# CFO Survey Europe – Quarterly Report

DUKE THE FUQUA SCHOOL OF BUSINESS

TILBURG UNIVERSITY
Understanding Society

CFO Europe

## Q2 2012

- European Companies Likely to Adjust the Capital Structure
- CFOs Seek to Reduce Dependency on Banks

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# Introduction

*CFO sentiment and economic outlook is back into negative territory*

*Economic uncertainty makes banks reticent in providing liquidity…*

*…forcing companies to reconsider dependency on debt financing…*

*…and focus on equity build up*

Optimism among CFOs worldwide has received another blow. The slight improvement that was observed during the last quarter of 2011 and the first quarter of this year was short-lived (figure 1).

Around 57% of the Asian executives are now less optimistic about the economic climate. In the US, the number of pessimists has doubled compared to the previous quarter and has reached now more than 30%. In Europe, even more than half of the CFOs have become less optimistic about the economic prospects.

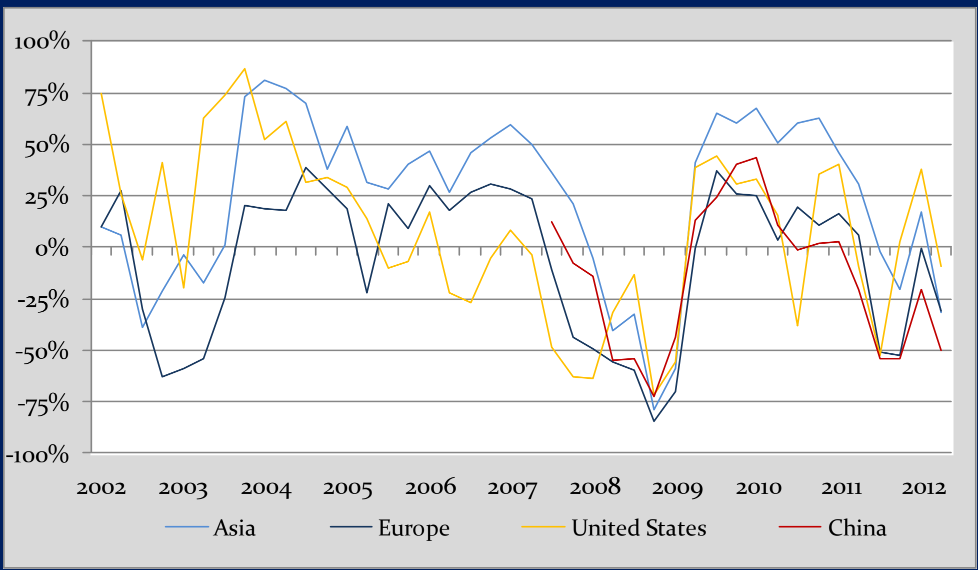
Although less severe, the sentiment among European financial executives with respect to the economic outlook for their own company has also deteriorated.

Nevertheless, the pressure is mounting on the European continent. In a weak economy, characterized by declining sales and profits, companies are increasingly reliant on bank loans that can provide them with the necessary liquidity. However, the same economic uncertainty that prevails among companies has resulted in banks becoming very reluctant in granting loans.

The deteriorating credit market forces companies to increasingly rely on themselves. In response to this, European CFOs seek to reduce their dependence on bank financing. Attracting equity is the preferred alternative.

However, it remains to be seen whether attracting equity capital is indeed a viable option in the current economic climate. Since the onset of the economic crisis, companies exhibit increasing debt ratios (debt-to-equity ratios), potentially inhibiting investors to provide financial funds.

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

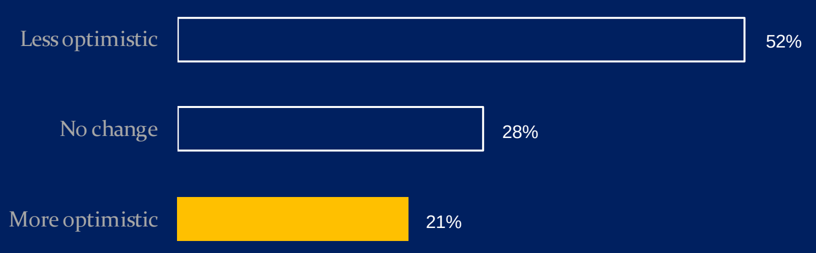


# *CFO optimism & sentiment*

*Optimism among European CFOs receives a big blow*

Economic sentiment among European CFOs has witnessed a significant setback during the second quarter of 2012, after the encouraging uptick in optimism during the first quarter of this year. More than half of the financial executives indicate that they are less optimistic about the economic prospect for the coming 12 months (figure 2). The average optimism index has dropped to 52 (on a scale of 100) pointing out the relatively low level of economic confidence.

