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Foreign exchange curveballs

Capitalizing on paradigm currency shifts

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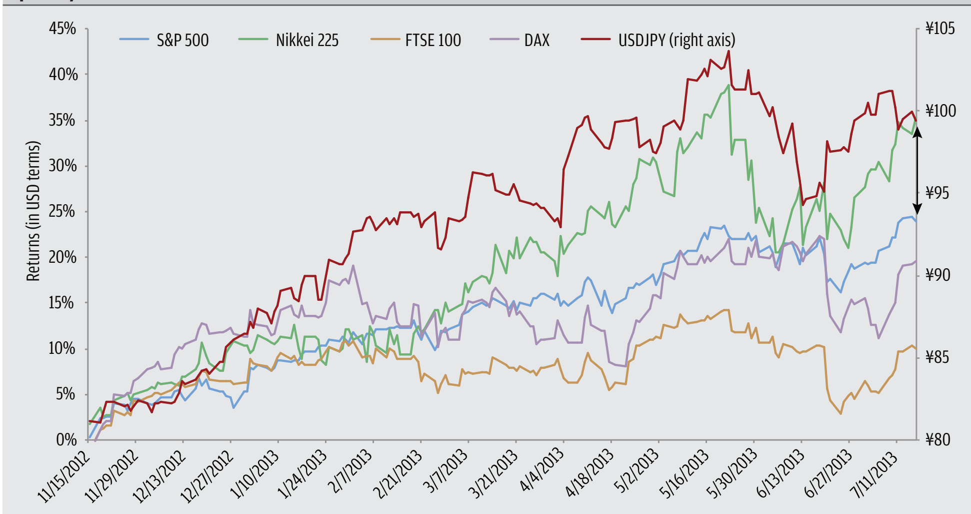
1. Recent paradigm shifts in foreign exchange rates

Foreign exchange rates often make large and persistent moves. Such swings should now warrant greater attention from senior decision makers in light of increasing competition among firms worldwide. For example, a country may pitch a curveball to foreign exchange markets by adopting a loose monetary policy that depreciates its currency. This move will likely benefit exporters based in that country at the expense of their foreign competitors. A case in point is the economic policy being pursued by the current Japanese government.

As part of its successful election strategy, the then opposition in Japan called for bold fiscal and monetary actions to boost Japan's long-stagnant economy in November 2012. These policies have been implemented since this new government took office in December 2012 and have resulted in an over 20% **depreciation of the Japanese yen (JPY) versus the U.S. dollar (USD) in six months.** Global markets seem to believe that this depreciation assists Japan's export-based firms: Since the announcement, the **Nikkei has been the best performer among major indices worldwide, surging 35%** in dollar terms and outperforming the S&P 500 by 11%, the FTSE by 25% and the DAX by 15% (Figure 1). Although this difference in performance has dampened somewhat in recent weeks, the general pattern still holds and analysts estimate that the JPY will continue to depreciate through the coming year.

Figure 1

Japanese equity markets outperform their global peers since the opposition called for bold policy shifts

