

Global CFO Survey: Private equity hurting corporate acquisitions; CFOs pessimistic

DUKE UNIVERSITY NEWS
Duke University Office of News & Communications
<http://www.dukenews.duke.edu>

HOLD FOR RELEASE: 4:45 p.m. EDT Wednesday, Nov. 29, 2006

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SURVEY: CFOS REMAIN PESSIMISTIC ABOUT U.S. ECONOMY; PRIVATE EQUITY DEALS ARE SQUEEZING OUT CORPORATE ACQUISITIONS

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DURHAM, N.C. -- Optimism about the U.S. economy improved slightly this quarter among chief financial officers, but fewer than a third of respondents to a quarterly survey say they expect the economic outlook to improve in the short term.

CFOs are particularly concerned about consumer demand, rising labor costs, high health care costs and a shortage of skilled labor. In addition, half of firms that are active in the acquisition market say that private equity investors have significantly inflated the price of acquisitions.

These are some of the conclusions of the November 2006 Duke University/CFO Magazine Business Outlook survey, which asked CFOs from a broad range of global public and private companies about their expectations for the economy. The survey concluded Nov. 20 and generated responses from 993 CFOs, including 446 from the U.S., 353 from Asia and 194 from Europe. The survey of European CFOs was conducted jointly with RSM Erasmus University in the Netherlands. Results in this release are for U.S. firms, unless stated otherwise.

SUMMARY OF SURVEY FINDINGS:

--Nearly 35 percent of CFOs say they are more pessimistic about the U.S. economy than they were last quarter. Thirty percent say they are more optimistic, up from 20 percent last quarter.

--Capital spending plans have been scaled back, with an increase of less than 5 percent planned over the next 12 months, down from 7.5 percent in June.

--Weak consumer demand, higher wages, health costs and skilled labor shortages are the top concerns of CFOs.

--Half of CFOs say that private-equity buyers are making it too expensive to acquire companies at acceptable prices.

--A quarter of publicly owned companies have been contacted by "activist investors" who are urging changes.

--CFOs say resolving the Iraq war should be the top priority when Congress reconvenes in January.

PRIVATE EQUITY AND CORPORATE ACQUISITIONS

Merger and acquisition (M&A) activity has been strong in recent years, with 45 percent of CFOs reporting that their firms have made acquisitions in the past year. However, corporate M&A activity is expected to slow in the coming year, with only one-third of firms expecting to increase their activity.

"Private equity activity has dampened corporate acquisitions," said John R. Graham, director of the survey and a finance professor at Duke's Fuqua School of Business. "One-half of CFOs say that private equity buyers have pushed prices of acquisition targets up to unacceptable levels, thereby curtailing corporate purchases."

PESSIMISM ABOUT U.S. ECONOMY, CAPITAL SPENDING, HIRING

The level of optimism about the U.S. economy recovered from a five-year low reached last quarter. However, the optimism diffusion index for the U.S. economy is still in negative territory, meaning pessimists outnumber optimists (see chart at bottom of release).

"The optimism index is still underwater," said Duke professor Campbell R. Harvey, founding director of the survey. "There is considerable worry that the slump in housing activity will negatively impact consumer spending and eventually hit corporate profits. This is why CFOs believe there is a 26 percent chance of a recession beginning in 2007."

The cautious outlook has not only caused a slowdown in capital spending plans, but CFOs are also scaling back domestic hiring plans, with an increase of just one percent forecast. Instead, they are looking abroad; outsourcing is expected to grow by 6.8 percent in 2007.

WEAK CONSUMER DEMAND TOPS CORPORATE CONCERNS

For the second consecutive quarter, weak consumer demand ranks as the top worry facing companies, followed by rising labor costs. U.S. firms expect wages and salaries to increase 3.6 percent over the coming year, on average.

Health-care costs are the No. 3 concern, while a scarcity of skilled labor, which can itself contribute to wage inflation, is fourth on the list. Skilled labor shortages are particularly acute in the consulting/service, high-technology and construction industries.

Earnings are expected to rise 9.3 percent in 2007, down from a long string of double-digit increases. U.S. firms will rely heavily on greater sales from existing products to drive earnings, with 59 percent of CFOs listing this as one of the top three factors expected to drive profit growth in 2007. Forty-two percent expect sales from new products and services to be important to 2007 profitability.

"The heavy reliance on increasing sales volume to drive profits heightens the concern over weak consumer demand," said Joseph McCafferty, departments editor at CFO magazine. "If consumer demand falters, then the top two drivers of 2007 profitability are in jeopardy."

Other factors that are expected to help drive 2007 profits include cost cutting (29 percent), product price increases (26 percent) and information technology efficiency gains (17 percent).

ACTIVIST INVESTORS

Activist investors (hedge funds or pension funds, for example) have targeted one-fourth of U.S. public firms in the past few years, according to CFO respondents. Thirty-five percent of the interactions between activist investors and management are described as friendly and another 48 percent are on neutral terms. Seventeen percent of the interactions are described as hostile.

Among firms that have been contacted by activist investors, 30 percent said the contact explicitly led to changes in corporate policies. Most often, the targeted corporate policies have been related to strategic decisions, M&A plans, board representation, personnel changes and financing decisions.

"While we uncover evidence of hostile investors disrupting corporate operations, it is notable that there is a lot of activity going on behind closed doors and on friendly terms," Graham said. "Most companies appear to work with the activist investors, adopting their suggestions. In fact, more companies (26 percent) tell us they are better off than tell us they are worse off (15 percent) after addressing the issues raised by activists."

CONGRESS SHOULD RESOLVE THE IRAQ WAR AND TACKLE HEALTH CARE

Out of a list of 13 potential issues, CFOs thought that Congress should make its top three priorities resolving the Iraq war (57 percent), reducing health-care costs (47 percent) and reducing the budget deficit (39 percent).

Notably, only 3.6 percent of CFOs think that congressional investigation into past political ethics violations should be a top congressional priority, and only 2.9 percent think that increasing the minimum wage should be.

RESULTS UNIQUE TO EUROPE

In an about-face, European firms expect to increase their domestic workforces by more than one percent over the next year, though cost of labor is the No. 1 corporate concern in Europe.

Forty-seven percent of European CFOs are more optimistic about their own countries' economies relative to last quarter, and 59 percent are more optimistic about the outlook for their own firms. These numbers are up slightly from last quarter.

RESULTS UNIQUE TO ASIA

Capital spending and hiring should both experience double-digit increases in 2007.

Activist-investor contacts are similar to, but somewhat more common than, those in the U.S. Only 4 percent of Asian CFOs say that their firms are worse off for dealing with activist investors. Nearly 80 percent of the activist contacts are tied to strategic decisions, 48 percent to financing decisions and 40 percent to M&A.

Detailed results, including tabular summaries of the numbers in this release and results from previous surveys, are available at <<http://www.cfosurvey.org>>.

About the survey: This is the 43rd consecutive quarter that the CFO Business Outlook survey has been conducted. Among the industries represented in the survey are retail/wholesale, mining/construction, manufacturing, transportation/energy, communications/media, technology and banking/finance/insurance. Revenue-weighted mean growth rates are provided for earnings, revenues, capital spending, technology spending and prices of products. Employee-weighted mean growth rates are used for health care costs, productivity, number of employees and outsourced

employment. The earnings, dividends and cash on balance sheet weighted numbers are for public firms only. Unless explicitly noted, all other numbers are for all firms, including private.

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Optimism diffusion measures the percentage of CFOs who have increased optimism minus the percentage who have decreased optimism.

