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Financial Risk Exposed

FiREapps 2014 Q1 Corporate Earnings Currency Impact Report – for North American and European Corporates

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Executive Summary: Currency Impact on North American & European Corporate Earnings in 2014 Q1

"FiREapps 800" Goes Global with Addition of European Earnings Call Data

As part of FiREapps' ongoing effort to provide insight into how currency affects corporations, every quarter we analyze the earnings calls of 846 publicly traded North American companies (dubbed the "FiREapps 800"). The companies included in this data set are Fortune 2000 firms with at least 15% international revenues in at least two currencies.

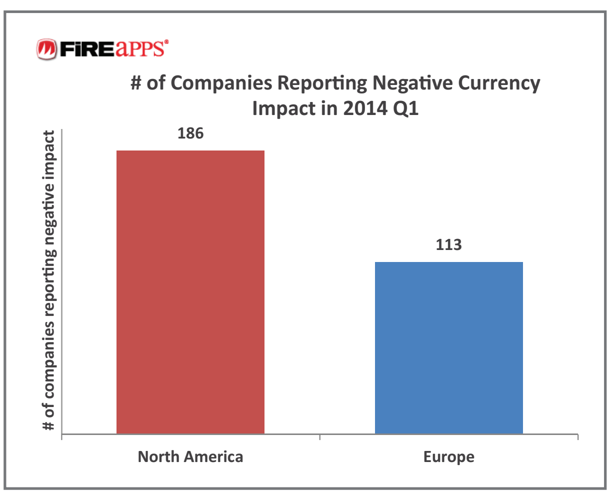
Beginning in the first quarter of 2014, we added 354 European corporations to our data set. These corporations, also all publicly traded, were selected to mimic the industry distribution within the "FiREapps 800". For example, if 10% of the 846 North American companies are in the Chemical Manufacturing industry, then we included the 35 largest Chemical Manufacturing companies in Europe (10% of the 354 European companies).

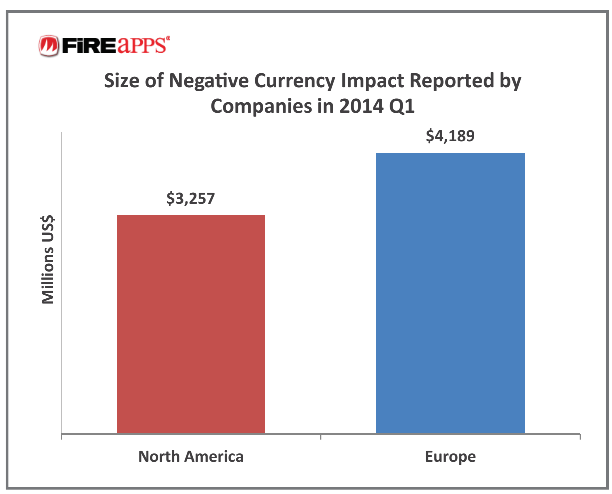
In this Corporate Earnings Currency Impact Report we will first provide an overview of aggregate impacts on North American and European corporates. The section after that details impacts on North American corporates; the section after that details impacts on European corporates. The last section reiterates the key takeaways from our first quarter 2014 analysis and offers actionable advice for CEOs and CFOs, treasurers and FX managers, investors, and analysts.

Key Highlights:

- **The total reported negative currency impact in 2014 Q1 was $7.4 billion.** A greater number of North American corporates (186) than Europeans (113) reported negative currency impacts in the first quarter. However, the aggregate impact quantified by companies in Europe was larger (€3.08 billion, or $4.19 billion) than in North America ($3.26 billion).

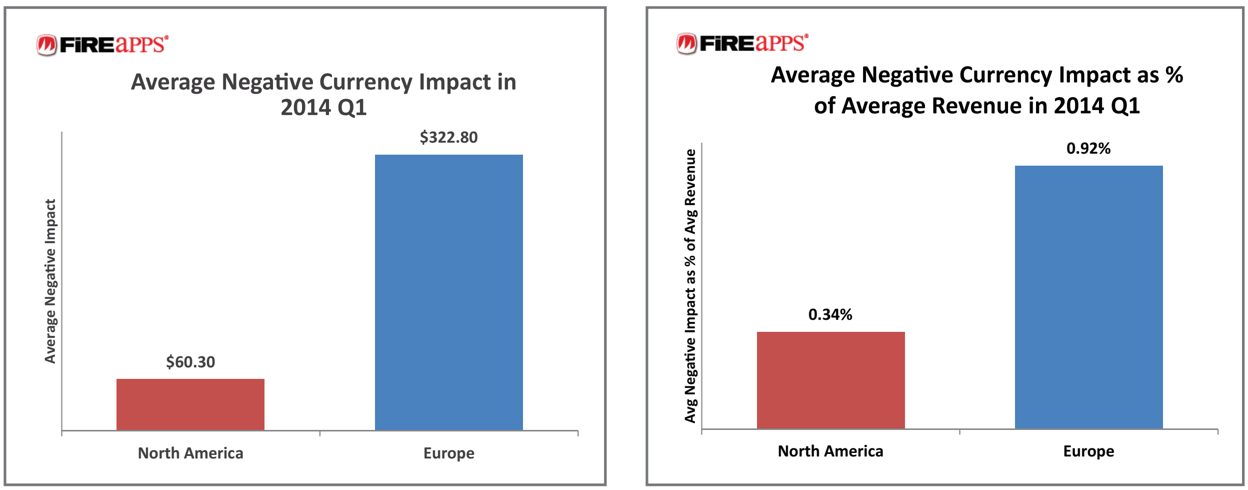
Figure 1: Negative Currency Impact Reported by Companies in 2014 Q1





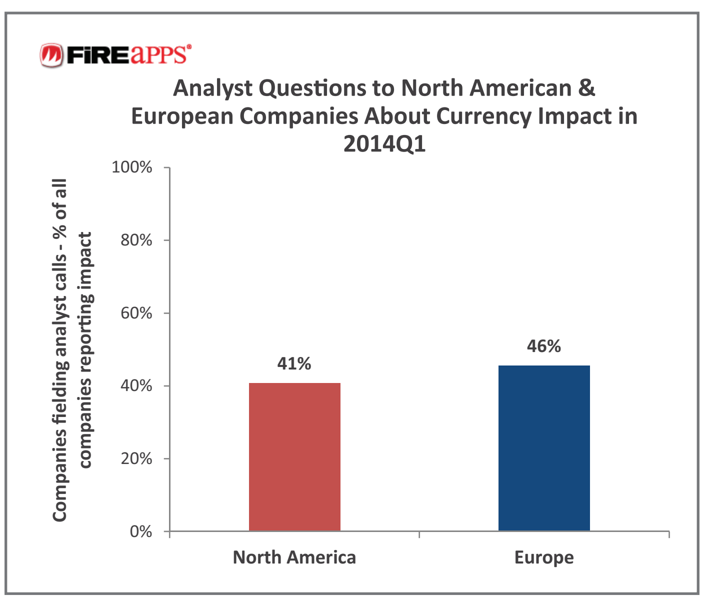
- **The currency impact reported by European corporates was larger than that reported by North American corporates in absolute and relative terms.** The average per-company negative impact – both as a number and as a percentage of revenue – was much larger for European corporates ($323 million, 0.92% of average revenue) than North American corporates ($60.3 million, 0.34% of average revenue).