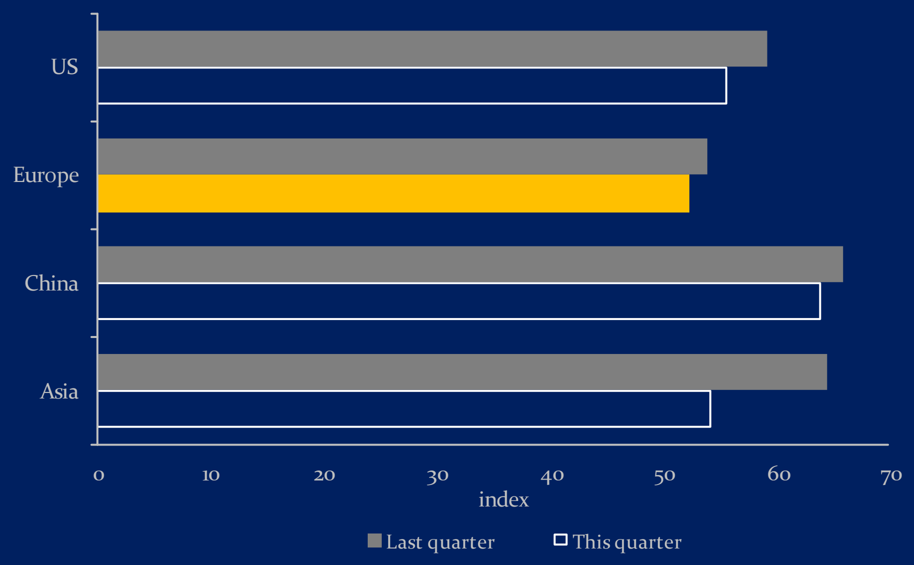
Figure 2. European CFO sentiment regarding economy of own country




Europe is not the only economic region that is experiencing a sudden drop. The number of optimist has significantly declined for all regions causing the optimism level in Asia for example to drop to 54 compared to 64.5 during the previous quarter (figure 3). The US and China are no exception as the optimism level has decreased to 55 and 64 respectively. With these negative developments, hope for recovery on the short term is fading.

*But the deterioration in economic sentiment is not restricted to Europe*

Figure 3. Optimism level about own country's economy



The deteriorating optimism about the economy is also, in part, reflected by a decline in optimism regarding the financial prospects of one's own company (figure 4). However, when looking at the optimism level with respect to the prospects of the own firm, we are observing a slightly higher level of confidence compared to that of the overall economy.

*Change in outlook for own company less severe but still negative*

Figure 4. European CFO sentiment regarding financial prospects of own company


Despite the macro concerns and internal worries (table 1), the average level of confidence regarding the financial prospects even has gained slightly compared to the previous two quarters and sits at 61 on a scale of 100.

*While macro and internal concerns remain unchanged*

Table 1. Macro and internal concerns of European CFOs

| *Macro concerns* | *Internal concerns* |
|---|---|
| ➢ Consumer demand | ➢ Ability to maintain margins |
| ➢ Global financial instability | ➢ Ability to forecast results |
| ➢ Credit markets and interest rates | ➢ Attracting and retaining qualified employees |
| ➢ National government policies | ➢ Working capital management |

# *Finance & capital*

Expenditures on major business components show a mixed picture. Compared to one year ago, all components (except for expenditures on technology) exhibit a decrease. The positive uptick during Q1 could not be sustained this quarter.

Companies seem to be strapped for cash. Only one out of four companies plan to deploy their cash reserves during the next twelve months. 23% of the financial executives do not know yet whether to deploy their cash reserves. More than 40% will definitely not deploy any cash reserves. For this latter group, liquidity constraints are the main reasons (table 2) that prevent them to freely deploy cash.

