

# THE EUROZONE MELTDOWN: RISK, VALUE, OPPORTUNITY



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# INTRODUCTION

The eurozone drama dominates the news headlines, its enormous and widespread implications reaching out far beyond Europe's borders. Increasingly, the commentary is of an austere Europe lurching from one crisis to another, teetering on the brink of stagnation, barely keeping intact. The worst-case scenarios verge on the apocalyptic.

And yet, as in any period of systemic dislocation, there will be winners as well as losers. A poll commissioned by FTI Consulting shows that many non-European investors are alert to the opportunities the crisis is creating. Europe's historically overpriced businesses are suddenly affordable. With large distressed asset portfolios to unload, Europe's banks will have to put many firms on the market at a time when their values are heavily depressed. However, investors will have to pick their way through sectors and countries with great care. Italy has a bench of very strong export-oriented companies whose fortunes are now overshadowed by runaway public sector debt. If that is addressed, corporate values may bounce back in Italy. Whereas in Greece, similar corporate opportunities may face long-term destruction because of prolonged uncertainty about the Greek government's ability to avoid default, remain in power and cling to the euro.

In this paper, we draw on the experience of FTI Consulting as a trusted advisor to many of the world's leading companies, banks and investors and on our intimate knowledge of the European business



environment, to discuss some of the issues that corporations, large and small, should be considering to successfully negotiate their way through a hostile and ever-changing landscape.

We include, as noted above, some insights from a recent poll of global business leaders in which we asked for their opinions of the eurozone crisis. Conducted to help our clients with business interests in Europe better understand the plans and perceptions of overseas investors, the survey reveals that while politicians, bankers and even public opinion might have written off Europe's prospects, those seeking value during these troubled times see the situation differently.

# OPPORTUNITIES FOR INVESTORS

Asset prices in Europe, overvalued for so long, are significantly lower than they have been for years. Today, it costs less to buy a business here than a similar one in Asia, for example, and right now the private sectors in Italy, Greece and Spain are replete with performing assets at discount valuations. With banks and other investors having to sell off huge portfolios of distressed assets and debt, it's a buyer's market for the right company.

As our survey shows, foreign investors are becoming increasingly aware of these opportunities, especially in Asia. While their North American counterparts are currently more cautious, over three-quarters of Asian respondents see their European Union (EU) competitors struggling and recognise the opportunities to invest in European businesses that this presents. In fact, almost half (45%) of Asian businesses that we spoke to are actively engaged in or are planning to make strategic acquisitions in the EU during the coming year. This contrasts sharply with their less optimistic counterparts in North America, where just 7% have similar plans. However, many large US private equity firms are reportedly planning to take advantage of what they see as a unique opportunity, not by targeting direct acquisitions but by purchasing portfolios of structured debt from banks in Europe.

Certain political and regulatory developments in the eurozone will create intriguing opportunities for investors with an appetite for risk. Consider the German energy market. Having made the environmental decision to shut down all its nuclear plants within 10 years, Germany is in the process of attempting to transform its entire energy network by investing in infrastructure and seeking alternative supplies. Major energy companies, such as E.ON and RWE, are having to reinvent their business models. As this new energy landscape takes shape, opportunities for promising investments are already appearing.

There are risks, of course. Having received heavy subsidies for years, German renewable energy businesses are not accustomed to strong price competition. With the subsidies cut and cheap solar panels available from China, German firms may face some big challenges. But this political decision is already having an impact far beyond Germany's borders and will influence the European energy landscape for decades to come.

# GROWTH AND THE EURO

Opportunities notwithstanding, however, economic and political risks remain high and are inextricably linked throughout the eurozone. Businesses will need to be aware of and prepared for these risks, whether they are hunting for bargains or preparing their defences.

In many parts of the region, economists have flagged the real possibility of a double-dip recession. Even in Germany, Europe's powerhouse economy and reluctant saviour, forecasters are predicting less than 1% growth for 2012. Many politicians and economists, both inside and outside the eurozone, also worry about the threat that resurgent nationalism and protectionism could pose to the single market and the free movement of capital, goods and people across the EU.

To others, the threat of social unrest and political instability conjures up the unwelcome ghosts of Europe's chequered past. As improbable as these more fevered fears may be, they could have a potentially detrimental impact on investor sentiment, especially overseas, as Europe's once bright and shiny brand becomes more tarnished by the crisis.

Even if these direr predictions remain unfulfilled, a sense of semi-permanent crisis where European leaders are viewed as failing to take a firm grip of events and arrive at long-term fiscal solutions

could mean that the currency and broader political risk remain a deterrent to acquisitions, however attractive the bargains.

Our survey shows that just 45% of overseas business leaders are optimistic of any economic growth in the EU during the next 12 months, with a real north/south disparity. Fifty-nine per cent anticipate growth in northern Europe while only 39% expect any improvement in southern EU countries.

Fear of the euro's disintegration and the reintroduction of national currencies continue to pervade both the markets and national psyches of many eurozone nations. On this issue, our survey also reflects a north/south divide in expectations. Most foreign business leaders believe the euro will survive (69%) but with fewer members (64%). Not surprisingly, Greece is the favourite to leave (29%), followed by Spain (14%) and Italy (12%).