Figure 2: Average Per-Company Negative Currency Impact



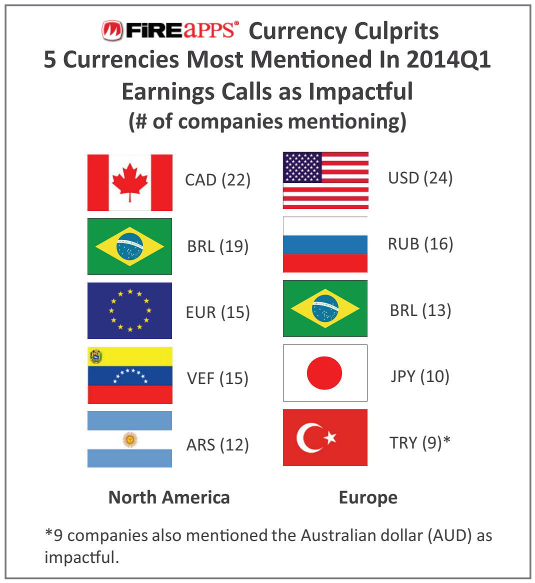
- **41% of the North American companies reporting currency impact fielded currency impact-related questions from analysts; 46% of the European companies did.**

Figure 3: Analyst Questions to North American & European Companies About Currency Impact in 2014Q1



- **Both North American and European corporates reported continued challenges from emerging market currencies.** Among the emerging market currencies reported as impactful by North American corporates were the Brazilian real, Venezuelan bolivar, and Argentine peso. European corporates also reported significant negative impacts from the Brazilian real, as well as from the Russian ruble and Turkish lira.

Figure 4: 5 Currencies Most Mentioned in 2014 Q1 Earnings Calls as Impactful

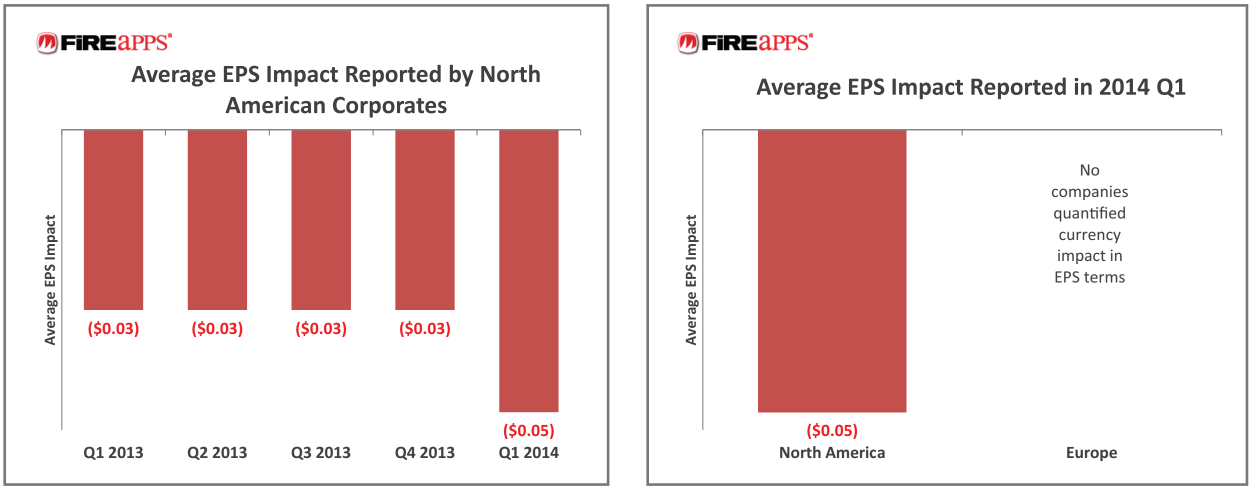


- **In North America and Europe corporates in the Miscellaneous Capital Goods, Chemical Manufacturing, and Medical Equipment & Supplies industries were particularly hard-hit by currency impacts.**

Figure 5: 5 Industries With the Most Companies Reporting Currency Impacts in 2014 Q1

- **For North American corporates, EPS impact jumped from an average of $.03 EPS every quarter in 2013 to $.05 EPS in 2014 Q1. None of the European corporates quantified currency impact in EPS terms.**

Figure 6: Currency Impact to Earnings per Share (EPS)



- **$7.4 billion in eroded revenue is a significantly negative impact. But the true cost of currency impacts is much larger, and has the potential to affect investors over the long term.** Erosion of revenue and – ultimately – of earnings per share, is clearly a significant impact for North American and European companies alike. But these are not the only currency-related impacts that companies face. When a company is impacted by currency over time, those impacts create ripples that affect the company more deeply. Those ripples include credit rating downgrades that raise the company's cost of capital; project reallocation; and debt covenant breaches that limit the company's access to liquidity. These are long-term effects that impact the company's ability to deliver profits for its shareholders.

Currency Impact on North American Corporate Earnings

In terms of the number of companies reporting negative currency impact and the aggregate negative impact quantified by those companies, the first quarter of 2014 was relatively better than every quarter since the first quarter of 2012.

