



The Deloitte CFO Survey Benchmarking Corporate Financial Attitudes

Corporates respond to the credit crunch: 2008 Q1 results

April 2008

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Deloitte CFO Survey: Corporates respond to the credit crunch

Key points from the 2008 Q1 survey

- Despite reductions in Bank of England base rates corporates are finding that credit has become pricier and harder to obtain.
- Companies expect to respond by squeezing discretionary spending, jobs and capital spending.
- CFOs believe that UK equities are undervalued.
- Lower valuations and less competition from private equity are creating opportunities for corporate M&A.
- CFOs think the credit crunch has at least six months still to run; most see credit conditions improving by mid-2009.
- Companies plan to raise gearing over the next 12 months.

Tougher credit conditions

The latest Deloitte CFO Survey shows that credit conditions deteriorated in the first quarter of 2008. Despite two rate cuts by the Bank of England, on 6 December and 7 February, corporates report that credit has become pricier and harder to obtain:

- 73% of CFOs said credit was costly in March, up from 64% in December.
- 62% report that credit is difficult to obtain, up from 55% in December and 48% in September.

Keeping faith with debt finance

CFOs think that the credit crisis has at least another six months to run. But most expect credit to become cheaper and more readily available by the middle of 2009. So while most CFOs think that this is not a good time to be issuing debt a majority say they are likely to issue debt in the next 12 months. And on a 12 month view 44% of CFOs plan to raise gearing with only 24% planning to reduce it. In short, corporates' underlying faith in debt finance remains fairly strong.

Although bank finance has become more expensive and more difficult to obtain, it is far more popular with CFOs than other forms of credit or equity. Lower equity values and disruption in debt capital markets mean that equity and corporate debt have dropped in popularity with only 29% of CFOs rating non-bank debt as attractive and only 18% rating equity. Conversely bank credit has risen sharply in popularity, up from 44% in December to 62% in March.

Credit crunch drives cost squeeze

The survey shows that firms are planning to squeeze costs in response to slowing growth and a credit crunch. At the top of a hierarchy of cost reduction is discretionary spending – areas such as travel, hotels, and entertainment and training budgets – with 65% of CFOs saying they are likely to reduce such spending. 55% of CFOs say they are likely to reduce future hiring and 38% are considering reducing current employee numbers. 38% plan to reduce capital spending while only 12% said they are likely to offshore functions. But CFOs are determined to protect dividends, with only 3% saying they are likely to reduce dividend payments.

These findings show how financial stress is likely to feed through into the real economy in the form of reduced corporate spending, lower capital investment and a squeeze on jobs.

Opportunities in corporate M&A

Yet despite the problems, 82% of CFOs see opportunities in the current environment. UK equities are now seen as being undervalued by most CFOs and this has bolstered sentiment about mergers and acquisitions (M&A). On balance CFOs think the credit crunch is likely to make it easier for corporates to undertake M&A, with CFOs citing lower valuations and weaker competition from private equity as supportive factors.

Background

This is the third quarterly Deloitte survey of Chief Financial Officers and Group Finance Directors of major UK companies. The Deloitte CFO Survey is the only survey of major corporate users of capital which gauges and benchmarks attitudes to valuations, risk and financing. The first quarter 2008 survey took place between 7 and 31 March. 34 CFOs participated representing 30 FTSE350 companies, two private companies and two small cap companies. The combined market capitalisation of the companies surveyed is close to £100 billion.

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Corporates respond to the credit crunch

The first quarter 2008 Deloitte CFO Survey shows that UK corporates are planning to cut costs in response to slower economic growth and tight credit conditions.

Two-thirds of CFOs expect to reduce discretionary spending, pointing to a squeeze on corporate travel, hotel, training and entertainment budgets. Some 55% of CFOs expect to curb future hiring and 38% are likely to cut current employment levels. 38% of CFOs expect to cut capital spending.

But CFOs are determined to protect dividends, with only 3% saying that they are likely to reduce dividend payments.