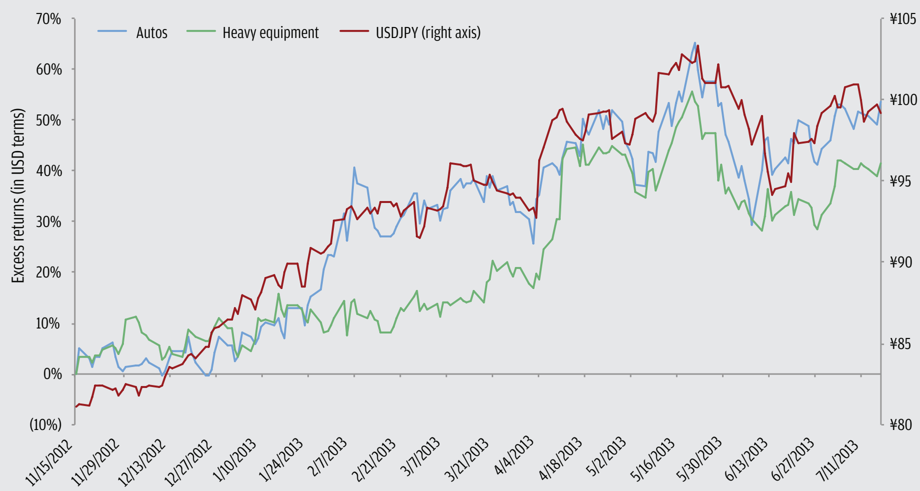


Source: FactSet as of 7/16/2013
Note: Based on USD returns

While Japanese equity outperformance has been evident across a wide range of industries, it is especially pronounced in export-oriented sectors where firms have major rivals in the U.S., Europe and Asia. Firms in two such industries in Japan—automobile and heavy equipment manufacturing—have significantly outperformed their global peers (Figure 2)

Figure 2

Excess equity returns for Japanese companies versus global companies in select sectors since shift in Japanese monetary policy



Source: FactSet as of 7/16/2013
Note: Based on USD returns

Today's globalized and competitive economy requires firms to be aware of the potential impacts from significant moves in foreign exchange rates. In this report, we provide an overview of the impact foreign exchange rates have on U.S. and global firms. More importantly, we suggest an action plan to help firms adjust to and capitalize on the current exchange rate environment. Highlights of our report include:

I	**Currency changes can be significant and long lasting** For example, the JPY fell over 25% relative to a basket of currencies between 1995 and 1997 and then traded in a relative flat range for most of the next decade. Such shifts in exchange rates may necessitate a significant "rethink" of corporate finance strategies, especially if we are once more heading toward an environment of broad USD strength
II	**Globalization increases the importance of exchange rate moves** Competition from foreign firms can exacerbate indirect exchange rate exposure (such as loss of relative pricing power)
III	**Exchange rates moves can have a double impact by both reducing cash flows and increasing risk** Disappointing 2013 Q1 top-line results coupled with a premium for low-volatility firms renew the focus on foreign exchange rates[1]
IV	**Firms should employ a multipronged action plan to capitalize on a strong USD** A combination of tactical and operational strategies can help overcome currency headwinds and lead to value creation—or prevent value destruction

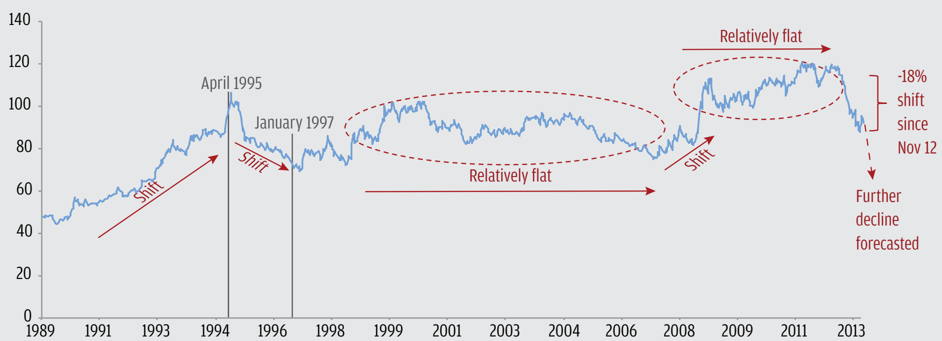
[1] For further reading, please see our October 2012 report: "Riding the foreign exchange roller coaster: Corporate finance implications of a riskier currency environment"

2. Heading toward a strong USD environment?

This is not the first time a major currency, including the JPY, has moved meaningfully relative to others. As previously noted, between April 1995 and January 1997, the JPY fell by 28% versus a trade-weighted basket of currencies. This move was powered by healthy global growth and a deflationary Japanese economy, and was then followed by a decade-long period of a relatively flat and weak JPY (Figure 3). **Currency moves such as these can have significant implications for global markets.** As a case in point, the weak JPY/ strong USD environment of the 1990s fueled U.S. consumption of imported goods and hastened the decline of the U.S. manufacturing industry. Simultaneously, the Southeast Asian nations whose currencies were pegged to the USD found their exports becoming increasingly less competitive and eventually succumbed to the financial crisis of 1997.

