Companies in Europe adapting to strong euro
Carter Dougherty

Corporations juggle activities to make the risks manageable.

When Louis Gallois, the chief executive of Airbus, sought recently to explain why the plane maker needed to cut thousands of jobs to improve competitiveness, he had a ready culprit — the strong euro.

"A strong euro is a choice," Gallois told workers earlier this month. "Unfortunately, I am not in charge of the currency policy of Europe."

A four-year run-up in the euro against the dollar, and a more recent rise in the euro against the yen, has been cutting into the bottom lines of Europe's blue-chip companies.

For big players like Airbus, whose costs are priced in euros while their products are priced internationally in dollars, the euro's strength can spell trouble if not adequately managed.

But over the last decade, many European corporations have shored up their safeguards against currency movements. Convinced that exchange rates are fundamentally uncontrollable, major companies as diverse as the luxury goods maker LVMH Moët Hennessy Louis Vuitton, the auto manufacturers BMW and Volkswagen, or the pharmaceutical maker GlaxoSmithKline have created business models that account for this reality.

Driven by the need to cut costs and diversify globally, many have smartly rearranged their sourcing of products and services; built new facilities around the world; and employed new financial instruments, turning the euro into what raw material prices have long been — a manageable risk.

"Corporates have turned much more laissez-faire, and this ideology permeates what finance ministries and central banks also believe," said Chris Turner, head of foreign exchange strategy at ING Barings in London. "The companies know they cannot expect to be bailed out."

Take BMW, the luxury automaker, that, like Airbus, has been hard hit by the strong euro.

Because most of its production is in Europe and much of its revenue is in dollars, BMW bears a large currency risk burden and tries to mitigate that burden through assiduous financial hedging, which is the buying and selling of currency derivatives. Still, not every risk can be eliminated and it sometimes does hit the bottom line.

BMW planned last year for a euro rate ranging from $1.17 to $1.20, but since the dollar was stronger for most of last year, the company expects to earn about €677 million less for 2006 than it would have if the dollar behaved as forecast.

Yet BMW is not clamoring for intervention in currency markets, said Mathias Schmidt, a company spokesman. Instead, the company is crafting its own solution.

"This has nothing to do with politics," Schmidt said.

Part of the solution lies in Spartanburg, South Carolina, where BMW has made cars for the American market since 1994.

Schmidt said the company could build another facility there in the future as part of a global strategy known as natural hedging that aims to ensure that costs and revenue are denominated in the same currency, in this case dollars.

GlaxoSmithKline, the Britain-based pharmaceutical manufacturer, has managed to naturally hedge away virtually all its currency risks by locating facilities across the globe.

About half of the company's revenue comes from the United States, but about 50 percent of its research and development costs — among the greatest expenses in pharmaceuticals — are incurred there as well. Britain is home to 40 percent of the company's R&D, but with labs in Italy, Spain, Singapore and in the future, China, the company has, from a currency perspective, balanced its costs and revenues.

Clive McDonnell, chief European strategist for equities at Standard & Poor's in London, analyzed the biggest European companies late last year and found that the health-care sector was among the least exposed to currency swings thanks to hedging. Without hedging, earnings per share could fall 4 percent, but hedging cuts that risk in half, he said.

He also found that companies were constantly revising how they organize production and their strategies for financial hedging.

Executives are probably much savvier today, McDonnell said, precisely be- cause they learned valuable lessons after taking hits during the 1990s.

"You cannot extrapolate that to today," he said. "They have made a lot of moves to limit the effects of currency swings."

Problems arise, however, when companies are limited by how much they can hedge naturally. Perhaps no European company faces more political limits to its natural hedging than Air- bus, which claims it loses €1 billion for every rise of 10 euro cents against the dollar.

Airbus, owned by European Aeronautic Defense & Space, is hamstrung in its choice of locations for facilities because of the political makeup of the parent company's shareholders. Factories are located in France, Germany, Britain and Spain, reflecting stakes that the various governments hold in EADS. That structure makes it politically difficult for Airbus to set up shop outside of Europe, reducing its ability to tap the natural hedge of production in dollar- based locations.

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