CFOs expect the credit crunch to hit their ability to finance their business, demand, capital spending and employment.

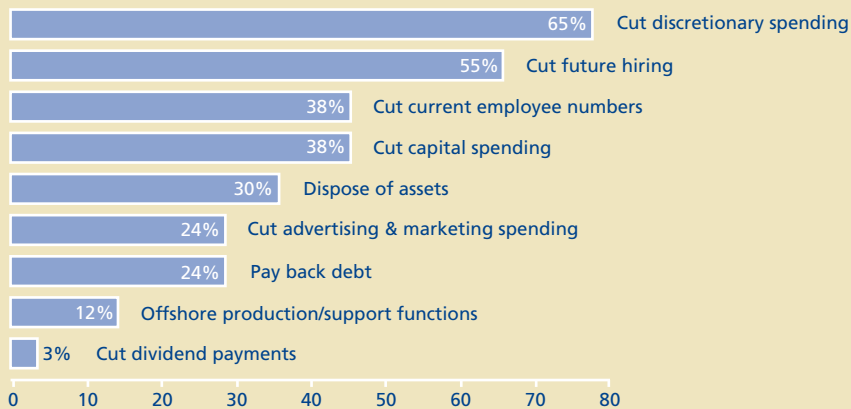
But the credit crunch is expected to make it easier for corporates to undertake mergers and acquisitions, with 29% looking for a positive impact.

More generally CFOs see opportunities in the current environment. 82% of respondents expect a weaker backdrop to create new opportunities.

M&A and the chance to take market share from weaker competitors were seen as the most significant opportunities by most CFOs.

Chart 1. Corporate responses to tougher market conditions

Percentage of companies likely to take the course of action



"In response to the credit crunch and the prospect of slower economic growth, which of the strategies do you consider your company is likely to pursue?"

Chart 2. Effect of events in credit markets on:

Percentage of respondents expecting positive/negative effect

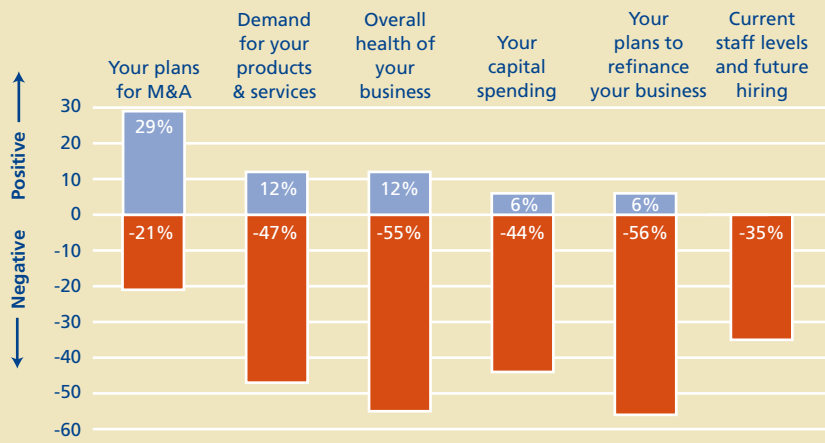


Chart 3. What opportunities do you see in the current market environment?

