

The Swiss Economy after the Currency Shock

Swiss companies adjust to a revalued franc via new pricing, layoffs, and renegotiated contracts

More than 90% of Swiss companies have been affected by appreciation of the franc, and average profit margins are expected to shrink about 10%

On January 15, 2015, the Swiss National Bank discontinued the minimum exchange rate of SFr1.20 to the euro, resulting in an immediate appreciation of the franc by more than 20%. After the franc had traded consistently at an average exchange rate of SFr1.05 to the euro for several months, effectively a 12.5% appreciation, an AlixPartners survey showed almost every company across a range of sectors expected negative impact on earnings before interest, taxes, depreciation, and amortisation (EBITDA).¹

Consumer goods and retail companies expected to suffer the least, forecasting an average margin depletion of about 6%. All other industries expected a negative impact around or well above 10%. The average EBITDA margin impact came out to negative 10.7%. Market uncertainties and the diverse types of companies surveyed yielded wide variance in expected negative-margin impacts.

More than 92% of respondents expected a negative impact on EBITDA. Almost 70% of respondents anticipated the impact to be less than 10%, though about 30% expected a negative profit impact of more than 10% (figure 2).

The survey assessed Swiss corporate leadership's reactions to the impact of the January 15, 2015, Swiss franc appreciation on Swiss companies and explored the following topics:

- ▶ Expected impact of Swiss franc appreciation on profitability
- ▶ Immediate steps to mitigate impact, the steps' perceived effectiveness, and the steps' ease of implementation

- ▶ Potential next steps to further improve efficiency, ranked by importance
- ▶ The roles of outsourcing and offshoring of various business functions
- ▶ Switzerland's role as a business location

Figure 1: Respondents by sales volume and industry

FIGURE 1a: Respondents by sales volume (SFr in millions)

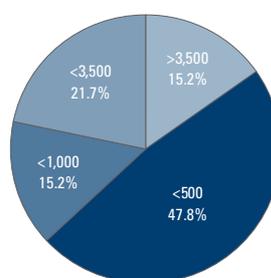
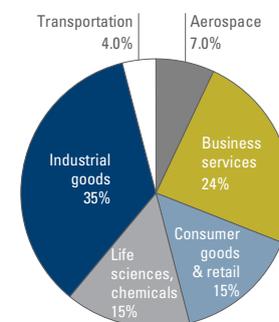


FIGURE 1b: Respondents by industry cluster



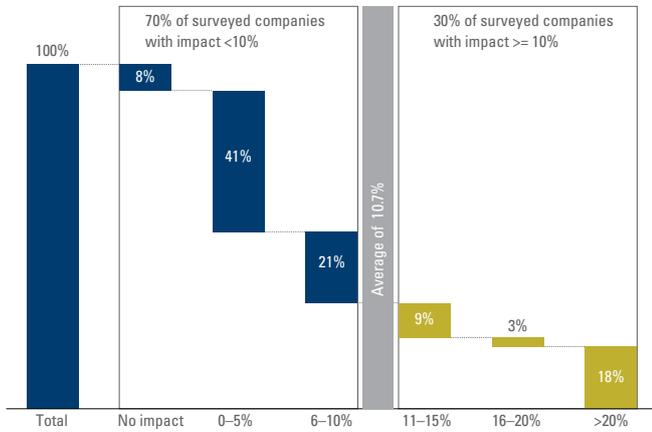
Source: AlixPartners

Large global firms were more resilient than small and medium enterprises

The smaller the company, the greater the effect of the currency shock. Our analysis clearly linked the severest impacts to companies with annual sales of less than SFr500 million (figure 3). The survey showed that companies with smaller total sales and smaller global footprints were affected twice as severely as bigger companies.

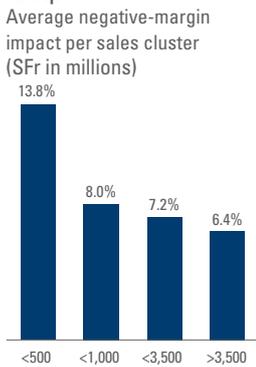
¹ The survey participant sample comprised a mix of Switzerland-based companies, representing 17 major industries (figure 1). For analytic purposes, the companies have been aggregated to six industry clusters. Participating companies represented a wide range of organisations of different sizes, ranging from typical small and medium enterprises to global multibillion-dollar corporations.