*CFOs not likely to deploy their cash reserves*

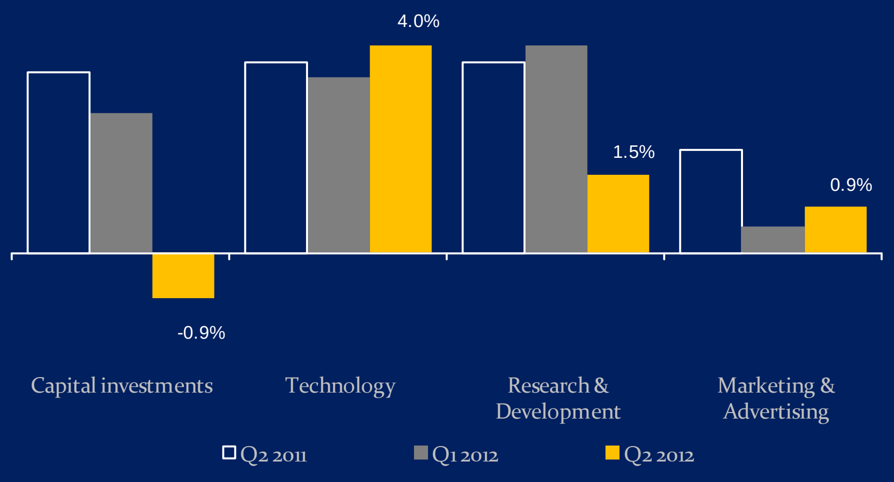
Table 2. Top 3 reasons for not deploying cash reserves

| | Reason | Share of respondents |
|---|---|---|
| 1 | Need cash as a liquidity buffer (e.g. in case credit markets tighten) | 45.2% |
| 2 | Lack excess cash to deploy | 33.3% |
| 3 | Hold cash until economic uncertainty declines | 33.3% |

It should therefore come as no surprise that capital investments are expected to decline and expenditures on R&D show very weak growth for the coming twelve months (figure 5). Spending on technology shows slight improvement compared to previous quarter.

*Implicating growth in major business expenditures*

Figure 5. CFOs' quarterly expected growth in spending for next 12 months




- Capital spending and investments are expected to decrease at an average rate of around 0.9% (2.7% in previous quarter)
- Technology spending is expected to increase with 4.0%

- Corporate spending on R&D has weakened and is expected to grow around 1.5%
- Growth in marketing & advertising expenditures remain weak at 0.9%

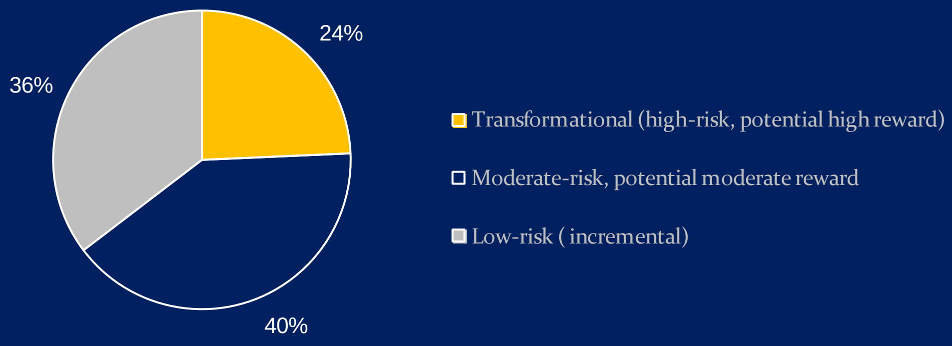
*There is still a significant portion of companies that allocate budget to innovation*

Over 40% of the European companies state to have invested a portion of their budget in major innovative projects that could significantly impact their business. This may reflect the small but positive uptick in technology spending.

On average, around 17% of the budget is allocated to such projects. However, innovation itself is not necessarily of high risk. In fact, three out of four companies pursuing innovation within the organization focus on a low to moderate risk exposure of innovative work (figure 6).

*But in doing so, they remain prudent and maintain a moderate to low risk exposure*

Figure 6. Risk profile of innovative work within European companies




*Does the weak economic outlook predict difficulties in sourcing financial funds?*

The continued weak outlook on business expenditures might be a precursor for a further worsening in the ease-of-access to financial funds (internal and external). The economic climate during the last couple of years has had a negative effect on the growth of company revenues and profits putting pressure on the ability to retain earnings, an internal source of financial funds. This severely limits companies to make the appropriate investments, or finance the necessary business expenditures.