Compared to the fourth quarter of 2013, the number of companies that reported negative impacts was down 5% and the size of quantified impact was down 44%. Still, 186 companies reported negative currency impacts in Q1, for a total of at least $3.26 billion in revenue eroded.[1]

Figure 7: # of Companies Reporting Negative Currency Impact

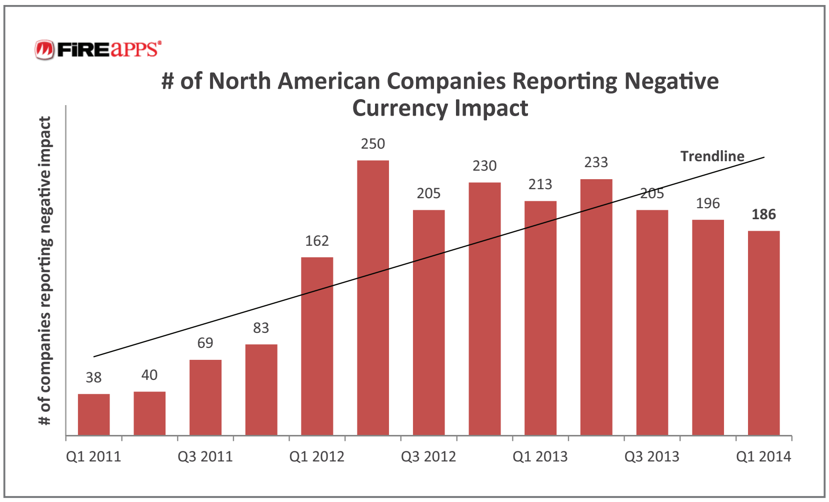
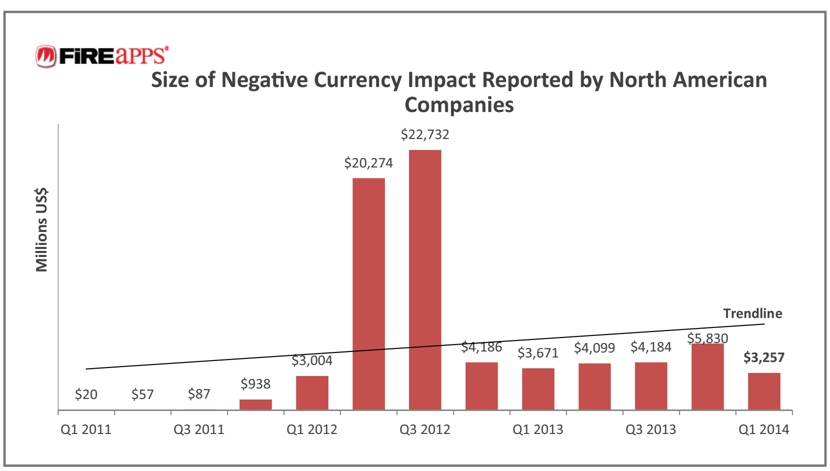


Figure 8: Size of Reported Negative Currency Impact



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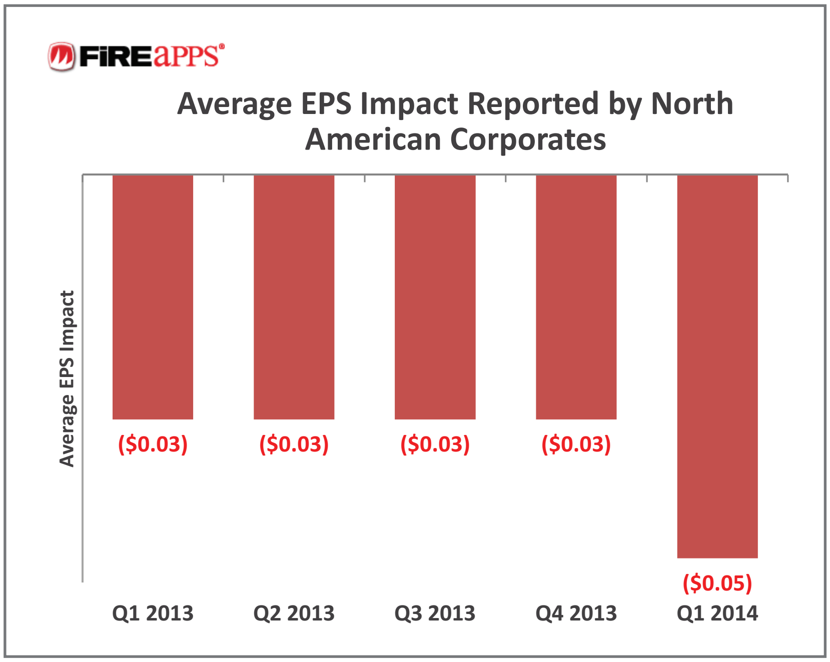
[1] As we have said before, impacts are likely to be underestimates. There are two reasons why: first, it is almost certain that some companies which faced currency headwinds did not specifically point them out. Second, of the total number of companies that did report negative impacts, only 29% of them actually quantified the impact.

Yet while negative currency impact – as measured by the number of companies reporting impacts and the total size of quantified impact – abated in the first quarter, currency impact quantified as a function of earnings per share (EPS) was up significantly. In all four quarters of 2013, EPS impact averaged $.03 among those companies quantifying impact in EPS terms. In the first quarter of 2014, that average EPS impact jumped to $.05.

Figure 9: Average EPS Impact Reported by North American Corporates



As we have said before, considering that FX managers from leading multinationals have MBOs (management objectives) of less than $.01 EPS impact from balance sheet exposures alone, an average $.05 hit to EPS from all exposures is large and material.

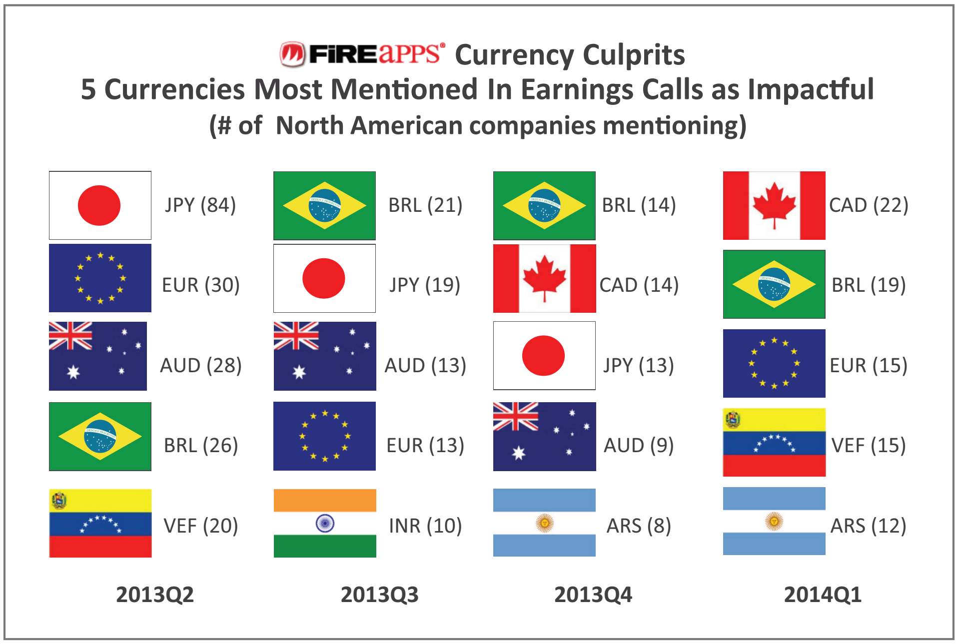
Furthermore, surprise currency impacts flow not only into earnings per share, but into share price as well. When those surprises are negative, the impact to share price is far more damaging than positive surprises are helpful. In fact, negative surprises generate stock declines about five times larger than the stock improvements generated by positive surprises.[2]

[2] For more detail on how earnings surprises affect stock price, including research behind the concept, see the FiREapps 2013 Year-End Corporate Earnings Currency Impact Report, available at http://fireapps.com/whitepapers.