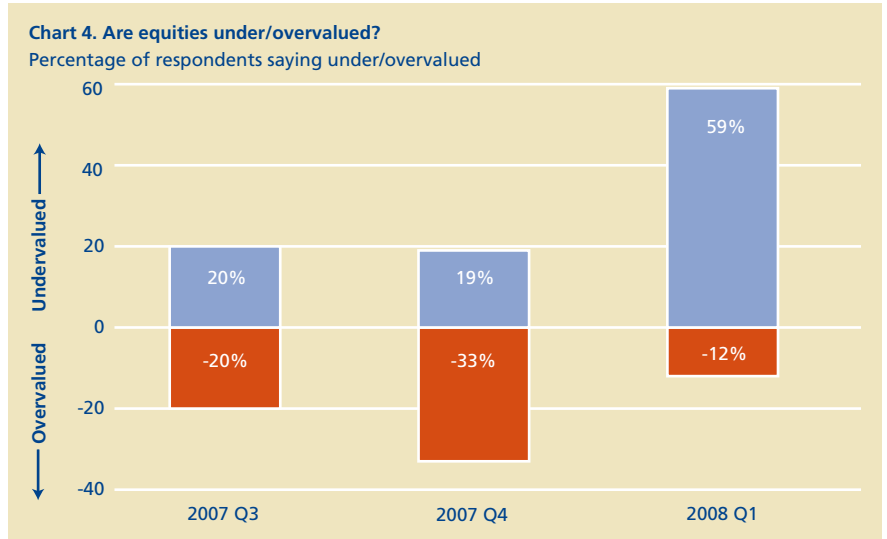
- "Competition weakened, realistic valuations for M&A, the absence of Private Equity."
- "Opportunities to buy assets from forced sellers."
- "Private Equity less potent competitor for assets."
- "Weaker competitors with weaker balance sheets should give us competitive advantage."
- "Easier hiring."
- "Forces smaller companies to be more receptive to acquisition approaches as they may struggle to fund their future aspirations."
- "Opportunities to invest in fundamentally undervalued situations."

Quotes from CFO respondents to the March 2008 CFO survey.

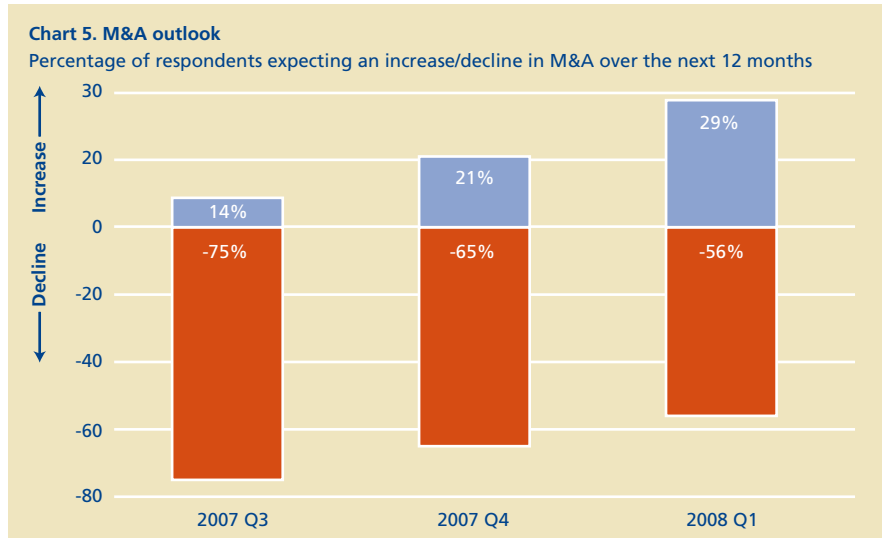
Cheaper equities bolsters M&A hopes

In December 2007 the dominant feeling among our CFO panel was that equities were overvalued. Since then the FT All Share index has fallen by 12% and this helps explain a marked shift in sentiment, with 59% of CFOs now seeing equities as undervalued.

