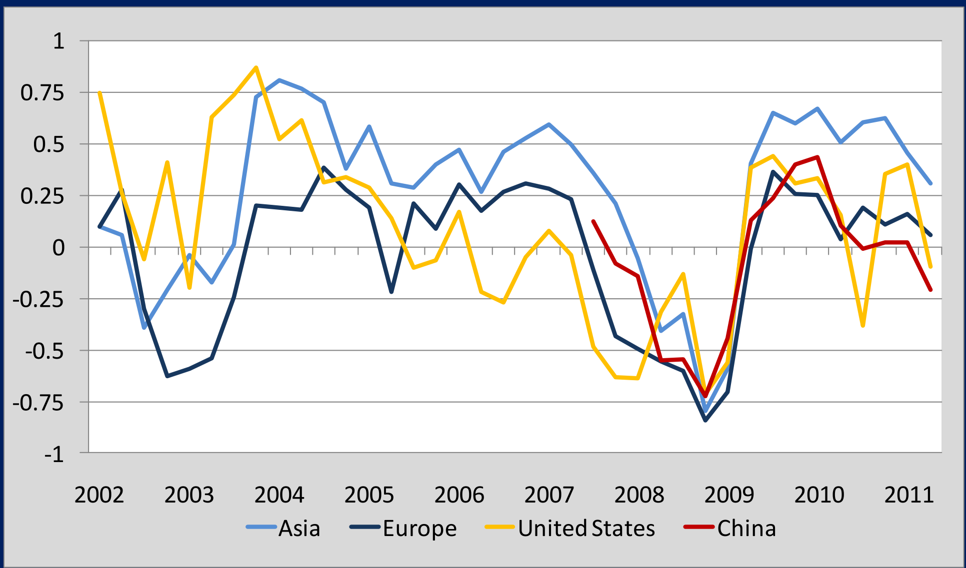
Worldwide, optimism about the economy has dropped to the same level as one year ago. While 56% of American CFOs remained optimistic about the US economy in the preceding quarter, this number has plunged to below 27%. The US economy has yet to show signs of the improvement that was still being expected in the previous two quarters.

In Asia too, the number of optimists has fallen considerably to a total of 57%. In Europe only 28% of financial directors say they are still optimistic about the economy.

As the crisis deepens CFOs brace for another European recession or depression

The debt crisis has led to stringent austerity measures being imposed on Spain, Greece, Ireland and Portugal, measures which are bound to inhibit economic growth. As a result, the CFOs estimate that there is at least a 30% chance that Europe will be hit by a new recession within the next two years. The probability of an economic depression in one of Europe's member states is even estimated at 48%.

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



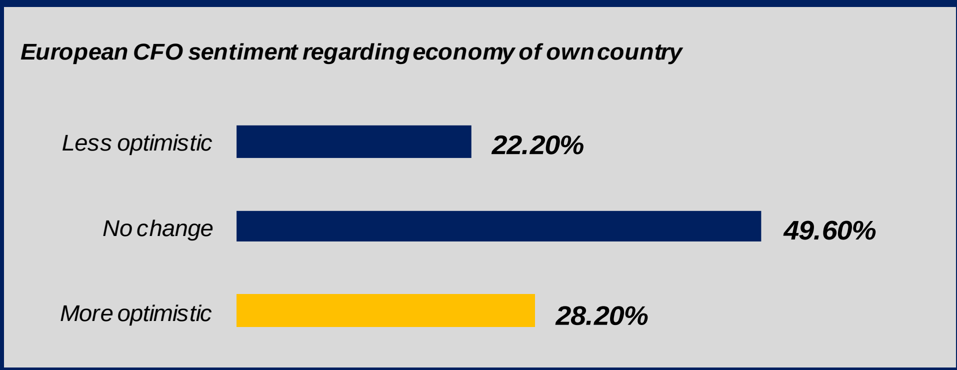
CFO optimism & sentiment

The optimism of European CFOs remains steady during the second quarter of 2011. Almost halve of the financial executives consider this period's economic outlook for their own country to be the same as the previous. Thus, the average optimism index is maintained at 58.5 (on a scale of 100).

Figure 2. European CFO sentiment regarding economy of own country

European optimism for the larger part unchanged

Less optimists and pessimists

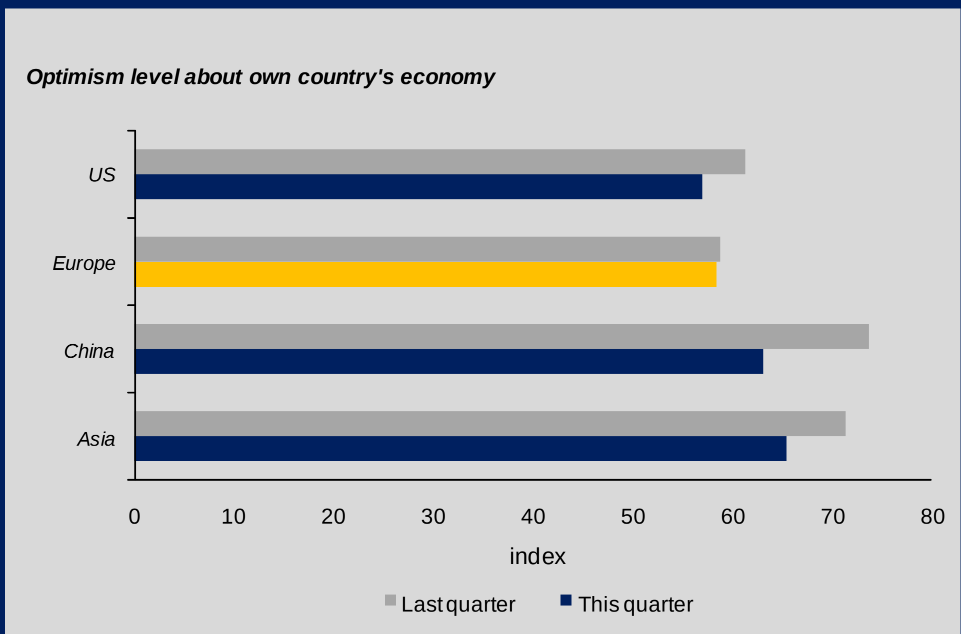


Global macro economic confidence under pressure due to continued worries on consumer demand and price pressure

Regions such as the US and Asia have witnessed a significant decline in the CFO optimism level this quarter compared to previous. The US CFOs for example, state that federal government policies and the federal budget deficit are their top concerns. In combination with continued worries about consumer demand and price pressure from competitors this may very well explain the deterioration in macro economic confidence.