The Most Impactful Currencies on North American Corporate Earnings

Figure 10 reveals the five currencies mentioned most often among the 846 North American corporates' earnings calls. Three were emerging market currencies that appeared on the Currency Culprits list at some point within the last four quarters: the Brazilian real (mentioned as impactful by 19 companies), Venezuelan bolivar (mentioned as impactful by 15 companies), and Argentine peso (mentioned as impactful by 12 companies). The most-mentioned currency, back for the second quarter in a row, was the Canadian dollar (mentioned as impactful by 22 companies). And the euro appeared back on the list (mentioned as impactful by 15 companies) after falling off in 2013 Q4.

Figure 10: Currency Culprits – The 5 Currencies Most Mentioned in Earnings Calls as Impactful
(# Companies Mentioning)



Emerging Markets

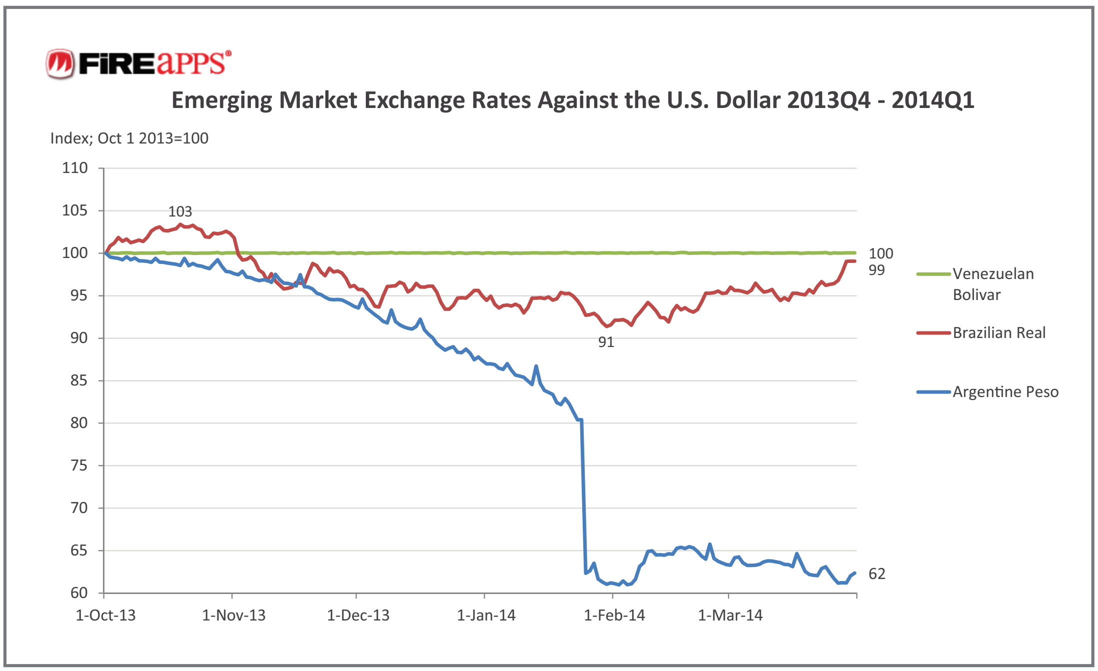
Among the emerging market currencies on the 2014 Q1 Currency Culprits list – the Brazilian real, Venezuelan bolivar, and Argentine peso – exchange rate volatility in the fourth quarter of 2013 and first quarter of 2014 varied.

The official Venezuelan bolivar exchange rate, for example, did not change at all in the first quarter 2014; it hasn't changed since it fell 32% in February 2013, devalued in an effort by the government to help narrow the country's budget deficit. Yet the unofficial, black market bolivar has been highly volatile as economic conditions in Venezuela continue to deteriorate. In March of 2014, the government announced a new currency market designed to make more dollars available and weaken the currency black market. At the end of March, the bolivar traded some 80% weaker in the new market than the official exchange rate.

The Argentine peso fell 23% in January 2014, the beginning of what Bloomberg described as "the single biggest selloff in emerging market currencies since 2009." (The emerging market crisis is detailed in depth in the whitepaper *Emerging Market Currency Volatility: What Is Happening, Why, and What You Can Do About It*.) In the last two months of the first quarter of 2014, the peso has bounced between 61 and 65, ending the quarter at 62.

After falling 5% in the fourth quarter of 2013, the Brazilian real – a top Currency Culprit in each of the last four quarters – was still volatile in the first quarter (though less so), falling as much as 3%, though the currency ended the quarter up 4%.