Figure 2: Size of EBITDA margin impact



Source: AlixPartners

Figure 3: Margin decline forecasts by company size and footprint



Source: AlixPartners

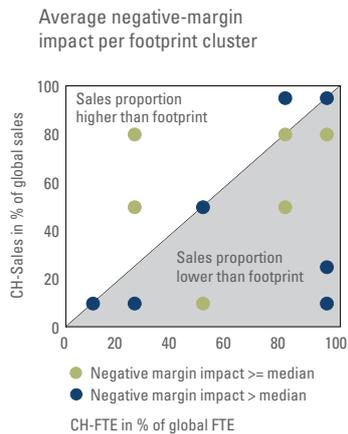
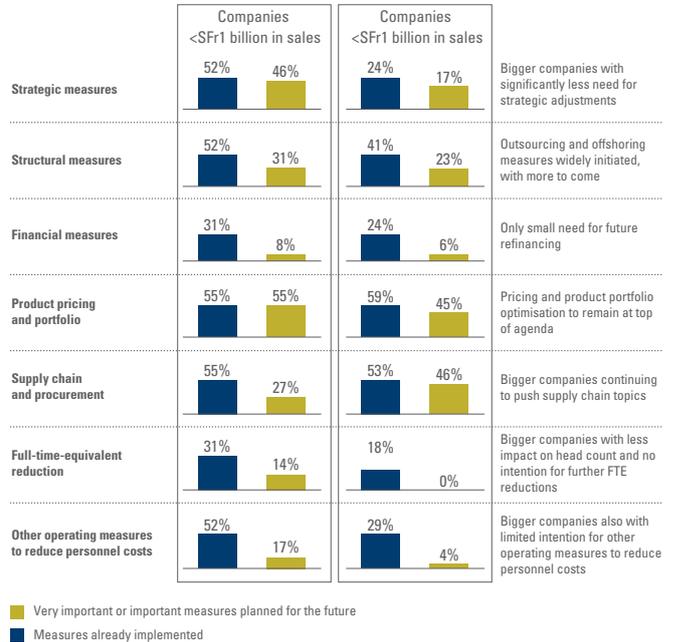


Figure 4: Current and planned responses after Swiss franc's revaluation



Source: AlixPartners

billion or more. The picture looks similar for personnel expense reduction activities: smaller companies felt the need to implement such measures almost twice as often as bigger ones did. Both groups preferred avoiding layoffs when possible. The discrepancy was most likely the result of smaller companies' lack of scale, which forced them to adopt more-drastic measures.

The Swiss business community still has a lot of work to do as it adjusts to the new currency regime. However, survey respondents generally said the lion's share of constructive responses has at least begun, and the measures are showing desired results to varying degrees. Only pricing, product portfolio, and supply chain optimisation were still considered as critical to the adjustment process as they were in the first half of the year. Smaller companies said they'd continue focusing on strategic measures for repositioning their businesses. Financial measures as well as layoffs (with the exception of structural measures such as outsourcing and offshoring) seem to have been fully implemented, leaving little more to do in the coming months. We noticed, however, that larger companies are again turning to layoffs.

... but 60% of companies faced implementation obstacles, and smaller companies struggled more than large ones

About three-quarters of the larger Swiss companies surveyed said they faced no significant obstacles in their first responses to the franc's appreciation. Among the smaller companies, two-thirds said they faced obstacles as they responded. This was mostly because smaller companies had less flexibility in their financial, production cost, and supply chain management options.

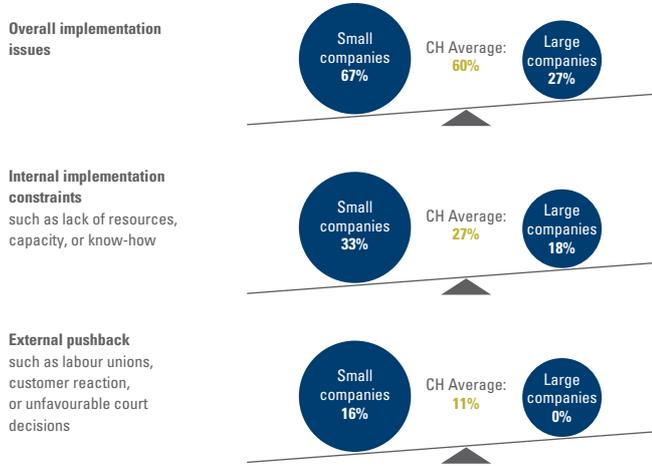
Most companies reacted quickly by implementing a significant number of performance improvement measures . . .