Figure 3. CFOs optimism level compared to last quarter

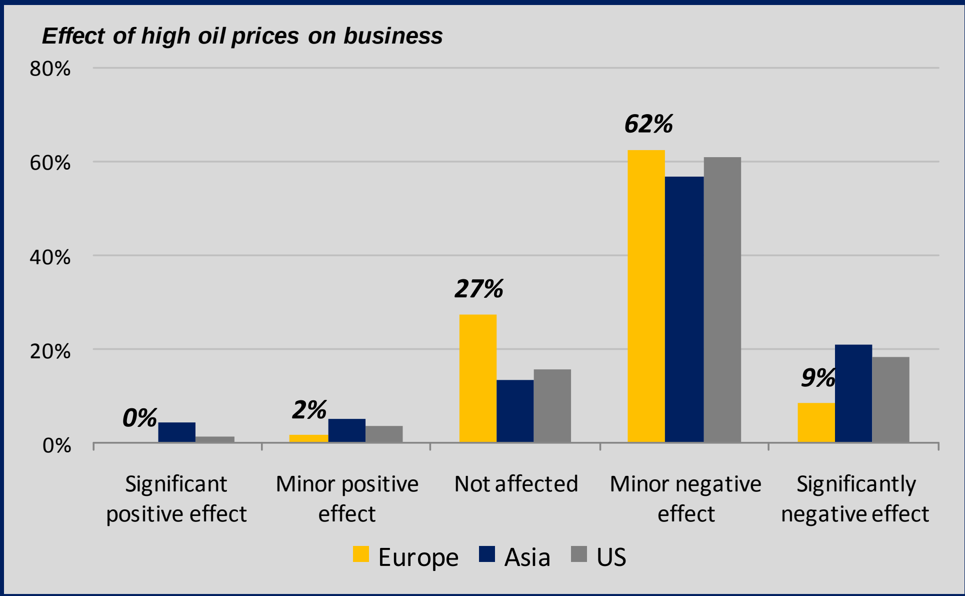
Translates in significant decline of optimism levels



One of the top macro concerns on the CFO-agenda in the Asian region is the rising cost of fuel. The recent surge in oil prices has not only impacted businesses in Asia but also in Europe and the US.

High oil prices have negatively affected businesses in all major regions…

Figure 4. Effect of high oil prices on business



..with companies in the US and Asia being affected severest

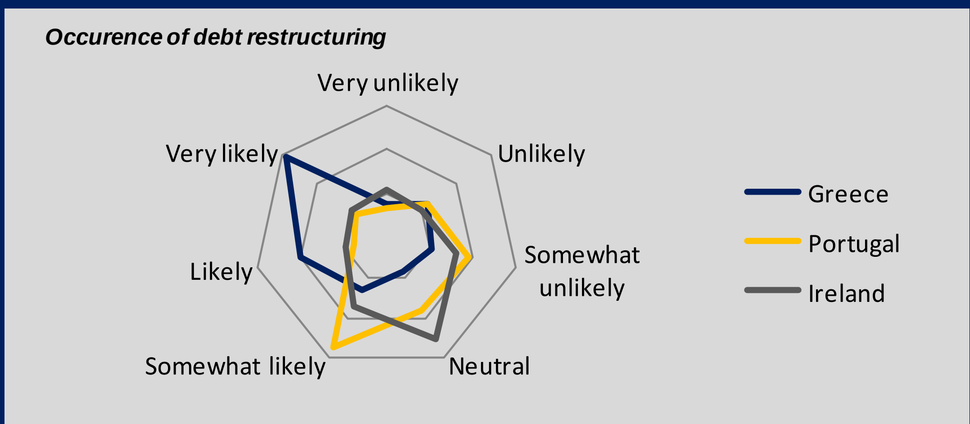
During the previous quarter, CFOs had already stated their concerns about the cost of fuel. This quarter the CFOs indicate that their companies indeed have experienced negative effects from higher oil prices. In Europe, 62% of the companies have felt minor negative effects while 9% experienced significant effects. However, this is in sharp contrast with the share of companies in the US and Asia. 18% and 21% respectively report to have experienced significant negative effects from the higher costs of fuel.

In Europe the global financial instability remains a top concern with Greece taking a central role

Continuing the trend of previous quarters, European CFOs consider the global financial instability and the credit markets (and interest rates) as one of the primary challenges faced by their companies. The current debate among European leaders on how best to deal with the sovereign debt crisis, the periphery states and the Greek situation in particular has not eased these concerns. European leaders and CFOs do not seem to be on the same wavelength with respect to Greece.

As the Greek crisis reaches its climax, European CFOs assess the chance of a debt restructuring

Figure 5. Likelihood of debt restructuring scenario in Greece, Portugal and Ireland



Massive debt pile unlikely to avoid a restructuring

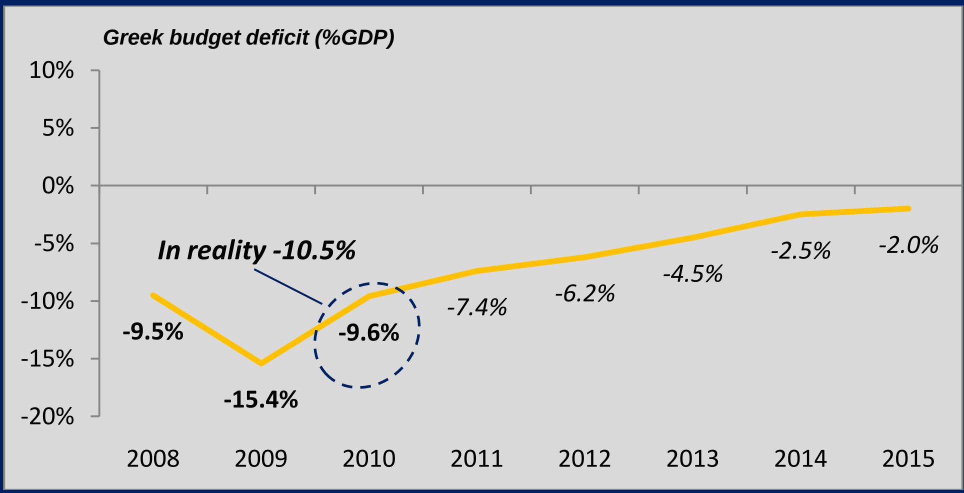
80% of the CFOs share the EU leaders' belief that Greece will default on its debt within a year if it were unable to receive additional financial aid. However, it also appears that financial executives agree to a large extent that some form of restructuring of Greek debt is a quite likely (and possibly necessary) scenario.