Figure 11: Emerging Market Exchange Rates Against U.S. Dollar 2013Q4-2014Q1



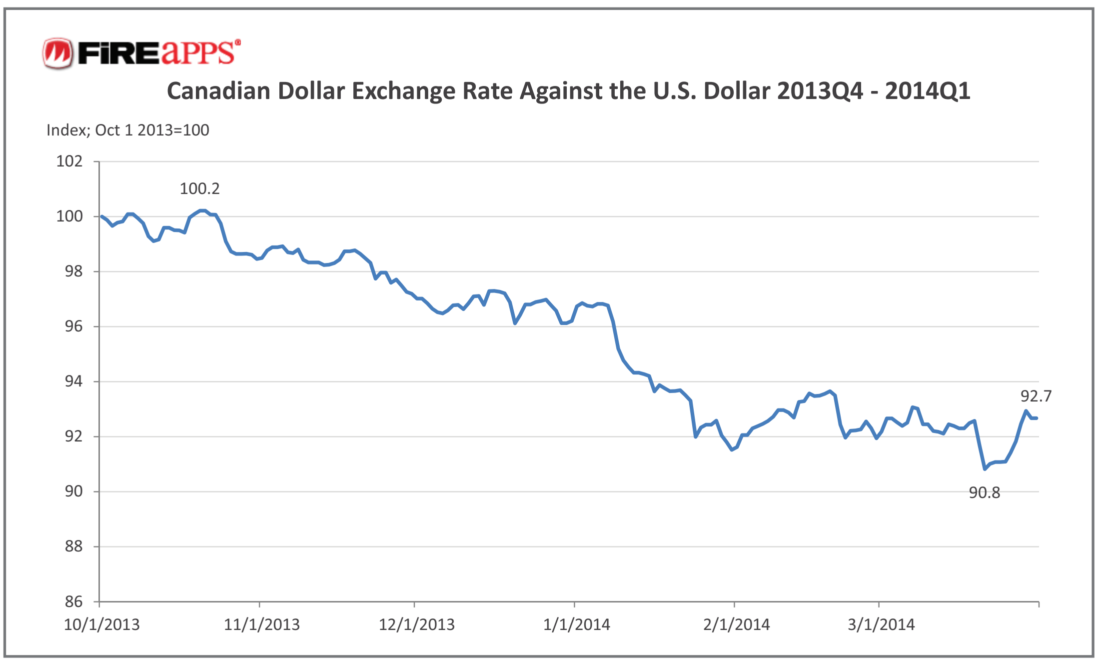
Canadian Dollar

In the [*FiREapps 2013 Year-End Corporate Earnings Currency Impact Report*], we wrote that it came as a big surprise to find the Canadian dollar among the five most impactful currencies in the fourth quarter. This is what we wrote about where the Canadian dollar had been and where it could be going:

> *Relative to the U.S. dollar, the Canadian dollar appears to be moving through a typical cyclical movement. The exchange rate hovered around parity in 2011 and 2012, but since then the USD has strengthened against the CAD. The USD strengthening gained speed in late 2013 – hence the fourth quarter impacts.* ***But relative to where the USD/CAD has been, we could still see more strengthening of the U.S. dollar relative to the Canadian dollar – and more fourth quarter-like impacts on companies that are not prepared.***

That is exactly what we saw in the first quarter of 2014: continued strengthening of the U.S. dollar relative to the Canadian dollar (or conversely, as Figure 12 shows, weakening of the Canadian dollar relative to the U.S. dollar). While the Canadian dollar ticked up a bit in the last week of the quarter, it was down overall 3.9% relative to the beginning of the quarter, and down 7.3% relative to the beginning of the fourth quarter 2013.

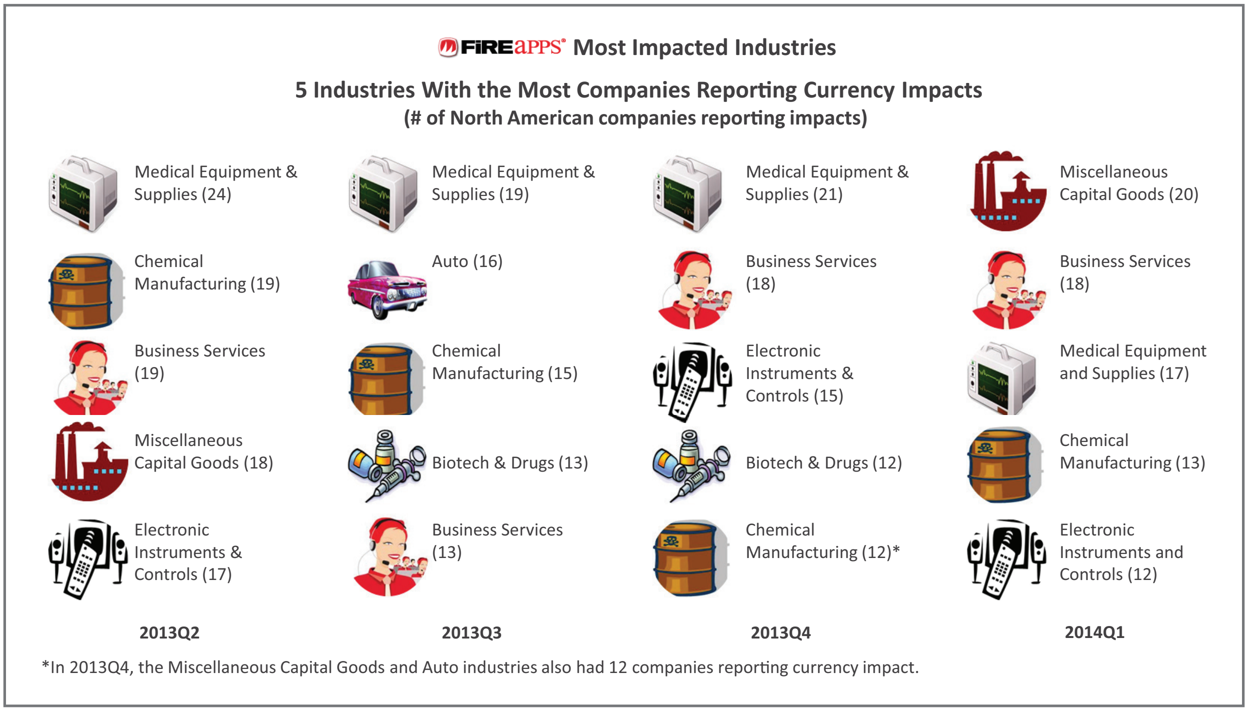
Figure 12: U.S. Dollar/Canadian Dollar Exchange Rate 2013Q4-2014Q1



The Most Impacted North American Industries

The five industries with the most companies reporting currency impacts included a number of "usual suspects" including Business Services, Medical Equipment & Supplies, and Chemical Manufacturing (all on the list in each of the last four quarters). Both Miscellaneous Capital Goods and Electronic Instruments & Controls industries were on the list in three of the last four quarters.