Figure 3

Trade-weighted index of the JPY: 1989–present



Source: FactSet, Bloomberg as of 7/16/2013
Note: For further reading on the new FX environment, please see our October 2012 report, "Riding the foreign exchange roller coaster: Corporate finance implications of a riskier currency environment." Based on GS JPY Trade-Weighted Index

Is this pattern repeating itself today with the sudden and severe devaluation of the JPY? Since November 2012, the trade-weighted index of the yen has steadily depreciated by 18% (although with increasing volatility in recent weeks). Moreover, the JPY is projected to continue depreciating against major currencies, with the consensus estimate of analysts pegging an additional 10% depreciation (from today's level) relative to the U.S. dollar by the end of 2014.[2] Adding fuel to this fire is the increasing secular strength of the USD, which is driven by a domestic economy growing at a faster clip than those of its developed peers. The result: Economic conditions could begin to strongly resemble those of the early-to-mid 1990s. A repeat of such a scenario could lead to a **persistently strong USD environment with long-lasting financial strategy implications.**

EXECUTIVE TAKEAWAY

We may be entering a persistently weak JPY/ strong USD environment with ongoing business ramifications. This requires companies to update their financial and operational strategies to ensure shareholder value creation (or limit value erosion).

[2] December 2014 forecast of ¥110 based on Bloomberg consensus economic forecast as of 7/16/2013

3. Foreign competition increases importance of currency moves

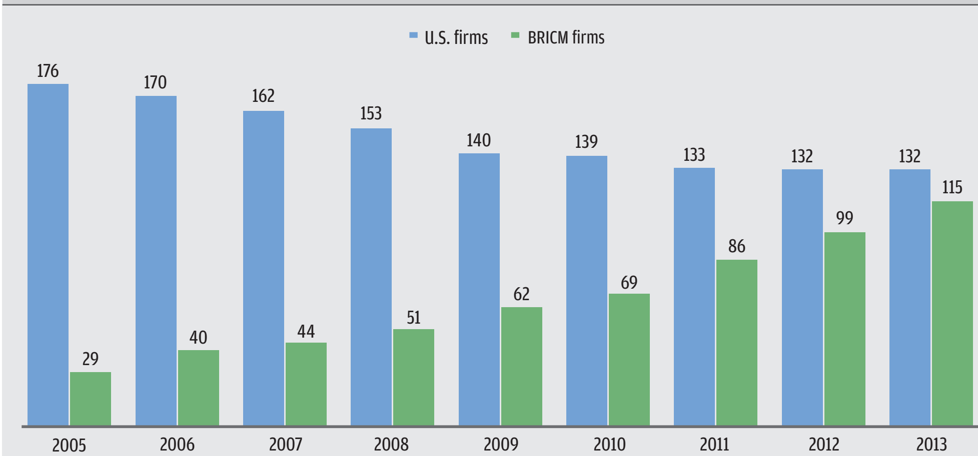
Firms with foreign operations face both direct and indirect challenges from exchange rate movements. Direct risks include transaction and translation exposure. Examples of transaction exposure include forecasted sales in a weakening currency supported by expenses in a strengthening currency (such as the home currency), as well as the revaluation of foreign currency monetary assets and liabilities, which will drive the value of foreign-currency receivables down and home-currency payables up. These exposures create margin risks and result in foreign exchange losses booked to current income. In the same fact pattern, translation losses will arise when a foreign subsidiary's balance sheet and income statement are translated into the parent company's functional currency, and while primarily reducing equity (via the CTA account), can also further marginally reduce consolidated earnings at the parent (when the average exchange rate for the period has depreciated against the historical exchange rates used for comparative purposes).

On the other hand, **indirect risks are inherent even in firms that sell and produce within a single country.** For example, a competitor to a U.S. auto manufacturer may produce in a country (Japan) that has experienced a currency devaluation relative to the currency in which their sales are denominated (USD). The competitor's improved margins may allow them to lower prices, which will affect the pricing power and market share of the U.S. firm remaining within their own borders.

While firms have long faced direct problems from exchange rate moves, indirect risks have risen in recent years from increased foreign-based competition. The last decade has seen the rise of major emerging markets corporations that are legitimate rivals to developed market firms. The number of U.S.-based firms in *Fortune* magazine's Global 500 list has steadily decreased from 176 in 2005 to 132 in 2013 (Figure 4). By comparison, the number of firms from the BRICM[3] countries has quadrupled from 29 to 115 over the same time frame.