But what exactly is the context that we are dealing with? Greece's weak economy seems to be in a vicious cycle:

- Extensive budget deficit
- Defective fiscal system
- Low economic growth combined with poor competitive position
- A high debt pile (> EUR 350 billion)

Figure 6. Projection of Greek Budget deficit

Greek budget deficit result of poor fiscal performance and excessive government spending

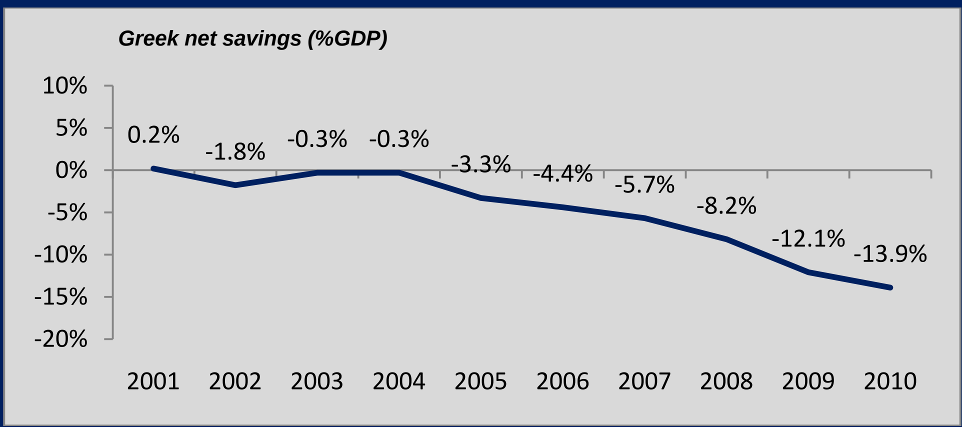


Data: IMF World Economic Outlook Database, European Commission Eurostat

The huge budget deficit (relative to GDP) is the consequence of both excessive government spending and poor fiscal performance. The Greek net savings have deteriorated significantly over the last decade, making it impossible to compensate for the budget deficit. As a result the current account has come under significant pressure.

Figure 7. Greek net savings

With no national savings in place to alleviate the problem

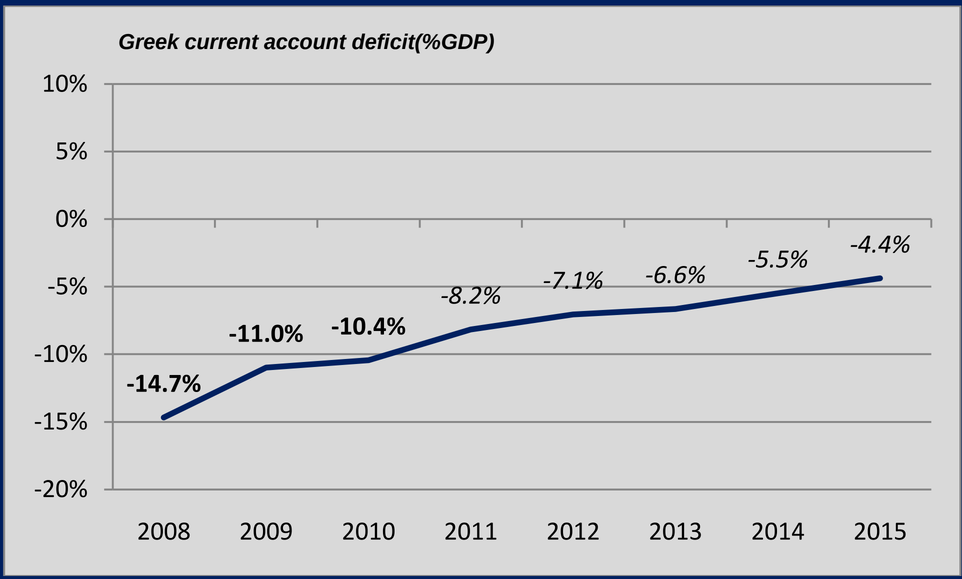


Data: Data: IMF World Economic Outlook Database, European Commission Eurostat

The weak competitive position of Greece has a detrimental effect on its current account. The fact that the level of Foreign Direct Investment in Greece has been relatively low also indicates that the current account deficit is for the larger part financed by external debt inflows.

A high and persistent current account deficit has turned Greece into a twin deficit country

Figure 8. Projection of Greek Current Account deficit



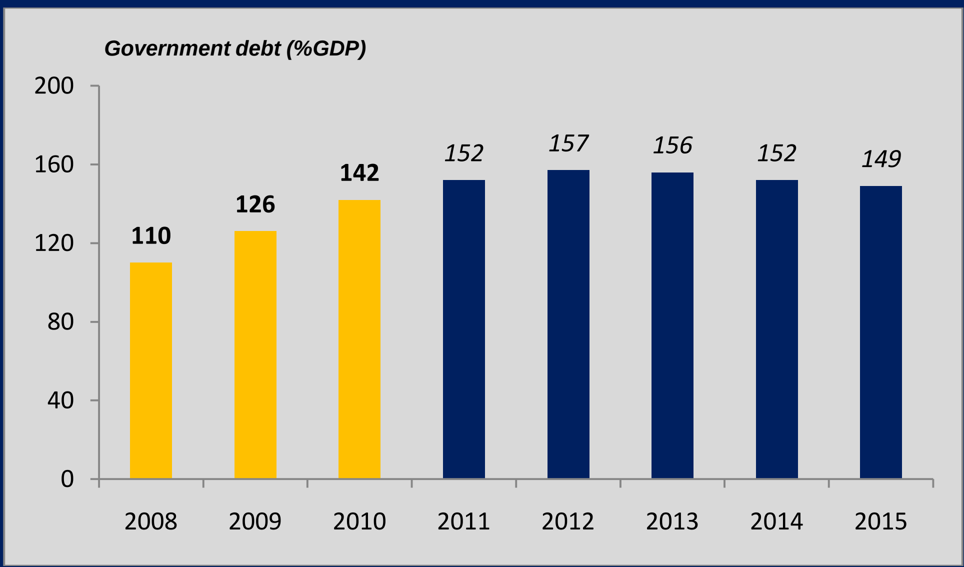
Data: IMF World Economic Outlook Database, European Commission Eurostat