Companies are thus forced to look for external financial sources that can provide them with the necessary liquidity. In this case, bank financing (loans) would be the first and most obvious alternative. Use of such option would be reflected in the capital structure of companies. Indeed, over the last couple of years, European companies have witnessed a steady increase in their debt-to-equity ratio (table 3).

Table 3. Average debt-to-equity ratio of European companies

*Increasing debt ratios may shed more light on this*

| Period | Debt-to-equity ratio |
|---|---|
| Current | 96.7% |
| 1 year ago | 83.8% |
| 2 years ago | 89.8% |
| 5 years ago | 72.3% |

Intuition would tell us that this increase is the likely result of a build up of debt, implying that companies do not experience any obstacles in accessing debt instruments such as bank loans and (corporate) bonds.

However, ECB statistics show us that non-financial companies in the Eurozone actually have made significantly less use of bank loans during the period 2007-2011 (table 4). Although other debt instruments exhibit a moderate increase during that same period, this is not sufficient to compensate the strong decrease in bank loans and hence does not clarify the average growth in the debt-to-equity ratio.

Table 4. Financial components of non-financial companies in the Eurozone

| Non-financial corporations (EUR bln, cumulated flows) | 2007 | 2008 | 2009 | 2010 | 2011 |
|---|---|---|---|---|---|
| Main items of financial investment | | | | | |
| Short-term assets | 167 | 72 | 91 | 43 | -33 |
| Currency and deposits | 153 | 15 | 87 | 67 | 0 |
| Money market fund shares | -20 | 33 | 40 | -23 | -44 |
| Debt securities | 34 | 24 | -35 | -2 | 10 |
| Long-term assets | 763 | 664 | 242 | 471 | 554 |
| Deposits | -8 | 39 | 0 | 12 | 53 |
| Debt securities | 51 | -42 | 18 | -9 | 23 |
| Shares and other equity | 412 | 331 | 110 | 238 | 275 |
| Other (mainly intercompany loans) | 308 | 336 | 114 | 230 | 203 |
| Remaining net assets | 209 | -27 | 56 | -35 | -111 |
| Main items of financing | | | | | |
| Debt | 928 | 664 | 79 | 181 | 243 |
| *of which: Loans from euro area MFIs* | *538* | *394* | *-113* | *-11* | *50* |
| *of which: Debt securities* | *32* | *48* | *88* | *65* | *46* |
| Shares and other equity | 413 | 315 | 284 | 260 | 232 |

*MFI: Monetary Financial Institutions*
*Source: ECB, Monthly Bulletin – Euro Area Statistics Online*

*European companies do not seem to have sourced that much additional debt since the beginning of the crisis*

*Possibly due to a tightening of the credit markets…*

Furthermore, there is evidence suggesting that the reduced use of bank financing can be entirely attributed to an actual tightening of the credit markets and not so much by a decrease in demand for financial funds by European companies.

*…caused by massive deleveraging by financial institutions*

Traditionally, bank financing (loans) has played a central role in the corporate financing of European companies. During the financial crisis, banks were forced to restructure their balance sheets and decrease their risk exposure (deleveraging). This has resulted in banks being more conservative in providing financial funds to the private sector, exacerbating the tight credit market even further.

To counteract this development, the ECB has executed a massive credit injection of EUR 489 billion in December 2011 with the objective to provide the financial system with enough cash to facilitate lending to private sector companies and provide extra air to an already tight credit market. However, instead of actually allocating this money to credit facilities destined for cash strapped companies, financial institutions have instead placed these funds into deposits at their respective central banks (figure 7).

Figure 7. Deposits at the Eurosystem of Monetary Financial institutions (MFI) in the euro area

*ECB action unable to reverse the credit crunch*


*Source: ECB statistics*

*Ease-of-access to debt capital not likely to have improved*

Clearly, the observed increase in the debt-to-equity ratios of European companies can not be fully explained by increases in (bank) debt financing. Even worse, the ease of access to debt capital (more specifically bank loans and credit) seems to have deteriorated further.

*Resulting in equity finance to be the most preferred source of capital…*

This also corresponds to what the financial executives are saying when asked about the degree of attractiveness of external funds. They regard equity finance to be the most attractive source while bank debt comes in second. Bonds are the least favored source of finance at the moment.