Figure 4

Presence of BRICM firms in *Fortune*'s Global 500 rapidly approaching that of U.S. firms



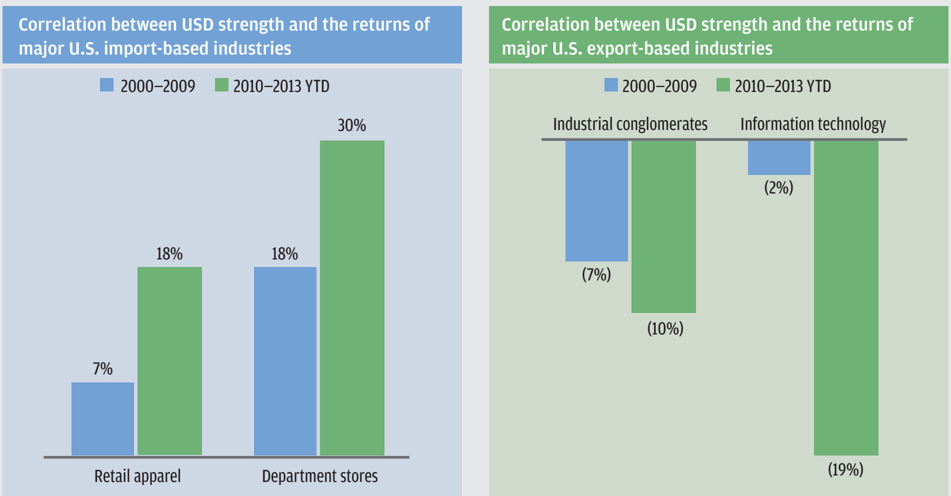
Source: CNN

[3] BRICM refers to Brazil, Russia, India, China and Mexico

The impact of exchange rates manifests itself differently in the various sectors making up the global economy. Importers tend to outperform and exporters tend to underperform when the home currency appreciates. Currency swings are especially relevant today given the indirect challenges posed by the international nature of corporate playing fields. **Global competition has therefore increased the sensitivity of U.S. stock returns to the strength of the USD** (Figure 5).

Figure 5

The increasing impact of currency swings on equity valuation



Source: FactSet, St. Louis Fed, J.P. Morgan as of 7/16/2013
Note: Based on weekly returns (2010-2013 YTD) of S&P 500 sectors relative to the S&P 500

EXECUTIVE TAKEAWAY

Exchange rates are more important in today's globalized economy. Their impact, and hence the required re-tooling of corporate strategy, will vary across sectors.

4. Exchange rate movements hurt firms through both cash flows and volatility

Swings in foreign exchange rates doubly impact firms by not just reducing cash flows, but also by increasing their volatilities. Figure 6a helps illustrate this point. Firm value equals expected cash flows discounted at the appropriate rate. Figure 6a describes how currency movements can affect both components of this equation. **Unfavorable exchange rate movements often lower net cash flows** through a combination of higher costs for one or more inputs, increased contracting costs and reduced pricing power/revenues. **Exchange rate swings also tend to increase the volatility of cash flows,** making them less predictable and increasing the required discount rate.

As mentioned in our prior report, market participants are paying increased attention to currency-related fluctuations in financial metrics.[4] This is especially so today given the recent increase in exchange rate volatility.[5] The rise in volatility affects valuation since the investors reward firms that manage down risk, especially financial risk (Figure 6b).

Figure 6a

Shifts in exchange rates doubly affect firms through both cash flows and volatility