***Figure 13: The 5 Industries Most Impacted** (# Companies Reporting Impact)*

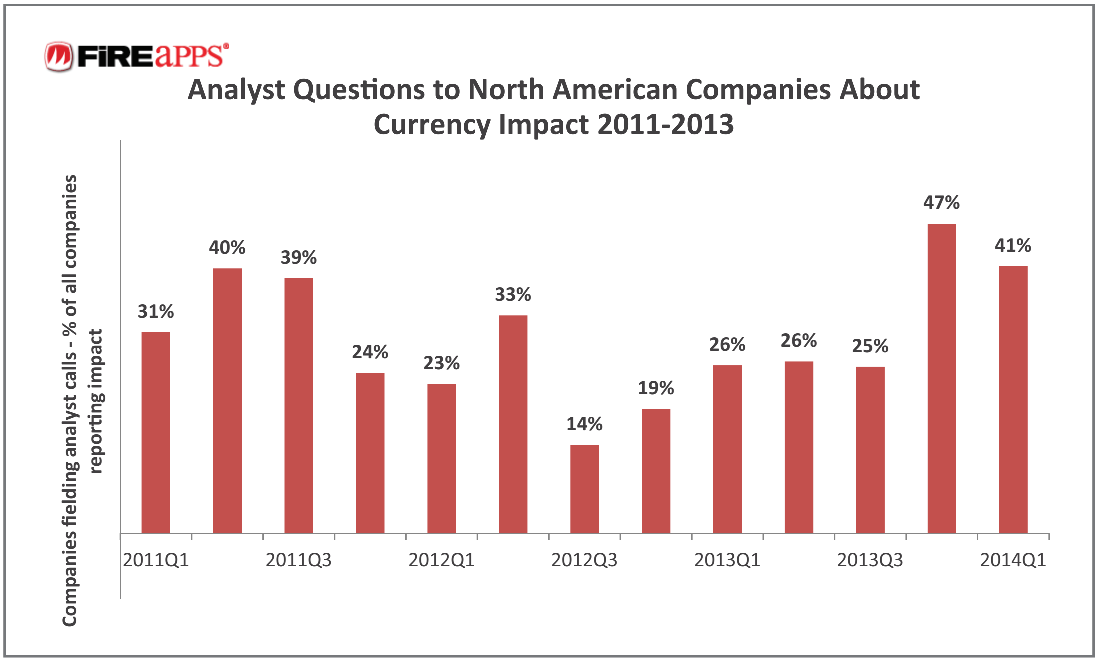


The relative concentration of companies by industry is fairly consistent. On the high end, 5.3% of the 846 North American companies are in the Business Services industry. On the low end, 3.2% of companies are in the Scientific & Technical Instruments industry.

Analyst Questions to North American Corporates

In the fourth quarter of 2013, 47% of corporates reporting currency impact fielded questions about currency impacts from analysts during their earnings calls. That was the highest number since we began this research, higher even than during the euro crisis. In the first quarter of 2014, corporates fielded fewer analyst questions – 41% – though that is still a relatively high number compared to previous quarters, as Figure 14 makes clear.

Figure 14: Analyst Questions About Currency Impact as a % of Total Companies Reporting Impact, 2011-2013



As we said last quarter, in an environment in which analysts are asking intelligent, informed questions about currency risk, corporate leaders must be prepared to answer them, for all currencies on which the company is exposed.

Currency Impact on European Corporate Earnings

The first quarter of 2014 is the first quarter for which we have included European corporates in our corporate earnings currency impact research. We analyzed the earnings calls of 354 publicly traded European corporations. 113 of those corporates reported negative currency impact. Across the companies that actually *quantified* the currency impact, total losses amounted to €3.08 billion ($4.19 billion).

As is the case for North American corporates, these impact numbers are likely to be underestimates. There are two reasons why: first, it is almost certain that some companies which faced currency headwinds did not specifically point them out. Second, of the 113 European companies reporting negative impacts, only 11.5% of them actually *quantified* the impact.

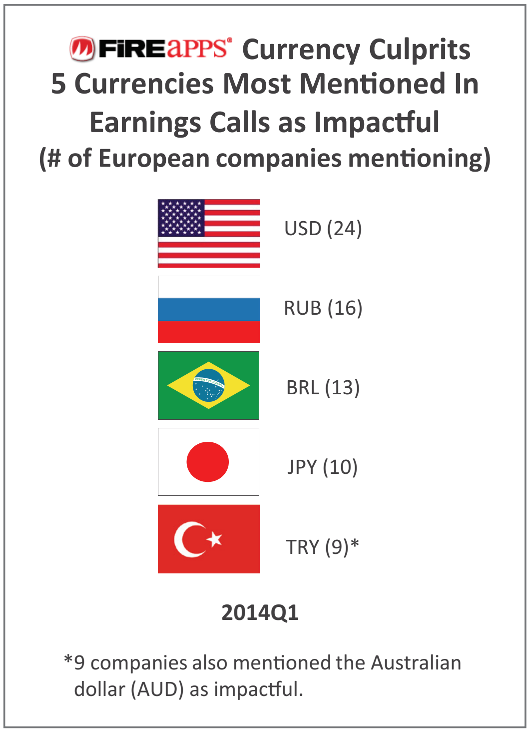
While an increasing number of North American corporates are quantifying currency impact in terms of impact to earnings per share (EPS) – rather than, say, impact to revenue – none of the European corporates quantified currency impact in that way. Regardless of how they are reported, currency impacts do flow down into earnings per share, affecting shareholder value.

Reporting currency impact as a function of EPS represents a consistent, standardized way to disclose currency impacts. It is also a best practice because it reflects the underlying reality of how currency impacts the corporation all the way to the bottom line. Within that context, it becomes clear how important currency risk management is; risking EPS is dangerous business because investors tend to react (usually negatively) first and ask questions later on earnings surprises.

The Most Impactful Currencies on European Corporate Earnings

The five currencies mentioned most often as impactful by European corporates (the "Currency Culprits") included three emerging market currencies that dealt currency surprises to companies in the first quarter: the Russian ruble, the Turkish lira, and the Brazilian real. The most mentioned currency of all, however, was the U.S. dollar.

Figure 15: Currency Culprits – The 5 Currencies Most Mentioned in Earnings Calls as Impactful
(# Companies Mentioning)