Moreover, companies indicate that they would like to restructure their capital. More than 40% of the European CFOs is of the opinion that their capital is not optimally structured at the moment. To achieve an optimal capital structure they look to increase the equity base (7.7% on average) and decrease the amount of bank loans (5.8% on average).

*…and companies seeking to reduce dependency on bank financing*

This obviously indicates a preference for equity finance and a move away from bank loan dependency. More importantly, it also supports the observed increase in the average debt-to-equity ratios of European firms over the last couple of years; companies now seek to improve their equity capital base which may have deteriorated over the last couple of years (due to the economic climate and circumstances), which caused the (relative) debt-to-equity ratio to rise over time.

We have mentioned two developments that may have been detrimental to the capital structure of European companies:

*Forces that have led to higher debt ratios…*

1. A worsening of the economic climate, possibly deteriorating the equity base of companies because net income declines and hence the ability to retain earnings.
2. A worsening in the ease of access to debt capital (more specifically bank loans and credit)

*…have also resulted in diverging capital structures among industry peers*

If European companies are indeed confronted with these two forces this might also explain why many companies have a debt-to-equity ratio that not only has increased over the last five years but also diverges from their respective industry benchmark (figure 8).

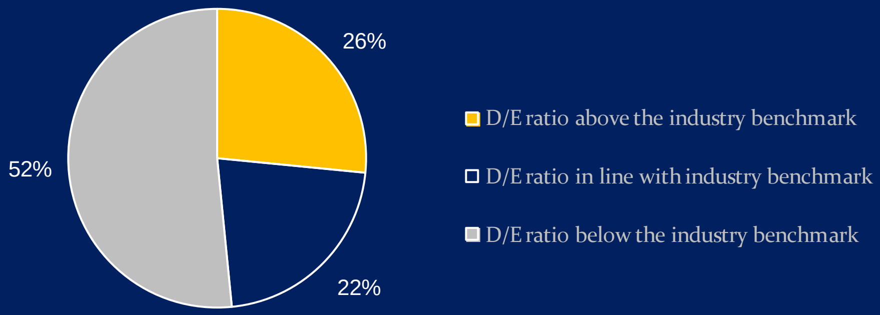
*Does a ratio below the industry benchmark indicate lower risk…*

For example, more than half of the companies indicate to have a debt-to-equity ratio below the industry benchmark possibly pointing towards a lower than average risk profile (compared to their respective peer group).

*…or just an inability to attract debt capital?*

However, in light of the previous discussion about the worsened ease-of-access to bank debt the lower ratio may very well indicate that companies are actually starving for external capital funds (e.g. bank loans). The inability to attract new debt financing, or at least maintain the existing debt at current levels (through rollover), will initially have a downward pressure on the debt-to-equity ratio.

Figure 8. Debt-to-equity ratio of European companies compared to their industry peers




*To what extent are higher risk companies able to attract external capital?*

In contrast, more than one fourth of the European CFOs state to have a debt-to-equity ratio above the industry benchmark. Compared with their peers, this would imply a relatively higher risk profile for these companies.

A higher risk perception by banks, investors and other sources of finance could implicate a company's ability to attract additional (external) financial funds. In this case, companies would be forced to fend for themselves and generate enough internal funds to be able to finance their operations.

*Are there any alternatives for them?*

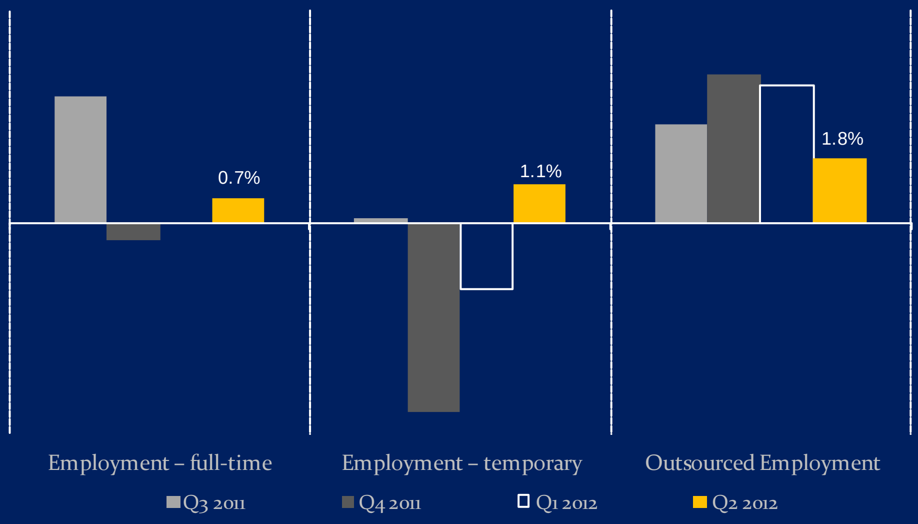
Retained earnings would in fact provide such financial means but in the current economic climate this source of funding is under heavy pressure as revenues and, consequently, net income have experienced significant decline over the last couple of years.