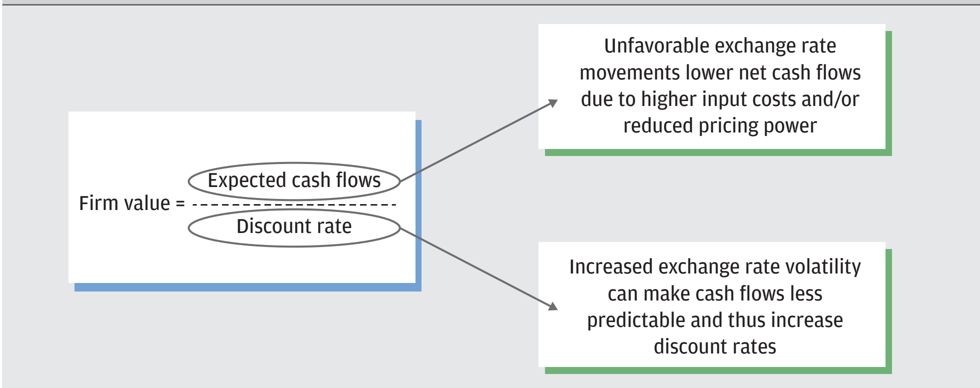
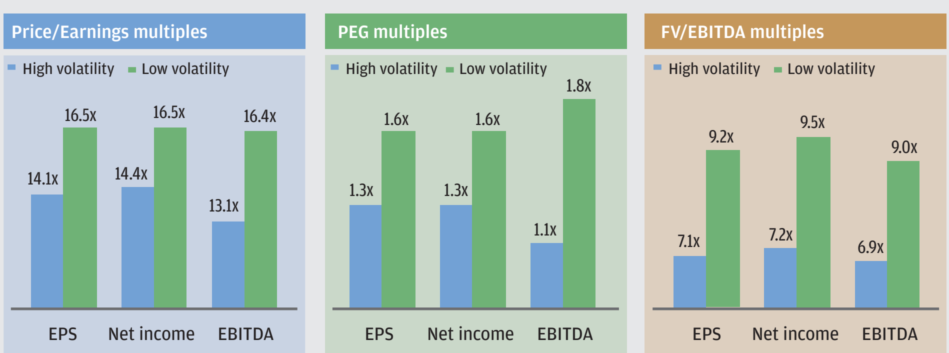


Figure 6b

Firms with lower earnings volatility trade at a premium versus companies with higher volatility



Premium for low-volatility firms

17%	15%	25%	26%	26%	60%	30%	31%	29%

Source: FactSet, Bloomberg, J.P. Morgan as of 7/16/2013
Note: Analysis is based on median P/E, PEG and FV/EBITDA ratios for high-volatility firms (75th percentile) and low-volatility firms (25th percentile) in S&P 500, excluding financials; volatility is defined as the standard deviation of annual growth over previous 10 years

EXECUTIVE TAKEAWAY

Shifts in exchange rate regimes doubly affect firms by reducing their profitability and by increasing the volatility of key financial metrics. Firms should therefore be strategic about likely impacts from foreign exchange rates.

[4] "Riding the foreign exchange roller coaster: Corporate finance implications of a riskier currency environment," J.P. Morgan Corporate Finance Advisory, October 2012

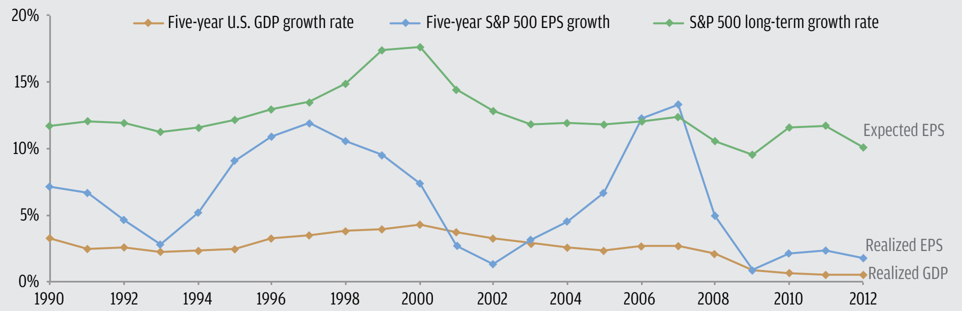
[5] For example, the three-month implied volatility for the USD-JPY cross rate increased from 9.4% on 1/1/2013 to 13.4% on 7/16/2013

5. Regime changes in exchange rates make challenging times tougher

Growth rates have declined in recent years in the U.S. The annualized five-year U.S. GDP growth rate is at its lowest level in the last 50 years. This slowdown has continued into 2013 Q1. The stagnant economy and reduced prospects have created challenging times for corporations. As seen in Figures 7 and 8, firms have consistently struggled to meet analysts' estimates. Compounding the problem for these firms is that the decline in the JPY has simultaneously benefitted their Japanese competitors (Figure 8).