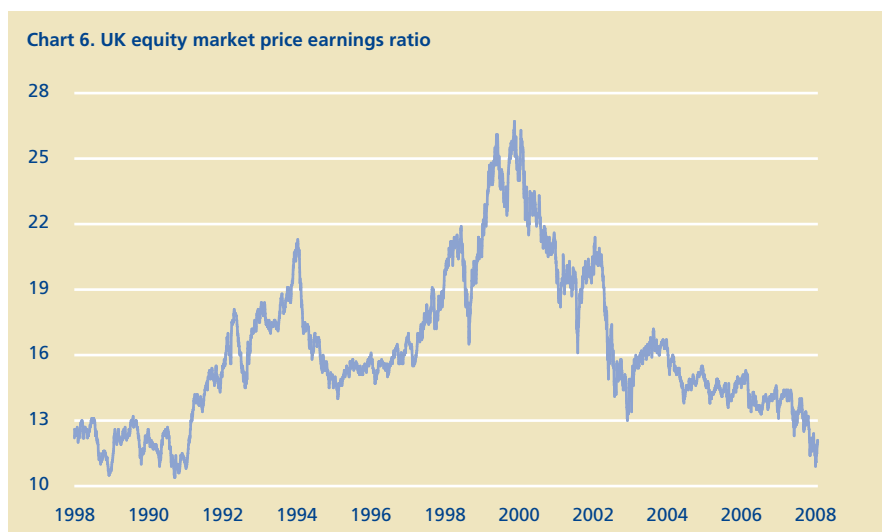
Since our December survey CFOs have become more positive on the outlook for equities, with 50% expecting the FTSE100 to be higher in a year's time, 24% expecting it to be broadly unchanged and 26% expecting it to be lower.



Most CFOs expect M&A activity to decline over the next year. But the real value in survey data is in the direction and rate of change in responses. The striking finding here is that sentiment about the outlook for M&A has improved on the responses in the September and December surveys.



More positive sentiment about M&A and equities probably reflects current levels of equity market valuations. Using the price/earnings ratio as a benchmark, UK equity valuations are at the lowest level since the early 1990s.

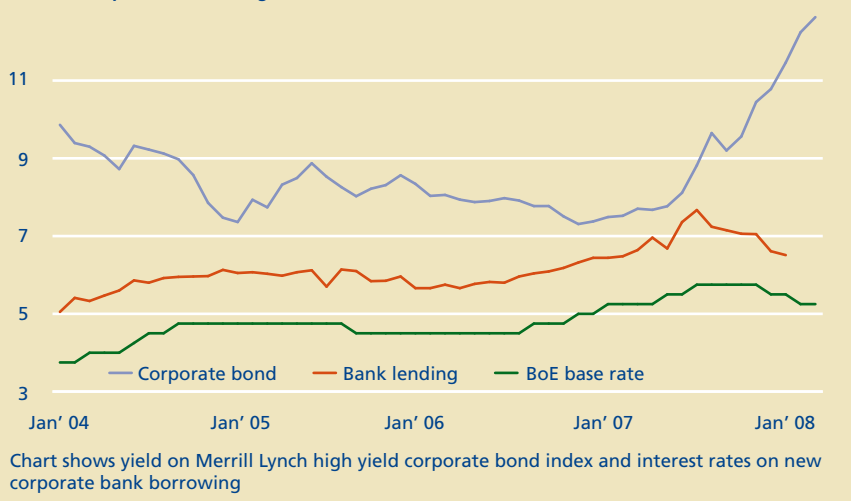


Gauging corporate credit conditions

The Bank of England reduced base rates by 25bp on 6 December, 7 February and, again, on 10 April.

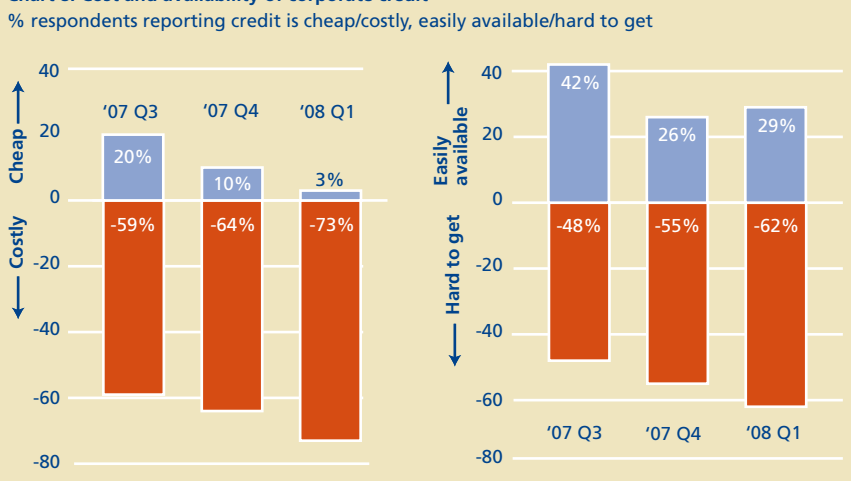
Bank of England data show that the cost of new floating and fixed rate bank lending to corporates has fallen in response to lower base rates. But the cost of borrowing through the corporate bond market has risen dramatically.