# Employment

*Although very marginal, employment is expected to rise*

Despite the weakening in economic sentiment among European financial executives the expected growth in employment is experiencing slight improvement compared with the previous quarter (figure 9). Both fulltime and temporary employment are back in positive territory, (albeit at marginal rates) breaking with the negative trend of the last three quarters

Figure 9. European CFOs expected growth for next 12 months in employee mix

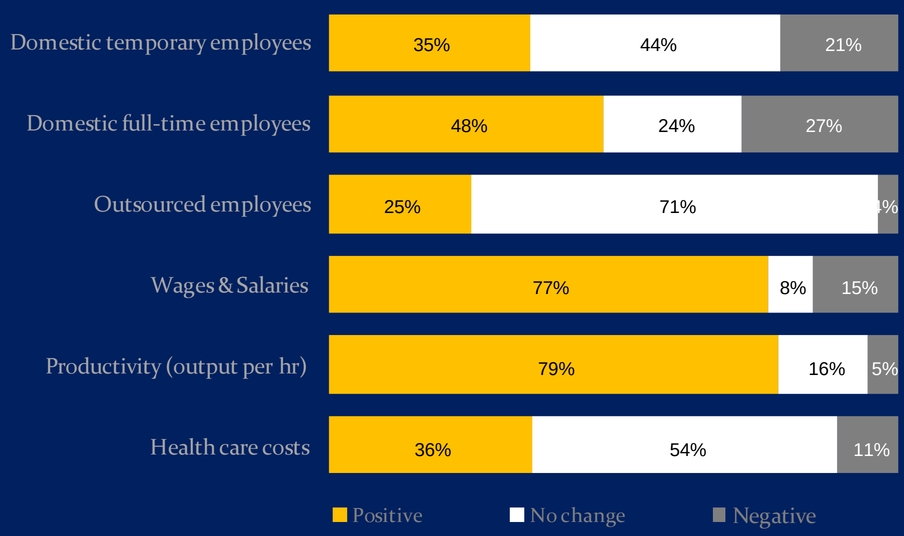



Compared with the first quarter of this year the distribution of growth expectations for the major human capital items remains intact. A large group of CFOs expect to see increases in wages and salaries, possibly offsetting any gains achieved from the expected increase in productivity (figure 10).

Figure 10. Relative to the previous 12 months, do you expect a positive or a negative change for your company in the following items?