Emerging Markets

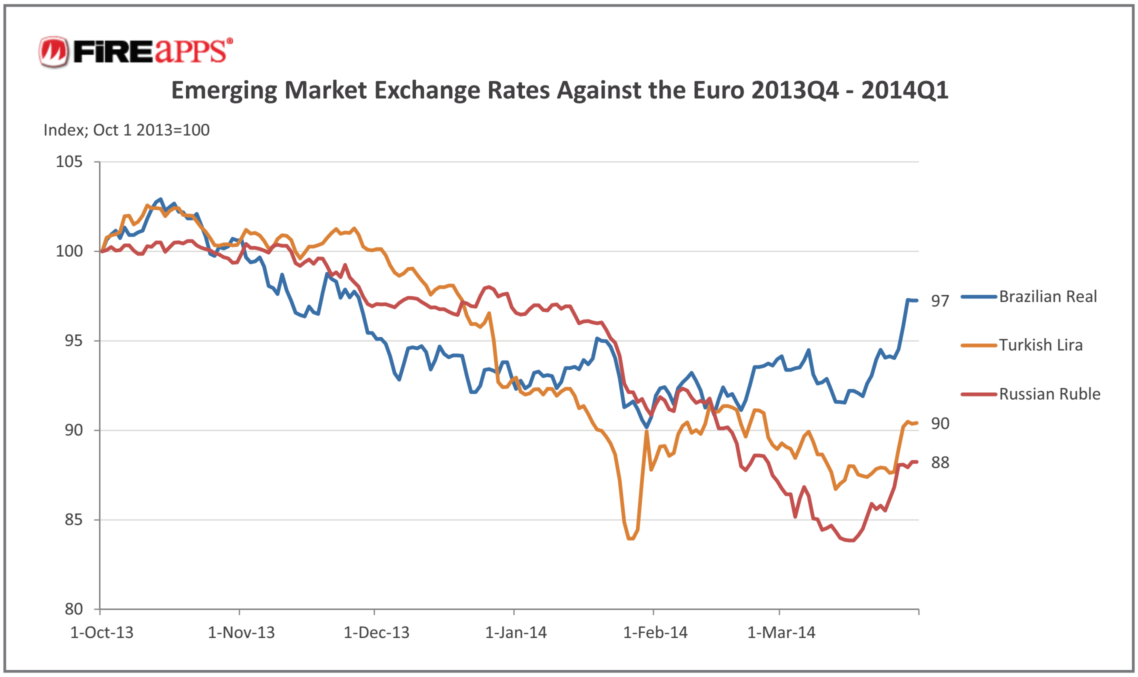
As they did for North American corporates, emerging markets dealt significant currency surprises to European corporates in the first quarter 2014. For European corporates, the specific emerging currencies reported as impactful include the Brazilian real, Turkish lira, and Russian ruble – all players in the emerging market "crisis" that began in late January, 2014.

All three of those currencies were significantly volatile in the first quarter. Against the euro, the Brazilian real was actually up 4.6% at the end of the first quarter compared to the beginning, but had been down as much as 2%.

The Turkish lira took an 8.4% plunge in January. After Turkey's central bank aggressively raised interest rates in early February, the exchange rate rebounded, though some of the rebound was eroded in March. The lira ended the quarter down 2.4% from the beginning of the quarter.

The Russian ruble has been on a general decline since the fourth quarter of 2013. Until a slight rebound beginning in the middle of March, the ruble had fallen 12.3% in the first quarter. It ended the quarter down 8% overall.

Figure 16: Emerging Market Exchange Rates Against Euro 2013Q4-2014Q1

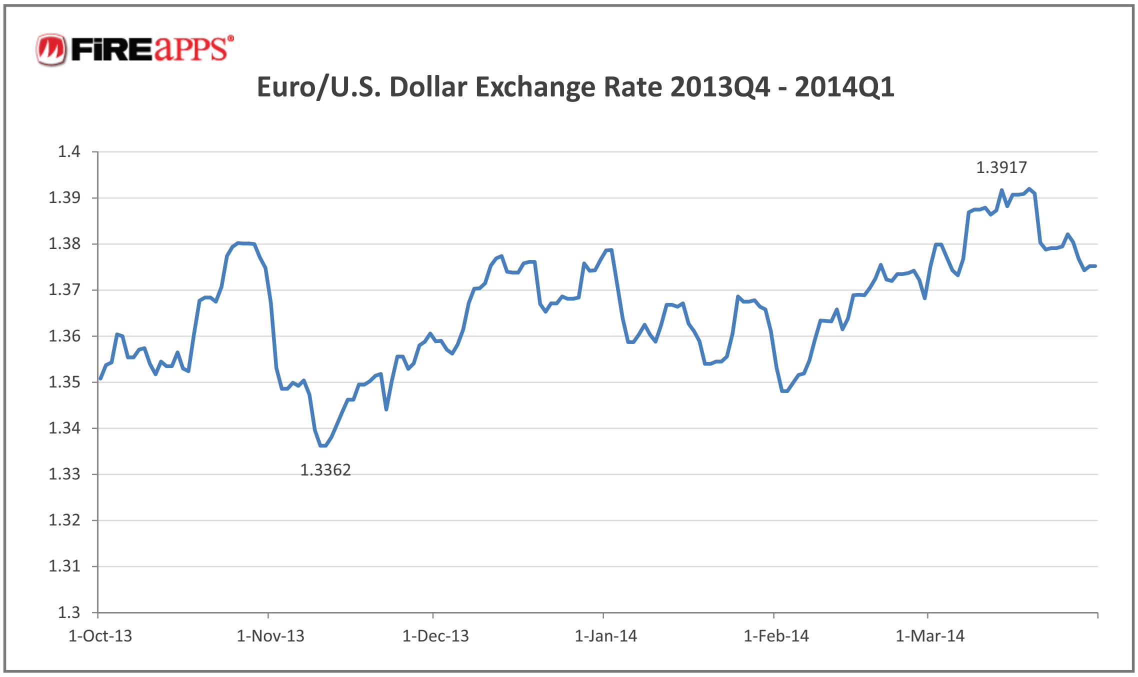


These emerging market currencies dealt surprise negative currency impacts to many European corporates in part because those corporates did not have visibility into their exposure to those currencies. One European corporate, for example, had assumed that its entities in Sweden were only generating euro/krona exposure, and was surprised with a significant Russian ruble impact. The company did not have visibility into the fact that its Swedish entities had ruble income.

U.S. Dollar

The currency most mentioned by European corporates in the first quarter of 2014 was the U.S. dollar. Between the beginning of 2013 Q4 and the end of 2014 Q1, the euro strengthened almost 2% relative to the dollar. Though in the last weeks of the first quarter of 2014, the euro weakened, ending the quarter at about the same level it began the quarter at. Within the quarter, volatility was not significant – at its highest point in the quarter, the euro was up 1.0%; at its lowest point, the euro was down 2.2%.

Figure 17: Euro/U.S. Dollar Exchange Rate 2013Q4-2014Q1



The relative strength of the euro in late 2013 and early 2014 came as a surprise to many corporates. Relative to the U.S. dollar, the euro defied expectations, which led to earnings surprises for many corporates. In December 2013, the mean estimate in a Bloomberg survey had the euro falling from 1.3758 to 1.28 in 2014. But at the end of the first quarter of 2014, the euro was at 1.38.

