



## **IS YOUR COMPANY READY IF THE EURO COLLAPSES?**

### **Seven steps for contingency planning**

By Professor Nuno Fernandes – December 2011

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On December 5th Standard & Poor's warned of a possible mass ratings downgrade for 15 euro zone countries, including the six with a AAA rating (Germany, France, Austria, The Netherlands, Finland and Luxembourg). This would have been considered unthinkable just one year ago.

In my opinion, the euro will survive, and there will be no major upheavals in the next few months. I even foresee a probable resolution of the current uncertainties being reached by the end of January 2012. The resolution is likely to consist of short-term measures (including a massive guarantee or liquidity provision by the European Central Bank) and medium-term measures (fiscal consolidation and competitiveness initiatives).

Nevertheless, business leaders must realize that there is a real threat of the euro breaking up and of several euro zone countries reverting back to their former currencies (the so-called redenomination risk). Some managers prefer to ignore this issue, and say that they don't have a contingency plan for a euro break-up. This is simply bad risk management. Even if the odds of such an event are low, the consequences can be severe.

We have seen this in the recent past. Many boards and companies were caught by surprise by the collapse of Lehman Brothers and the freezing of credit markets, which precipitated a recession across the Western hemisphere.

Companies have a duty to their shareholders not to be unpleasantly surprised by a potentially threatening crisis. They must not ignore worst-case scenarios, which, though unlikely, can be devastating.

So as a senior manager, what steps should you take to prepare for a possible euro collapse?

As a minimum, you should analyze the legal consequences of a euro zone break-up for outstanding cross-border commercial contracts. Overall, the impact does not have to be hugely negative, since some companies will benefit from natural hedges.

Beyond the direct impacts, companies should consider several other implications of redenomination risk. They should take steps to manage not only the direct exposures, but also some of the indirect ones, and should not put all their eggs in one basket.

I would recommend the following seven steps as the basis of sound contingency planning:

- 1) Handling a liquidity crunch. Interbank lending already dropped sharply this year, and a euro collapse would squeeze liquidity further. The question is whether the credit crunch will reach beyond Europe. You have to worry about balance sheets around the world. Are you ready to fund your operations for the next 12 months, without access to bank credit or bond markets? In addition, many of your loans and bonds may have covenants linked to the rating of your firm, or even to the sovereign rating of the country where your firm is located. Are you capable of sustaining uninterrupted funding for your operations in case the covenants are breached?
- 2) Focus on investments that can safeguard you in harsh times. Some companies are better placed than others. If you generate more than half of your sales outside Europe, from emerging markets, you are on safer ground than others. Have contingency plans that allow you to focus on your core business, and minimize disruptions to it. This may involve divesting some non-core assets. Remember, when everybody is selling, it is not a good time to be a seller!

- 3) Ensure a strong balance sheet, and manage your debt maturities. If you have to roll over a substantial amount of debt in the next few months, what steps can you take if there is a substantial worsening of economic conditions, leading to a complete freeze of credit markets? You must prepare to ensure an uninterrupted flow of funds to continue your business operations.
- 4) Manage exposure to foreign exchange. If you are mainly a euro zone exporter, what procedures do you have in place to deal with currency uncertainty? Reconsider currency hedging programmes. With countries coming out of the euro, we will see some massive devaluations (30 to 60%) that will make imported products very expensive. Doing nothing may mean that your profits, when converted into a common currency, can plummet substantially. However, take extreme care with derivative market hedging. A substantial part of the CDS market is unlikely to serve as a hedge. Indeed, following the recently approved 50% haircut on Greek debt, bondholders are still complaining that this is a “credit event” that should lead to payment under the CDS contract. The issue is not settled yet, but, unfortunately there are political pressures to end the validity of the CDS as a credit/hedging tool.
- 5) Incorporate a reconversion of currencies into your strategic planning. This has huge balance sheet implications for exporters in particular. Hoping for the best is no longer an option. What will you do if there is a massive devaluation (relative to the dollar, pound, Swiss franc or yen) of the currencies (re)adopted by peripheral euro zone countries after they leave the euro? Do you have the payment systems ready for a change in the invoicing currencies, and consequent changes in cash flows?
- 6) Watch your supply chain carefully. Small firms could be disproportionately hit if they depend on exports to the European continent. Watch your suppliers’ finances carefully too, and, when possible, try to work with them on some win-win propositions for both sides.
- 7) Assess how prolonged recession in Europe would affect your balance sheet. Be sure to place cash reserves in safe investments and control non-essential expenditures. Also take into account the weak economy and constraints on consumer spending that may result from this crisis. Consumption patterns will no longer be the same.

Good risk management means planning for unlikely scenarios. The odds of a euro break-up are small. However, the consequences could be devastating, and you don’t want to be caught off guard.

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