Chart 7. Corporate borrowing costs



Certainly the experience of CFOs is that lower base rates have failed to reduce corporate borrowing costs. On the contrary, CFOs report a sharp rise in the cost of credit and a further decline in the availability of credit.

Chart 8. Cost and availability of corporate credit

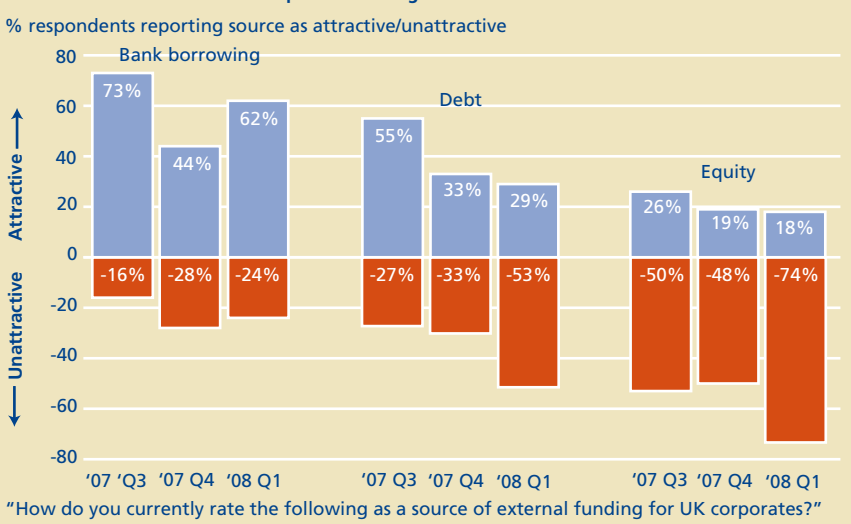


Despite these problems – and the fact that the credit crisis has been heavily focussed on the banking system – corporates still see banks as offering the most attractive form of external finance for their businesses.

With credit markets severely disrupted, debt issuance has become increasingly unattractive to CFOs. Equity offers an alternative but it has been out of favour with corporates for several years and, in the last quarter, has become markedly less popular.

This fits with the view that after recent falls equities are undervalued and, by implication, that equity finance is an expensive form of finance for companies.

Chart 9. Favoured sources of corporate funding

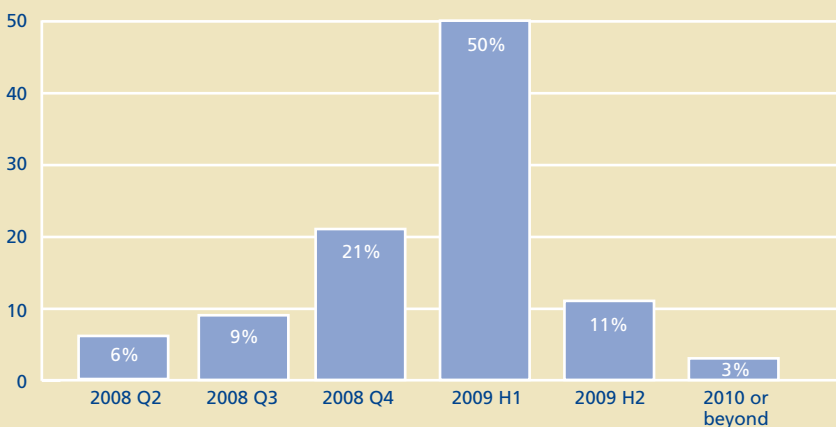


Calling the end of the credit crisis

CFOs believe that the credit crisis has at least another six months to run. But most expect to see credit become cheaper and more plentiful by the middle of 2009.