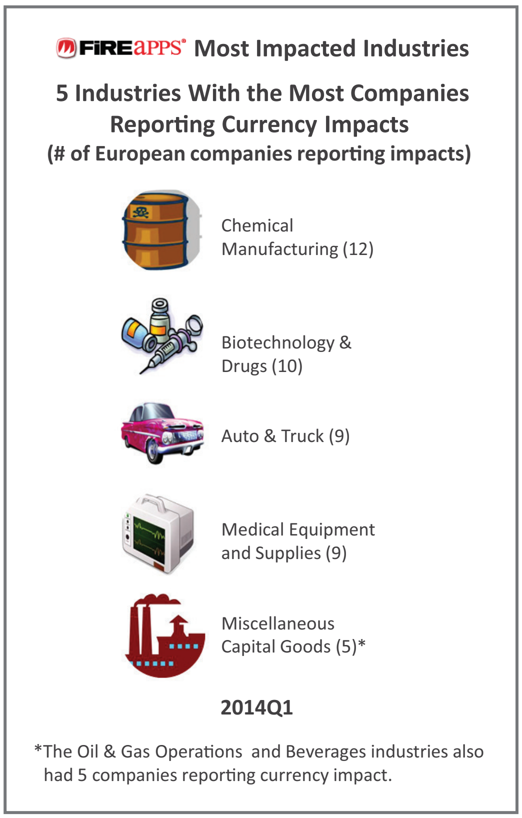
European corporates that guided based on a lower EUR/USD saw revenue eroded. European companies that issued earnings guidance based on a weaker euro now have to explain the erosion of top-line revenue to analysts and investors. Add emerging market currency volatility into the mix, and the effects on European companies are even more significant – because while EUR/USD is the largest exposure for many European companies, it is not the only exposure.

We have seen this phenomenon before – in the U.S., when a stronger-than-expected dollar caught U.S.-based corporates by surprise. We are seeing European companies do what their U.S. counterparts have done in responses to currency surprises: step back and think about how to manage currency risk to avoid these kinds of surprise impacts.

The Most Impacted European Industries

The five industries with the most companies reporting currency impacts in the first quarter of 2014 included Chemical Manufacturing, Biotechnology & Drugs, Auto & Truck, and Medical Equipment & Supplies. The Miscellaneous Capital Goods, Oil & Gas Operations, and Beverages industries tied for fifth place in the list; five companies within those industries reported currency impacts.

***Figure 18: The 5 Industries Most Impacted** (# Companies Reporting Impact)*



The relative concentration of companies by industry is fairly consistent. On the high end, 5.9% of the 354 European companies are in the Auto & Truck industry. On the low end, 2.3% of companies are in the Beverages industry.

Analyst Questions to European Corporates

In the first quarter of 2014, 46% of European corporates reporting currency impact fielded questions about currency impacts from analysts during their earnings calls. That is high relative to the typical number of analyst questions fielded by North American corporates.

As is the case for their North American counterparts, European corporate leaders must be prepared to answer analysts' questions about the steps they are taking to mitigate currency impact – for all currencies on which the company is exposed.

Bottom Line

Key Findings Recap

- The total reported negative currency impact in 2014 Q1 was $7.4 billion. European corporates reported $4.19 billion in negative currency impacts; North American corporates reported $3.26 billion.
- The average per-company negative impact was much larger for European corporates than North American corporates.
- 41% of the North American companies reporting currency impact fielded currency impact-related questions from analysts; 46% of the European companies did.
- Globally, corporates reported continued challenges from emerging market currencies – including the Brazilian real, Venezuelan bolivar, and Argentine peso (for North American corporates) and the Brazilian real, Russian ruble, and Turkish lira (for European corporates).
- Globally, corporates in the Miscellaneous Capital Goods, Chemical Manufacturing, and Medical Equipment & Supplies industries were particularly hard-hit by currency impacts.
- For North American corporates, EPS impact jumped from an average of $.03 EPS every quarter in 2013 to $.05 EPS in 2014 Q1. None of the European corporates quantified currency impact in EPS terms.

Action Items

If you are an investor:

For investors in North American and European corporations, it is critical to understand that some companies' earnings per share are being diminished by currency-related losses. While expansion into emerging markets does indeed hold the potential for significant value returns, that is only the case if the corporation can mitigate the risk associated with doing business in those markets – including the very real risk of currency impact.

To understand how a company is impacted by currencies investors should 1) read Item 3 in the quarterly report; 2) read Item 7A in the annual report; and 3) read the transcript of the quarterly earnings call, which can quickly be searched for key words like “currency” and “foreign”.

If you are an analyst:

Continue to press CEOs and CFOs to explain how they are managing currency risk, from emerging markets and elsewhere. Corporates have the ability to understand how currency volatility impacts earnings, and should be able to explain impacts and articulate what they are doing to manage currency risk more effectively in the future.

If you are a CEO or CFO:

There are a variety of reasons to expand operations into emerging markets, from lower production costs to enormous untapped consumer bases. Ultimately, your investors expect those expansions to generate value, and they are increasingly sensitive to the steps you are taking to ensure that the risks associated with emerging markets are well understood. It is your responsibility to communicate with your investors the steps you are taking to manage the currency risk associated with doing business in volatile markets.

Your investors know that if you have currency impacts greater than $.01 EPS, you are not managing currency risk to the market standard, and are therefore likely to have continuing surprises. That uncertainty and lack of predictability impacts your share price. Furthermore, analysts have a tendency to extrapolate the lack of risk management in one area to a lack of risk management in other areas, especially those that are tangential to finance.

Managing currency impacts to less than $.01 EPS is doable. For example, a recent article in FierceCFO profiled how Pfizer – a multinational pharma that is “heavily exposed to currency risk” – keeps its currency impact to less than $.01 EPS. “Pharmaceutical giant Pfizer makes most of its money abroad these days, so its operations are exposed to significant currency risk. Such exposure has taken some other multinationals by surprise, as evidenced in sizable hits to earnings. Yet Pfizer's results suggest that it is effective at actively hedging its currency risk.” [3]

If you are a treasurer/FX manager:

Getting the kind of accurate, complete, and timely (ACT) visibility that many corporate treasurers now understand they need requires instituting an analytic framework that bridges the accounting and treasury organizations. The analytic framework allows the treasury organization to see every currency exposure in the business, and thereby understand the effect that operational decisions might have on those exposures and, by extension, on earnings. In that way, the analytic framework can mitigate currency impacts that are often preventable, and always explainable.

[3] FierceCFO, “How Pfizer stands out in FX hedging,” 6 Jun 2014. http://www.fiercecfo.com/story/how-pfizer-stands-out-fx-hedging/2014-06-06

About FiREapps

FiREapps is the leader in Big Data Analytics for Corporate Foreign Exchange. For over a decade, the company has helped global leaders eliminate FX surprises, reduce transaction costs and increase operational efficiencies. Multinational corporates of all sizes and industries including 75% of top technology distributors, 60% of top pharmaceutical manufacturers, and 40% of top Internet service providers rely on FiREapps technology to identify, analyze and manage FX risk to within the industry benchmark of $.01 EPS. FiREapps is headquartered in Scottsdale, AZ, with offices in New York, Portland, and San Francisco.

For more information, go to www.fireapps.com. Twitter @fireapps

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