Financed primarily through debt instruments

At the moment the Greek debt pile amounts to more than 150% of GDP. Research from the National Bureau for Economic Policy Analysis in the Netherlands shows that for Greece to reduce its debt to 60 percent of GDP in 2035, the Greek government is required to spend 13.7 percent of GDP annually on interest and principal payments.

Resulting in an unsustainable amount of debt

Figure 9. Greek debt as percentage of GDP



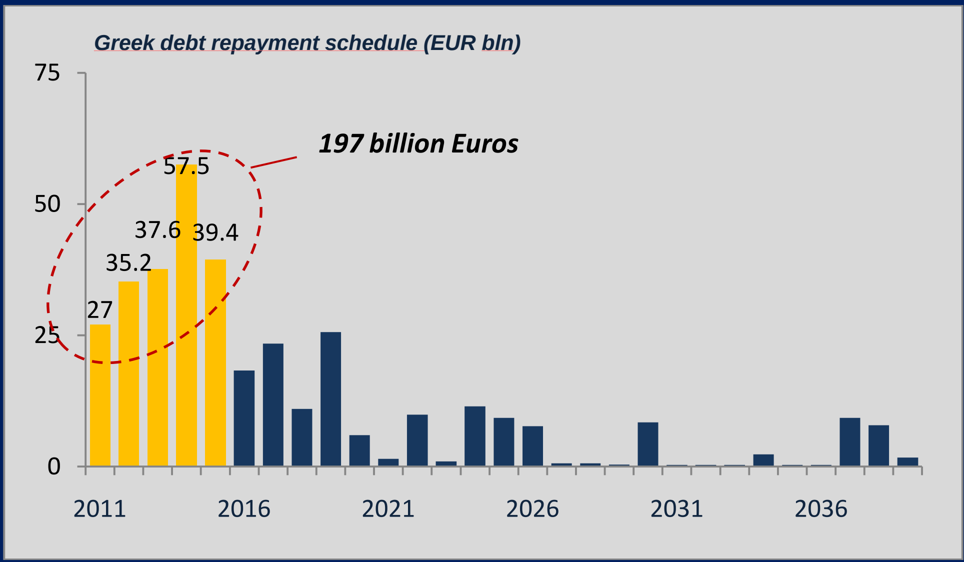
Source: data from Public Debt Management Agency (PDMA) Greece

But repayment schedule is reason for more concern

The structure of the debt pile is as worrisome as its huge size. The amount of debt that needs to be redeemed within the next five years totals EUR 197 billion. With almost EUR 355 billion of total debt outstanding, the required debt redemption during this period is 55%.

Current composition of debt requires Greece to redeem 55% of its total debt within the next five years

Figure 10. Greek debt structure



Data from Public Debt Management Agency (PDMA) Greece

"Soft" restructuring unlikely to be enough

Under the current conditions that apply, it is difficult to imagine that Greece will be able to fully redeem its debt obligations. It is for this reason that more than 70% of the European CFOs are of the opinion that EU leaders should offer Greece:

- an *extension of the repayment period* of its debts
- a *lowering of the interest rates* that it pays on its debts

However, taking the full macro economic context of Greece into account one can easily argue that the increasing debt burden is unsustainable and the Greek debacle should be viewed (and treated) as a solvency problem instead of a liquidity issue.

Solvency problem requires severe measures

It should come as no surprise that two thirds of the European CFOs believe that measures such as extending the repayment period and lowering the interest rates would prove to be insufficient to avoid (additional) restructuring.

"Hard" restructuring implying a haircut and private sector involvement is most preferred among CFOs

When asked what European policymakers should do, more than halve of the CFOs opted for a hard restructuring of Greek debt. This would involve a haircut on Greek debt whereby bondholders (predominantly banks, pension funds, and insurance companies but also governments and the ECB) are repaid less than they initially lent.

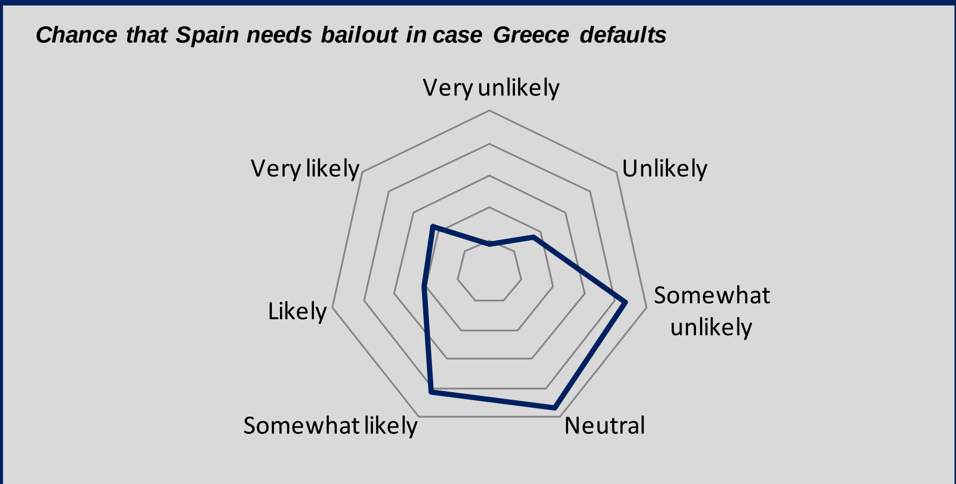
A much smaller group (31 percent) believes that European policymakers should delay any hard restructuring and inject more cash into Greece. This would mean that risk is transferred from the private sector to the public sector.