Figure 7

Growth has been weak relative to expectations



Source: Bureau of Economic Analysis; FactSet

Figure 8

Many firms explicitly draw attention to the impacts of currency fluctuations

U.S. and global firms – Q1 2013

"We entered the quarter with a modest currency headwind, but became more pronounced due to currency movements over those last 90 days especially in the yen. When you look at the reported revenue for the quarter, currency impacted our revenue growth by two points."

– U.S. technology firm

"We had a strong start into the year with overall 6% sales growth on the group level at constant rates. In Swiss Francs, it was slightly lower at 5% mainly due to weakening of Japanese yen."

– European pharmaceutical firm

"The depreciation of the yen reduced first quarter passenger revenue...and we expect the year-over-year yen pressure to continue throughout 2013."

– U.S. airline

Japanese firms – Q1 2013

"Sales for the fourth quarter ended March 31, 2013 increased 8.3% year-on-year...This increase was primarily due to the favorable impact of foreign exchange rates and the impact of the consolidation."

– Japanese technology firm

"Operating income increased substantially due to...the correction of yen appreciation in the second half of the fiscal year."

– Japanese auto maker

"YoY decrease both in sales and profit due to the sluggish sales in coal chemical and functional materials, and a heavy repair cost despite of margin recovery by yen depreciation."

– Japanese heavy metal firm

Source: Earnings call transcripts, news articles

EXECUTIVE TAKEAWAY

U.S. firms have struggled in recent quarters to meet expectations. Currency moves have exacerbated these challenging times, renewing the focus on foreign exchange rates.

6. Summary of corporate action plan for exchange rates

Since the financial crisis of 2008, foreign exchange rates have experienced paradigm shifts. The latest of these swings is the 18% depreciation of the JPY relative to a basket of key currencies. While this shift has explicitly benefitted a large number of major Japanese firms, their global rivals have struggled with this movement. **Recent exchange rate trends could solidify into a strong USD environment in the coming months driven by relatively healthy growth in the U.S.** With this backdrop, it is critical for senior decision makers and boards to be cognizant of significant moves in exchange rates, to understand their impact and to be prepared to take advantage of meaningful shifts.

Corporations can utilize several strategies to enhance valuation in the current environment. **We propose two modes of action for corporate executives** to take advantage of the current weakness of the Japanese yen and the rising strength of the U.S. dollar. **The first comprises tactical methods** such as capital markets-based solutions, including **global financings.** Such a shift in capital raises should lessen currency-based asset liability mismatches as well as help international companies benefit from recent paradigm exchange rate movements. These tactical solutions provide the additional reward of raising valuation multiples by lowering foreign exchange-induced earnings volatility.

The second mode of action is a strategic rework of operations to "go on the offense." This includes renegotiating key agreements (such as supply, purchase and labor agreements) to lessen currency impacts, implementing a comprehensive risk management framework to anticipate currency moves and to diversify production and sales capacity geographically. A key example of this approach is for companies to **leverage the recent strength of the USD for overseas acquisitions,** thereby capitalizing on potential disconnects between exchange rates and economic conditions. Among other benefits, this helps to globally diversify the supply chain, to potentially expand into untapped markets and to reduce (at least in the short term) the trapped cash problem U.S. firms face.

Corporate action plan for exchange rates	
Tactical	• Hedge foreign currency transaction risk with derivatives • Adopt capital markets-based strategies to offset translation risk • Raise financing in local markets (or swap USD debt) to lessen currency-based asset liability mismatch
Strategic	• Implement updated risk management framework and adopt enhanced operating guidelines • Renegotiate purchase, supply and labor agreements to offset recent and anticipated currency movements • Develop production capacity in low-cost and/or undervalued regions • Capitalize on strengthening USD to acquire undervalued/distressed assets overseas

EXECUTIVE TAKEAWAY

Firms can capitalize on paradigm shifts in exchange rates to create lasting value by adopting a multipronged action plan. We offer tactical and strategic options to assist firms with the decision-making process.

Notes

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