21% of CFOs see credit conditions improving in the fourth quarter and 50% see things getting better in the first half of 2009.

Chart 10. When do CFOs expect credit conditions to improve?
 Percentage of respondents expecting conditions to improve in each period

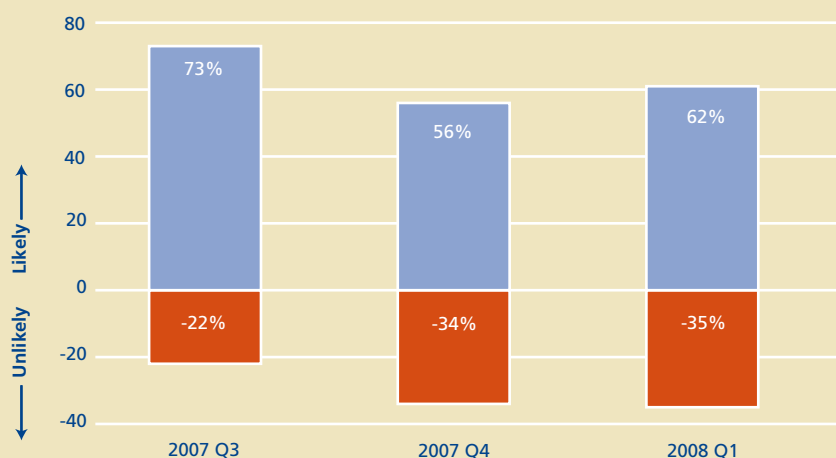


"When do you expect to see an improvement in the supply and price of new credit available for your business?"

Views on the timing of an improvement in credit conditions help explain attitudes to debt issuance.

Unsurprisingly, most CFOs think that this is not a good time to be issuing debt but some 62% say they are likely to issue debt in the next 12 months. Again, the view seems to be that credit markets will improve from the turn of this year, paving the way for a recovery in debt issuance.

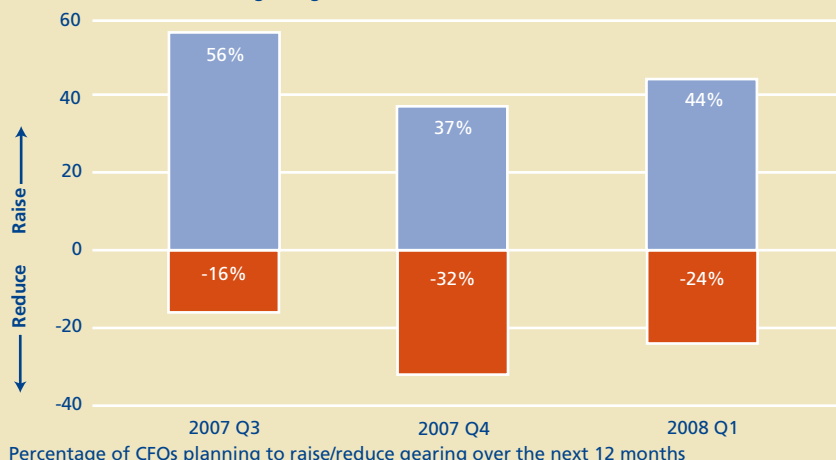
Chart 11. Plans for debt issuance
 Percentage of respondents who say they are likely/unlikely to issue debt in the next 12 months



The same story emerges looking at corporates' plans for gearing. Despite the many problems of the debt markets, more corporates plan to raise gearing than to cut it over the next year.

The debt culture has taken a terrific knock and CFOs do not see things improving quickly. Nonetheless, CFOs expect better times in 2009 and, in aggregate, are planning to issue debt and to raise gearing over the next year.

Chart 12. Level of gearing
 CFOs' aims for their level of gearing over the next 12 months



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