But is there a risk of contagion?

Scenarios for Greece are evaluated on basis of various factors including the degree of contagion risk. If this risk is indeed substantial, then Spain would most certainly pose the greatest threat to the Eurozone stability. At this moment there is no clear agreement among the European CFOs on the chance of Spain needing a bailout if Greece were to default.

European CFOs remain divided on potential spill-over effect

Figure 11. Contagion and spill-over effect of Greece w.r.t Spain



Preliminary research shows limited risk of exposure

Research performed at Bruegel indicates that risk of contagion might not be as severe as initially assumed by EU leaders. The research in fact shows that the exposure of banks in the Eurozone to the periphery countries is smallest for Greece. The exposure in this case amounts to approximately 13% of which 90% is through national debt exposure and 10% exposure to the Greek banking system.

Figure 12. Estimated exposure to government debt and banking system, end 2010

	Greece	Ireland	Portugal	Spain	Total
Total government debt (at face value)	325	153	142	677	1297
of which held by:					
Domestic banks	68	11	19	227	336
Rest of euro-area banks	52	14	33	79	166
Other banks	6	9	5	24	43
Non-banks (both domestic and foreign)	119	97	64	347	627
ECB	50	22	21	0	93
IMF, EU and official lenders	32	0	0	0	32
Ratio of average market value to face value of government debt	0.75	0.85	0.9	1	
Foreign banks' exposure to national banking systems	10	119	43	209	381
of which euro-area banks	6	66	37	154	264
Eurosystem lending to banks	95	132	41	65	333

Source: Bruegel, see Darvas et al (2011)

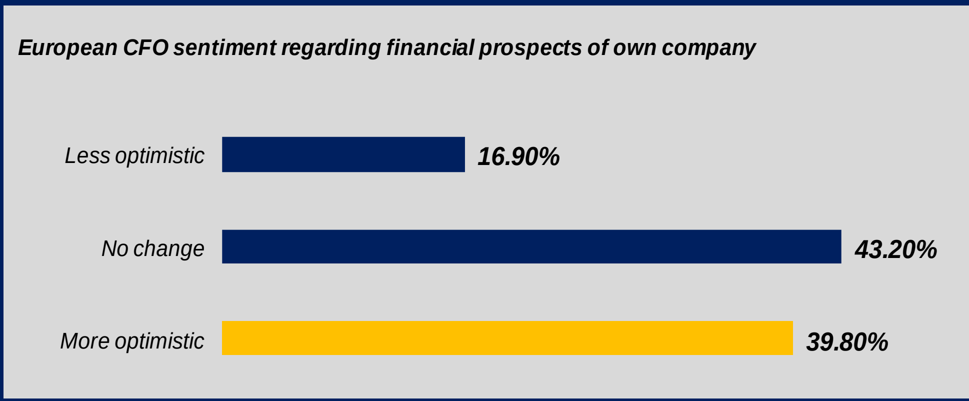
European bank stress tests should provide a more decisive answer

The stress tests planned for the European banking sector should provide more insight on the capacity of the European banks to absorb a possible sovereign default of Greece. This information is crucial for any decision pertaining to a Greek restructuring program.

Following the trend of previous quarters, European CFOs remain more optimistic about the (financial) prospects of their own company than the economy albeit that the actual level of optimism has slightly decreased to 63 on a scale of 100.

Figure 13. European CFO sentiment regarding financial prospects of own company

European CFOs clearly have better hopes for their own company



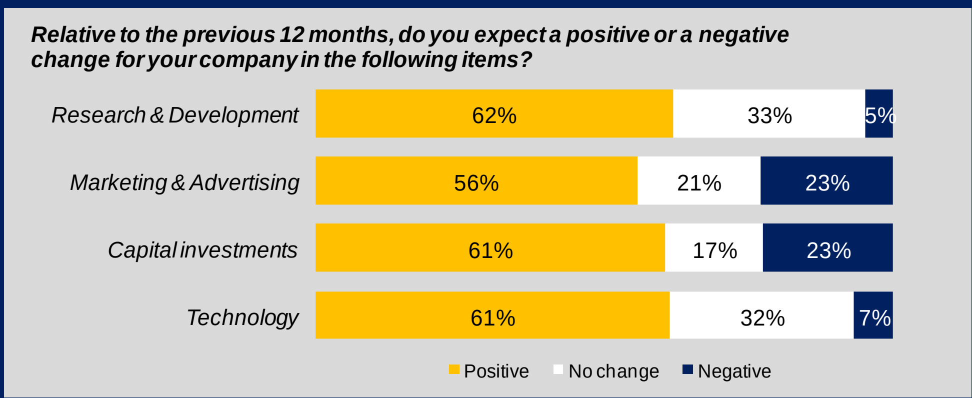
Maintaining margins and attracting and retaining qualified personnel remain biggest internal concerns

The group of optimists has decreased slightly (from 46% to almost 40%) but so did the number of pessimists (down to almost 17% from 22%). The same internal worries from previous quarters apply to this quarter's top concerns. Maintaining margins and attracting and retaining qualified personnel continue to pose the biggest challenges for the CFOs.

Although in this second quarter a larger group of European CFOs plan to increase corporate spending relative to the last twelve months, the average amount of spending is quite lower compared to previous quarters.

