



### Impact of EU debt restructuring on corporate profitability

We believe the most likely outcome from Europe’s fiscal crisis is that Greece restructures its government debt, with others in the ‘olive belt’ closely avoiding this predicament. In this event, there are likely to be knock-on effects to global corporate profits. Analysis of revenue exposure on an aggregate basis for various regions suggests that Greece, Italy & Portugal have very EU-centric revenues, with an average exposure of 78%. That leaves little opportunity to benefit from the depreciating euro and resultant boost to foreign revenue. In contrast, EU-sourced revenue for the eurozone as a whole is approximately 51%, with Ireland, Germany and Netherlands having even lower exposure, with a much greater proportion of revenues derived from the US. As expected, EU-sourced revenue makes up a much smaller proportion outside the eurozone, with Switzerland, China and UK having 39%, 19% and 13%<sup>1</sup> exposure respectively. The US is at the low end of the scale, with only 8% exposure.

Recent shocks to the financial system, such as the Lehman Brothers collapse, saw an annual decline in US revenue growth of approximately 8%. In our corporate earnings sensitivity analysis we have assumed a more moderate decline in EU revenues of 5%, due to the more EU-centric/less global nature of this crisis. Costs, such as labour, are generally fixed and comprise 62% of total revenue on average. Therefore, the impact on earnings from a decline in revenue tends to be highly geared.

Exposure to currency movements is an additional concern for international corporates. This can exacerbate this gearing effect, as foreign revenue streams are usually un-hedged due to the expense

and are at the whim of investor appetite and central bank actions. We have therefore assumed a euro depreciation of between 5% and 10%, depending on the base currency. Our sensitivity analysis suggests that operational gearing is likely to be most detrimental to the PIIGS (Portugal, Italy, Ireland, Greece and Spain), as a result of their EU-centric revenue streams, although some of them are much more exposed than others.

#### Impact on earnings from EU, euro exposure

| Base country | Exposure to EU revenue | Earnings impact of 5% decline in EU revenue and euro weakness* |     |     |       |
|--------------|------------------------|--|-----|-----|-------|
|              |                        | EU   | US  | EM  | Total |
| UK           | 13%                    | -26%   | -   | -   | -3.3% |
| US           | 8%                     | -38%   | -   | -   | -3.0% |
| EU           | 51%                    | -13%   | 26% | 13% | -0.8% |
| Germany      | 65%                    | -13%   | 26% | 13% | -2.9% |
| Ireland      | 32%                    | -13%   | 26% | 13% | 9.2%  |
| Netherlands  | 43%                    | -13%   | 26% | 13% | 4.3%  |
| PIIGS        | 73%                    | -13%   | 26% | 13% | -5.9% |

\*assumes 10% euro decline vs dollar, 5% decline vs sterling & emerging-market currencies.

Source: JPMorgan, Coutts

Despite a negative hit to PIIGS & EU total earnings growth, currency weakness should provide significant support through increased foreign revenue streams. While native earnings decline by an average of 13% in both the PIIGS and the EU, the support derived from higher foreign revenue reduces the overall impact on earnings, with average declines of 5.9% and 0.8% respectively. Indeed, the weak euro would provide such a boost to EU-wide foreign revenue under this scenario, that total earnings in the region would fall by 0.8% year-on-year, compared with estimated declines of 3% and 3.3% for US and UK companies respectively.

If the euro were to fall by another 5% against the dollar (to \$1.15), EU earnings growth would turn positive, and be particularly beneficial for exporter nations such as Ireland, Germany and Netherlands. For Portugal, Greece and Italy, the euro would have to fall below parity with the dollar to produce positive earnings growth.

<sup>1</sup> A large quantity of data is classed as unallocated due to a lack of information on revenues.

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