*Wages are expected to rise…*

*..but will likely be offset by a rise in productivity output of employees*

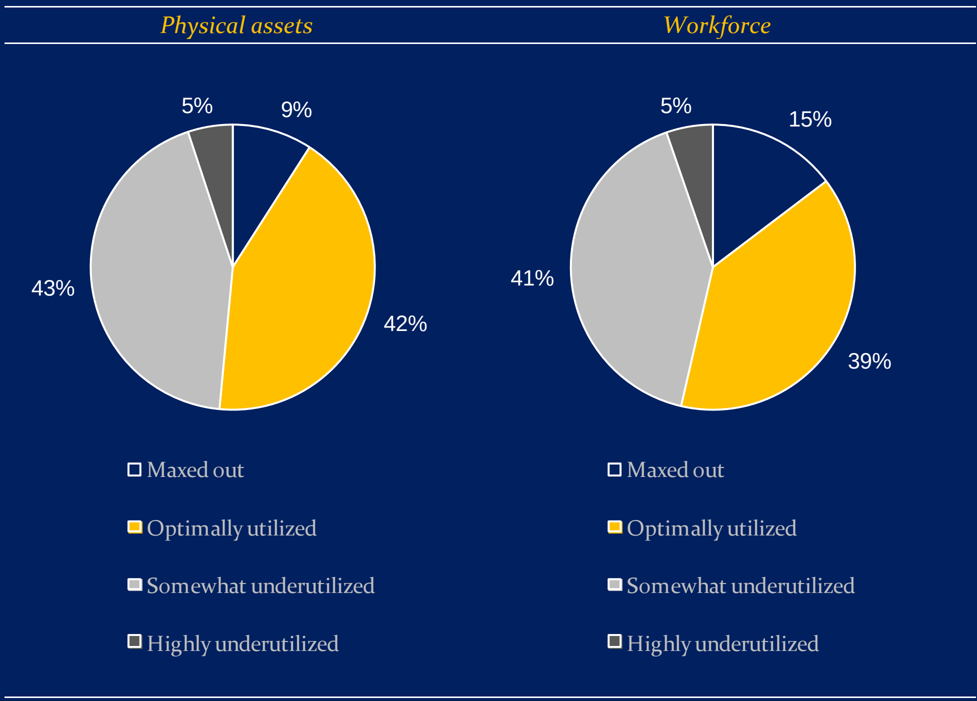


*Less than half of the European companies are operating at optimal capacity*

Roughly 40% of the European companies are currently operating their assets and workforce at optimal levels (figure 11). However, almost a same share of companies states that they are underutilizing both their workforce and their physical assets. This is a relatively large share of companies and as such indicates that there is still plenty room for economic recovery.

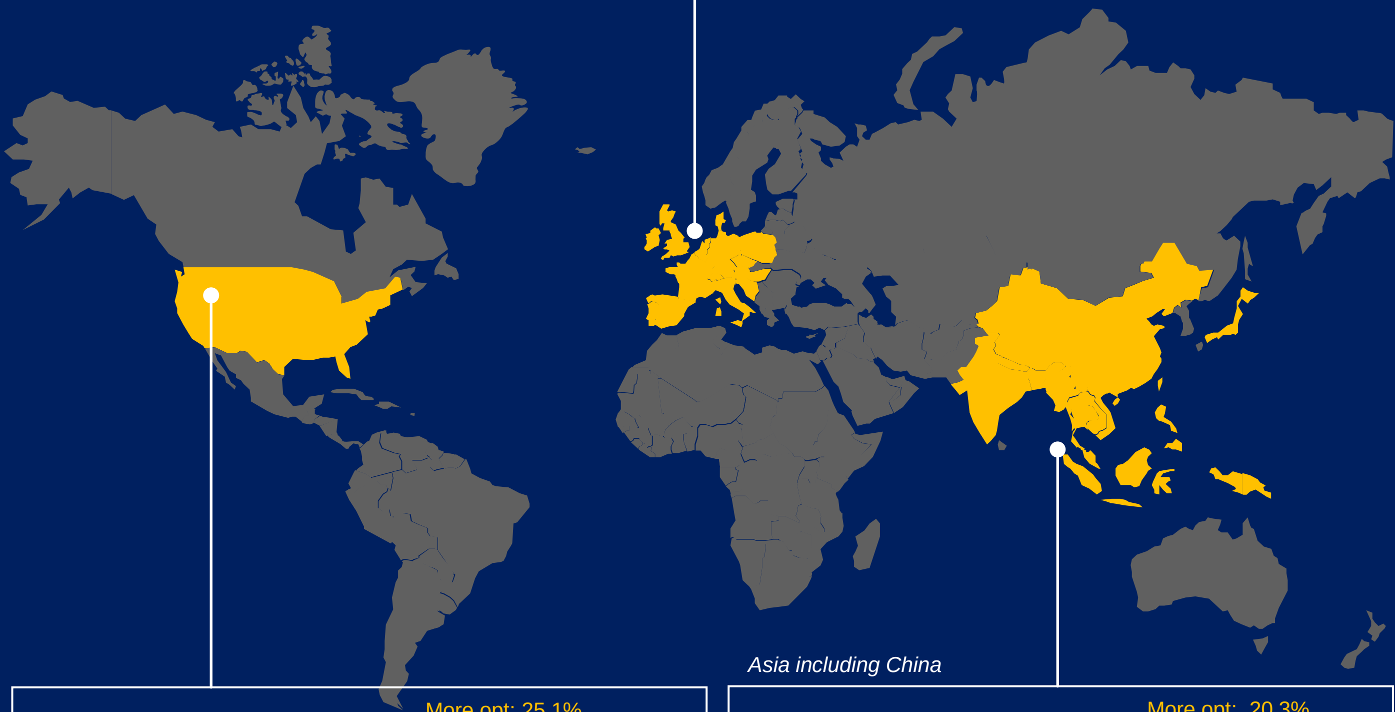
*Leaving quite some room for up scaling production*