Figure 14. Breakdown of CFOs' responses to questions regarding corporate spending

Corporate spending expected to pick up…



…but at a much more moderate rate than previous quarters

- Capital spending and investments is expected to increase at an average rate of around 3.5%
- R&D expenditure is estimated to increase by 3.0%
- Corporate spending on advertising and marketing is expected to increase at a moderate 2%

Finance & capital

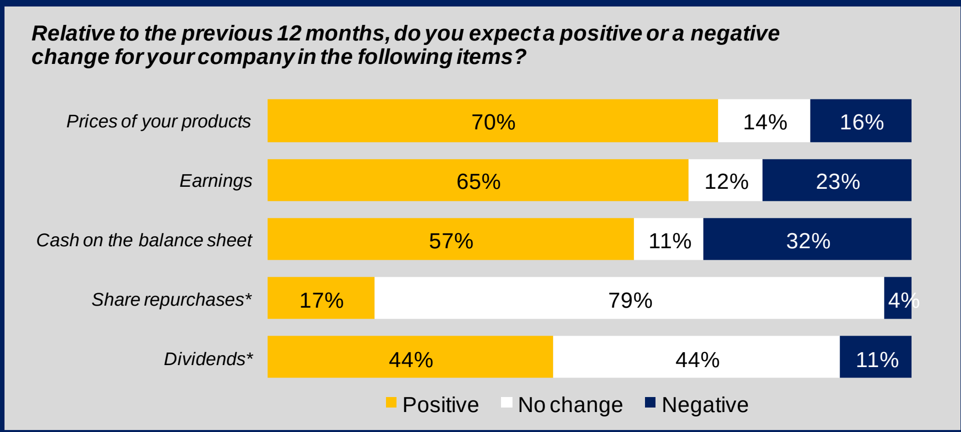
Prices of products are expected to see a rise

Possibly translating into higher earnings and cash on balance sheet

But at a significantly lower growth rate compared to Q1 2011

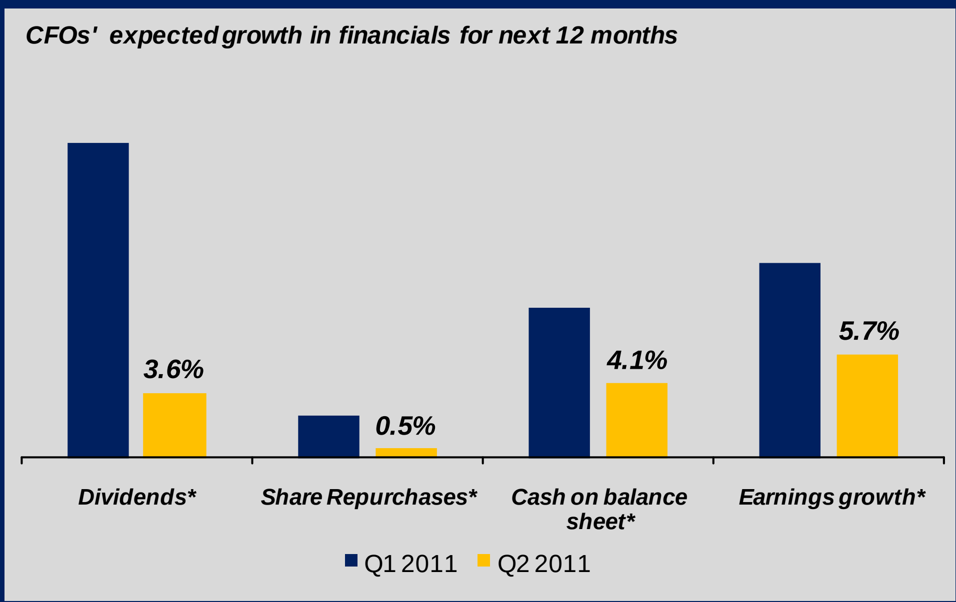
The continued moderate but positive sentiment among European CFOs is not expected to translate into strong financials. Although there is a significant group that expects to see improvements compared to the last twelve months, the anticipated growth in major balance sheet and income statement items is actually much lower compared to the previous quarter.

Figure 15. Breakdown of CFOs' responses to questions regarding finances



Especially the publicly listed companies who provided last quarter's surprise do not seem able to continue the trend. Dividends, cash and earnings growth expectations have been slashed.

Figure 16. CFOs' expected growth in financials (publicly listed companies only)

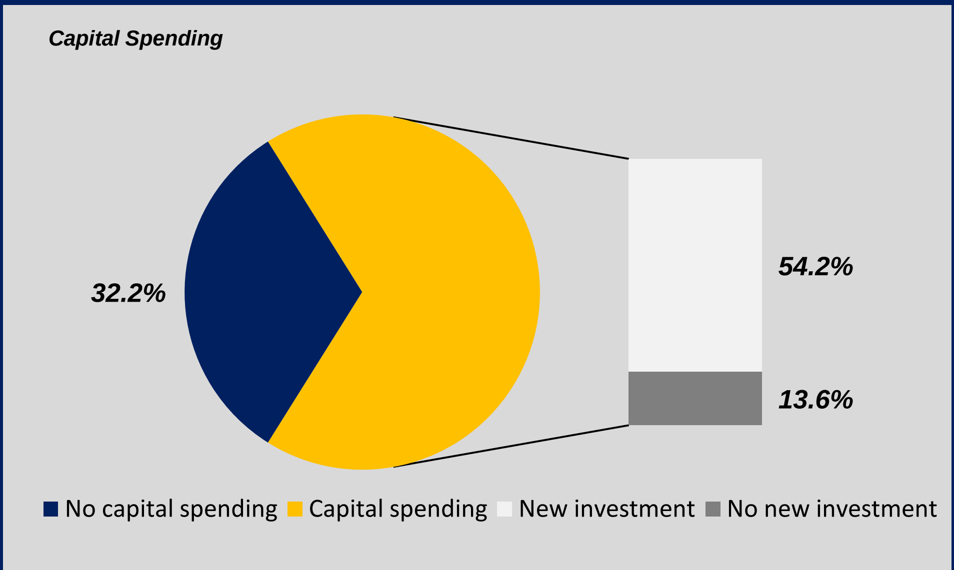


Capital spending is expected to exhibit an uptick…

…of which most of the funds is allocated to replacement spending

We have seen that capital spending is expected to increase at an average rate of 3.5%. Around two thirds of the financial executives state that their company will engage in some capital spending activities. 80% of this group indicates that this will include new investments of which, on average, 61% is allocated to replacement investments.