Recognising the likelihood of a splintering of the eurozone, potential investors will have to be meticulous in their due diligence and risk assessment. While 66% of the respondents in our survey conducted business in the EU during the past year (77% from Asia, 25% from North America), with a similar number intending to continue during 2012, companies are aware of the need to take

steps to protect their interests. Believing that countries leaving the euro would be worse off for doing so (67%), companies would prefer to do business in countries unlikely to quit the eurozone (67%). To protect their interests, a similar number (63%) already have or would request that contracts take account of this possible scenario.

There are additional steps that companies could take to protect themselves against such risk. Irish building materials conglomerate CRH, for instance, recently downgraded its listing on the Dublin stock

exchange and made its primary listing in London. The greater liquidity of the London market may have played a role in the company's decision, but the British pound's independence from the euro could also have added to the appeal of a London listing. In fact, most of our survey respondents (72%) believe that the UK will increase in importance as a gateway to the European Union for international businesses.

## MANAGING RISKS AND REPUTATIONS

The prevailing political mood in Europe is marked by fear, pessimism and retribution. The consensus view among many audiences is that banks and businesses have been under-regulated for far too long; tougher regulation is needed to rein in and punish reckless corporate behaviour. Those who try to resist this strong political current face a tough and unrewarding struggle. Instead, companies should seek to channel rather than block the regulatory wave or risk being swept away in a rip tide of controls.

Today, openness and transparency are no longer corporate virtues to be merely aspired to; they are the requirements of everyday behaviour and a business's best defence. Increasingly, policymakers and

stakeholders expect to be kept informed. Most important, a company needs to tell its own story, not have others write the script. Strong and consistent messaging is no universal panacea. But it can help soften regulatory burdens, mitigate market reactions to negative news, and win some goodwill among investors, employees and customers whose support may prove critical through the challenging times ahead.

Take the profound crisis afflicting Europe's banking system. The bank bailouts of 2008 and 2009 required institutions to establish stricter capital ratios by 2013. That deadline is rapidly approaching. Many banks have postponed action in the hope that an economic

upturn would make it easier to sell assets. But their previous hesitation may now force banks to offload these assets into a buyer's market.

Still, banks need not accept this situation as a *fait accompli*. In fact, they have a strong argument for persuading regulators that the deadlines set in 2008 and 2009 no longer make sense given the economic turmoil that followed the original crisis. Banks can work towards convincing authorities to extend the capital ratio deadline beyond 2013, individually or even collectively. By that time, the market may have improved to the point where the assets will fetch something closer to what banks see as true valuations.

However, the herd instinct of the market tends to over-estimate the speed and impact of legislation and regulation under consideration. Maintaining a sense of proportion and perspective is essential. Measures such as the mooted EU-wide financial transaction tax may make headlines, but the possibility of its introduction has been priced into stock market valuations already. New regulations can also yield investment opportunities. The anti-monopoly regulations that forced Royal Bank of Scotland to spin off a portion of its retail business created an opportunity for Banco Santander to expand its presence in the UK, for example.

Similarly, even the political instability of the eurozone has its advantages. With all eurozone companies suffering under the same dark cloud, the debt of some solid firms is trading at discounts of 10% to 20%. This is allowing investors to purchase high-quality commercial paper with effective annual yields of 13% to 15%.

# MANAGING THE DEBIT CRUNCH

European regulators may have enacted strict bank capital ratios in order to promote stability, but these ratios will have serious implications for corporate borrowers. If banks refuse to extend refinancing on some of the €300 billion in corporate debt coming due in 2012, some large and highly leveraged companies without access to bank credit could face financial distress.

With the price of their existing debt increasing and debt profile shortened, the funding of growth opportunities for their business would be limited. Stronger companies will get stronger and the weaker ones, like some of the retail companies that have been going into insolvency recently, will disappear or their valuable stores sold at distressed prices.

Everywhere there is evidence that banks are battenning down the hatches. In the UK, Lloyds Bank is shrinking its balance sheet and reducing the size of its corporate loan book. Germany's Commerzbank has already stopped giving loans in most of its non-domestic markets and has become more selective at home, too, reportedly needing additional government assistance to stay solvent.

Some firms that have been denied access to conventional credit lines — or are not prepared to wait complacently until the banks cut them off — instead are creating their own internal arrangements

or negotiating alternative lines of credit. Private equity houses will follow their investment if the economics are right. But many will walk away from the investment if they cannot see a decent return for the new money required by the investee company and a good prospect of recovering at least part of their current investment.

Alternative lines of credit are more likely to come from asset-based lenders if the company has a good underlying security in receivables and inventory.

For companies that find themselves excessively leveraged and dependent on bank capital, the storm clouds are gathering. For them, the best possible strategy may be to find a buyer or a merger partner with the assets to help them survive in an environment where access to capital most likely will be highly constrained.

But for well-capitalised firms, the misfortunes of their more leveraged peers could spell opportunity. Over the past few years, companies like Daimler and Siemens have cut costs, streamlined operations and stockpiled profits. They are now sitting on huge piles of cash — an estimated €10 billion to €12 billion for automaker Daimler, €7 billion to €8 billion for Siemens — that could be put to use acquiring attractive public or private assets that come up for sale.