Figure 11. Capacity utilization of workforce and physical assets



# *Key results CFO Survey – Europe, US and Asia*

| | | | |
|---|---|---|---|
| Optimism about the country's economy | More opt: 20.8%<br>Less opt: 51.5%<br>No chg: 27.7% | Employment – full-time | 0.7% |
| | | Employment – temporary | 1.1% |
| | | Outsourced Employment | 1.8% |
| Country optimism level | 52.1 | Wages and Salaries | 4.8% |
| Optimism about own company | More opt: 29.4%<br>Less opt: 38.2%<br>No chg: 32.4% | Productivity | 2.9% |
| | | Inflation (own-firm products) | -0.4% |
| Own company optimism level | 60.9 | Earnings growth* | -1.7% |
| | | Dividends* | 2.6% |
| Capital spending | -0.9% | Share Repurchases* | 1.5% |
| Technology spending | 4.0% | Cash on balance sheet* | 0.1% |
| R&D spending | 1.5% | Mergers and Acquisitions | Not asked. |
| Advertising and marketing spending | 0.9% | | |




| | |
|---|---|
| Optimism about the U.S. economy | More opt: 25.1%<br>Less opt: 34.8%<br>No chg: 40.2% |
| U. S. optimism level (0 to 100) | 55.7 |
| Optimism about own company | More opt: 37.5%<br>Less opt: 28.9 %<br>No chg: 33.6% |
| Own company optimism level | 64.1 |
| Capital spending | 4.9% |
| Technology spending | 8.0% |
| R&D spending | 3.1% |
| Advertising and marketing spending | 3.3% |
| Employment – full-time | 2.5% |
| Employment – temporary | 0.6% |
| Outsourced Employment | 3.8% |
| Wages and Salaries | 2.6% |
| Productivity | 3.2% |
| Inflation (own-firm products) | 1.8% |
| Earnings growth* | 10.9% |
| Dividends* | 5.5% |
| Share Repurchases* | 3.9% |
| Cash on balance sheet* | 8.8% |
| Mergers and Acquisitions | Not asked. |

| | |
|---|---|
| Optimism about the country's economy | More opt: 20.3%<br>Less opt: 58.1%<br>No chg: 21.6% |
| Country optimism level | 57.6 |
| Optimism about own company | More opt: 33.8%<br>Less opt: 44.9%<br>No chg: 21.3% |
| Own company optimism level | 62.3 |
| Capital spending | 7.4% |
| Technology spending | 2.9% |
| R&D spending | 4.1% |
| Advertising and marketing spending | 3.3% |
| Employment – full-time | 3.2% |
| Employment – temporary | 3.5% |
| Outsourced Employment | 4.0% |
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| Productivity | 2.7% |
| Inflation (own-firm products) | 0.7% |
| Earnings growth* | 0.7% |
| Dividends* | 2.8% |
| Share Repurchases* | 0.2% |
| Cash on balance sheet* | 4.9% |
| 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 2012. The survey concluded May 31, 2012. Every quarter, CFOs in Europe, the US, Asia and China are questioned about their economic expectations. Current records go back 65 quarters. The CFO Survey is conducted jointly by Tilburg University, Duke University (Durham, North Carolina) and CFO Magazine.

*Note for the Press*

Previous editions of the CFO Survey can be found at www.cfosurveyeurope.org. For further information, please contact Reggy van den Bosch, Tilburg School of Economics and Management, tel.+31-(0)-134668923 or e-mail r.vandenbosch@tilburguniversity.edu

## *CFO Survey Europe team*

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

Reggy van den Bosch (contactperson)
Science Communications Officer
r.vandenbosch@tilburguniversity.edu
+31-(0)-13 466 8923

Christian Staupe
Research and Policy Officer
c.p.staupe@uvt.nl