Figure 16. Share of capital spending allocated to new investment



Employment

Internal concerns on attracting and retaining personnel may prove to be a driver for growth in full time employment

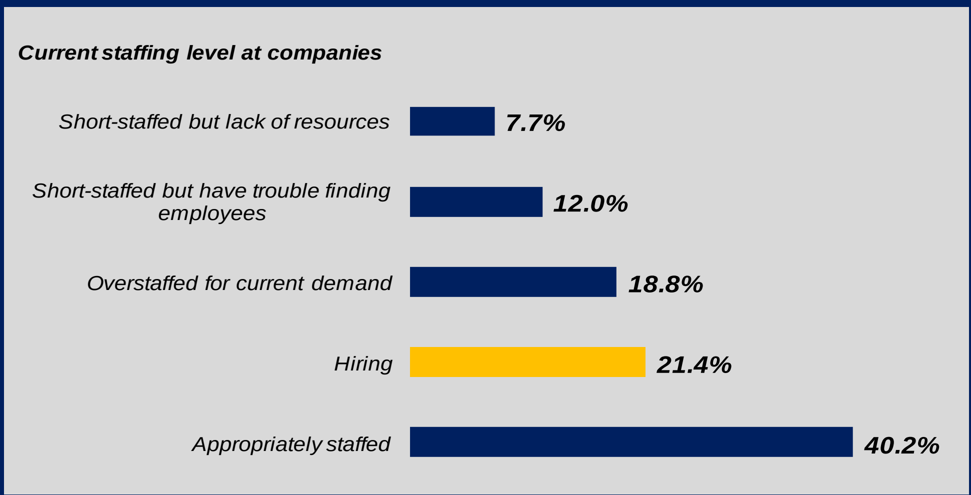
This second quarter seems to break with the trend of previous quarters where outsourced employment outweighed full-time and temporary contracts. The employee mix is expected to see a significant change in the next twelve months. CFOs have stated that attracting and retaining qualified personnel is one of their priority concerns and the steep increase in expected full-time employment indicates that companies are taking serious measures to prevent skilled labor from leaving.

Figure 17. Expected growth in employment

The expected rise in employment is supported by current labor dynamics at European companies. Although 40% of the companies are appropriately staffed and 19% is overstaffed for current demand, at least 21% of the CFOs state that they are hiring at the moment. Another 20% would like to hire but have insufficient resources or have trouble in finding appropriate employees.

A significant number of companies are currently hiring

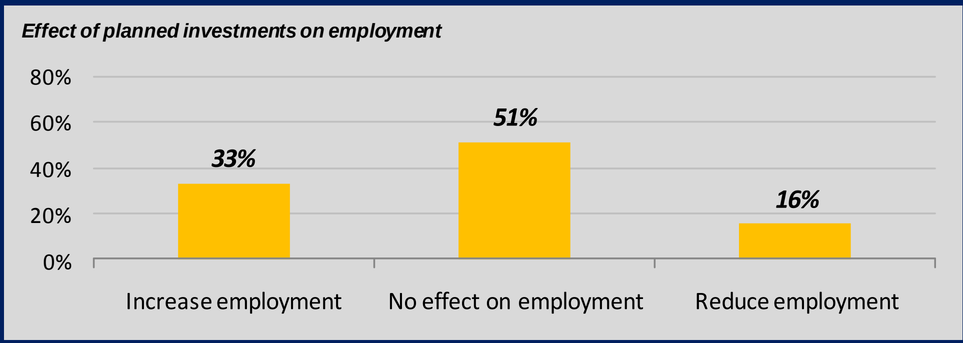
Figure 18. Current staffing level at European companies



The current hiring efforts of European companies may in large part continue throughout the next twelve months as capital spending picks up. One third of those companies that plan on engaging in new investments expect the investment to result in increased employment.

Future hiring is in part driven by planned investments that lead to increased demand for labor

Figure 19. Effects of investments on employment



Productivity, and wages and salaries are expected to see significant improvement in the coming period. 85% of the CFOs expect the latter to increase. 42% of the European companies have reduced the working hours per week during the recession period (2007-2009). As 74% of the financial executives expect to see a rise in the output per hour, this might indicate that companies are returning to normal production levels.

Productivity is expected to pick up again…

Figure 20. CFOs' anticipated developments in employee hiring, productivity and wages

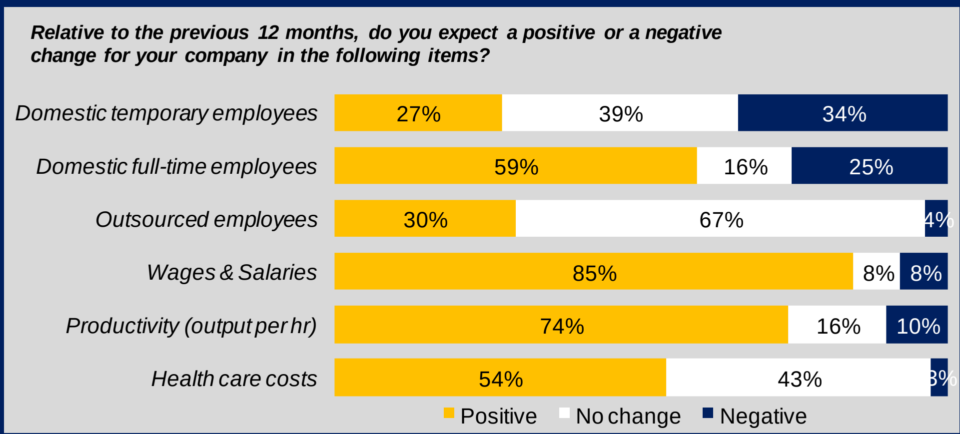
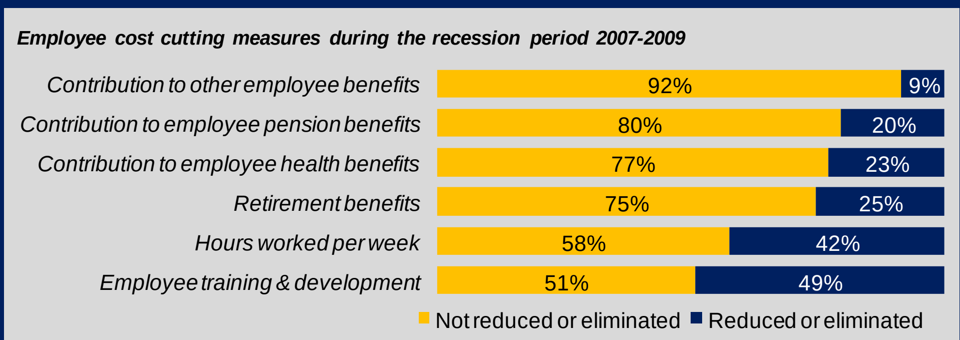