# LETTING INVESTMENT FUNDS OFF THE LEASH

As our survey confirms, overseas investors are actively seeking promising opportunities. And once EU-funding bodies are convinced that mechanisms are in place to ensure accountability and transparency, public funds should start flowing again towards badly needed infrastructure projects in Greece and elsewhere. These funds will be a boon for construction firms and a range of manufacturers.

The relative abundance of cash means that sound companies should be able to gain backing for their ventures, and attractive leveraged buy-outs should still be able to find support from the banks. That said, it is likely that debt/equity splits will be more heavily weighted towards equity for the foreseeable future. Where banks were willing to fund deals on a 70:30 debt/equity split just a few years ago, we believe most deals will need to be closer to a 50:50 ratio in the future.

Meanwhile, companies should not shy away from making the right M&A deals. The recent \$8 billion sale of natural gas provider El Paso's exploration and production assets and business software giant SAP's \$3.4 billion investment in cloud computing with its purchase of SuccessFactors (on track for final regulatory approval in the first quarter of 2012) show that transactions can still move forward for buyers who have their downside risks under control. Early movers with the most courage are most likely to gain the biggest advantage when the eurozone economy does enter its next growth phase.

# A GOOD TIME FOR ACQUISITIONS

For companies that have managed to maintain strong balance sheets, there are and will be plenty of opportunities in the near future to purchase distressed assets at fire-sale prices from three primary sources:

- The banks that are selling off their assets to meet regulators' capital ratio requirements.
- The liquidation of excessively leveraged companies that have been unable to secure adequate refinancing.
- Those nation states that are selling off assets to help reduce their budget deficits.

The first two sources should be the most interesting. Proceeds from the sale of national assets are unlikely to make any meaningful dent in the fiscal problems faced by eurozone governments. Even where they are forced by the rescue plans they have negotiated to reduce the size of the public sector, auctioning state companies is difficult at a time of such policy and currency uncertainty. The prospective sales of national lottery companies in Greece and Spain have stalled at the moment for political reasons.

Risk-averse firms may prefer to continue cutting costs, but many already have done as much as they can to slash expenses to the bone. Further trimming may undercut core competencies. And, in any case, cost cutting is rarely a path towards profitable growth.

The combination of the upcoming refinancing "wall" in 2013 to 2015, the deleveraging of the banks and increasing austerity measures will impact access to funding for two classes of lenders in particular. While large, investment grade companies will be favoured by banks as customers, the mid-market, and in particular mid-market private equity-backed companies, will be squeezed.

Already, the cost of refinancing for such companies has risen and the length of facilities shortened. Only the very best prepared mid-market leveraged companies will secure the funding they need to be able to focus on running their business rather than managing a continual work-out process.

The key is preparing and presenting a refinancing plan that balances:

- Volume growth in difficult consumer and customer markets that is not considered optimistic.
- Pricing that reflects increasing competition.
- A differentiated product or service development strategy.
- Cost and cash flow management beyond what management already might have thought possible.

Given the challenges facing the eurozone, troubled companies without the desire or ability to pursue bold breakout growth strategies may need to take a hard look at maximising value for shareholders through asset liquidation.

# OPPORTUNITIES FOR INNOVATIVE INVESTMENT

The best opportunities for investors in an unsettled market may lie beyond asset sales and bankruptcy auctions. For example, corporate buyers and private equity businesses may be able to create value by taking over businesses from hedge funds that have neither the skills nor the patience to make the operational improvements necessary to turn their businesses around in the current economic climate. However, with less leverage available, private equity firms may need to readjust the expectations of their investors about likely rates of return.

But if some hedge funds are offloading traditional investments, others are seeking new arbitrage opportunities. Some, for instance, are purchasing distressed company debts at bargain rates (3% to 4% of face value) in the hope of using litigation to settle the debts. If they can get settlements at 7% or 8% of nominal value, they can double their investments.

Meanwhile, investment funds like Calunius, a founding member of the Association of Litigation Funders of England and Wales, are offering to help companies with legal costs in exchange for a percentage (typically 20% to 30%) of monies recovered. Leveraged companies, without the cash to pursue cases on their own, may welcome help from partners such as Calunius. Even those with deep pockets may prefer to accept lower returns in exchange for letting such an organisation take on the costs and some of the risk of a lengthy court battle.

# CONCLUSION

It is clear that 2012 will not be a year of mere decline in Europe. The next 12 months and beyond will see massive shifts in corporate ownership on the continent, with non-European entities playing a decisive role.

Those seeking investment opportunities will require the persuasive powers of an ardent suitor combined with the cunning and vision of the hunter. Vulnerable incumbents will need to hone their survival skills, make their deals and mount their defences.

The challenges truly are epic and unprecedented. But so are the opportunities and potential rewards. One thing is certain: the European business landscape will never be quite the same again.

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Where others see only volatility and risk, our consultants see opportunity. We help our clients find the best ways to overcome challenges and maximise value.