Figure 21. Cost cutting measures during recession

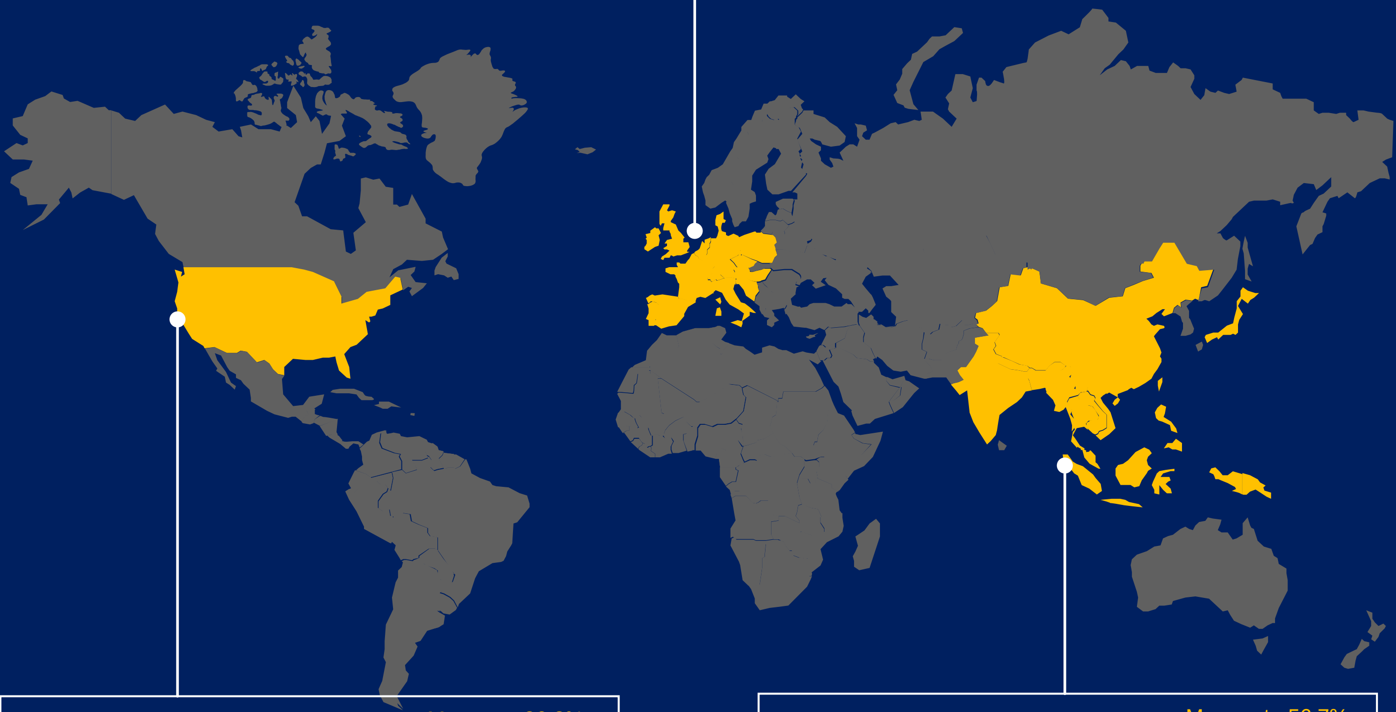
…possibly returning to pre-recession levels

As four out of ten companies have economized on the hours-worked-per-week during 2007-2009



Key results CFO Survey – Europe, US and Asia

Optimism about the country's economy	More opt: 28.2% Less opt: 22.2% No chg: 49.6%	Employment – full-time	3.6%
		Employment – temporary	0.1%
		Outsourced Employment	2.8%
Country optimism level	58.5	Wages and Salaries	2.8%
Optimism about own company	More opt: 39.8% Less opt: 16.9% No chg: 43.2%	Productivity	2.7%
		Inflation (own-firm products)	1.6%
		Earnings growth*	5.7%
Own company optimism level	62.9	Dividends*	3.6%
		Share Repurchases*	0.5%
Capital spending	3.5%	Cash on balance sheet*	4.1%
Technology spending	3.7%	Mergers and Acquisitions	Not asked
R&D spending	3.7%		



Optimism about the U.S. economy	More opt: 26.8% Less opt: 36.3% No chg: 36.9%
U. S. optimism level (0 to 100)	57.1
Optimism about own company	More opt: 38.6% Less opt: 31.1% No chg: 30.3%
Own company optimism level	65.4
Capital spending	8.7%
Technology spending	6.0%
R&D spending	2.0%
Advertising and marketing spending	2.5%
Employment – full-time	0.7%
Employment – temporary	-0.3%
Outsourced Employment	3.2%
Wages and Salaries	2.8%
Productivity	3.9%
Inflation (own-firm products)	2.9%
Earnings growth*	8.1%
Dividends*	9.8%
Share Repurchases*	2.6%
Cash on balance sheet*	-0.4%
Mergers and Acquisitions	Not asked

Optimism about the country's economy	More opt: 56.7% Less opt: 25.8% No chg: 17.5%
Country optimism level	65.5
Optimism about own company	More opt: 57.5% Less opt: 22.5% No chg: 20.0%
Own company optimism level	67.6
Capital spending	5.3%
Technology spending	11.9%
R&D spending	6.9%
Advertising and marketing spending	6.5%
Employment – full-time	6.0%
Employment – temporary	-1.5%
Outsourced Employment	5.8%
Wages and Salaries	9.7%
Productivity	6.4%
Inflation (own-firm products)	3.8%
Earnings growth*	11.1%
Dividends*	4.3%
Share Repurchases*	0.0%
Cash on balance sheet*	1.8%
Mergers and Acquisitions	Not asked.

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 second quarter of 2011. The survey concluded June 3, 2011. Every quarter, CFOs in Europe, the US, Asia and China are questioned about their economic expectations. Current records go back 61 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 Margreet Punt, Tilburg School of Economics and Management, tel. +31-(0)13-4663765 or e-mail margreet.punt@uvt.nl

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