Most companies reacted quickly to the currency shock and created long lists of performance improvement measures that included strategic, structural, financial, and operational initiatives (figure 4). The five most popular measures were:

- ▶ Procurement negotiations and supplier network optimisation
- ▶ Price adjustments
- ▶ Hiring freezes
- ▶ Layoffs
- ▶ Offshoring

Smaller companies typically sought to make major adjustments in all possible areas; larger companies were more selective. That was true for strategic measures in particular, which were applied by every second company with annual sales of less than SFr1 billion, but only by every fourth company with annual sales of SFr1

Figure 5: Obstacles to a swift response



Source: AlixPartners
 Note: Large companies: >CHF 1bn annual sales

Larger companies constantly seek to improve performance in response to competitive pressure and so were already better able to respond to the currency shock. Many of them have dedicated business development teams and could leverage their market power and international-asset footprint.

Smaller companies historically thrive in niche markets, which provide a certain level of protection from competition. Due to their size, though, smaller companies usually don't have internal consulting resources or large business development teams. Those constraints, together with globalisation's general trend of opening up former niche markets to wider international competition, created a more difficult proposition for nearly every business sector we surveyed (figure 5). Factor in the less-significant market size of those smaller players, and it clearly became more difficult to pass on the pricier franc's currency pressures to suppliers and consumers through price increases, procurement contracts, and pricing renegotiations with suppliers.

Rapid responses largely blunted the impact of the exchange rate appreciation

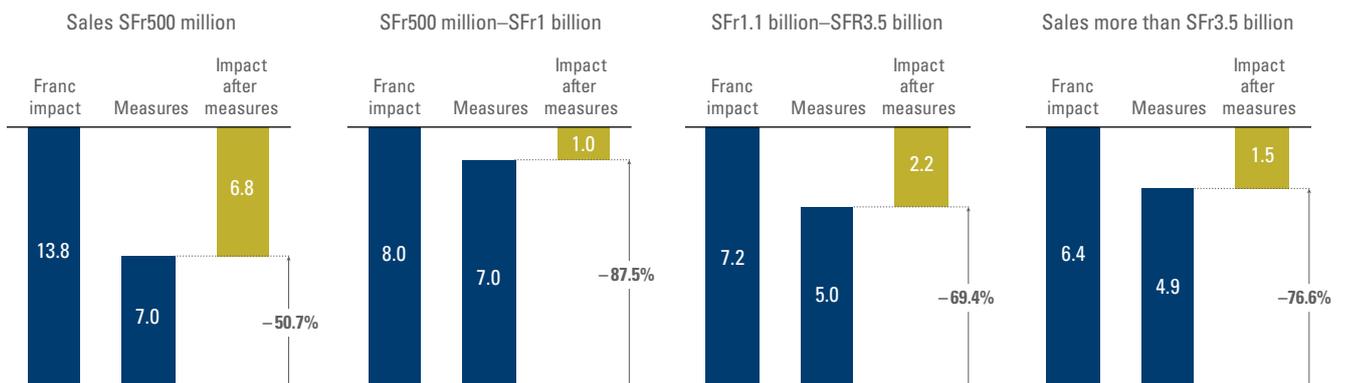
When asked to rate the level of success of the initial set of measures taken to counter the negative impact of the Swiss franc's appreciation, 63% of respondents rated measures as successful or even very successful. The remaining 37% rated their measures as moderately successful or less successful. None rated measures taken as completely unsuccessful. Among the measures usually taken, respondents said they found the following ones to be particularly successful: renegotiations of procurement contracts, hiring freezes, layoffs, and reductions of other benefits.

"The greater danger for most of us lies not in setting our aim too high and falling short; but in setting our aim too low, and achieving our mark."

(Michelangelo, 16th century)

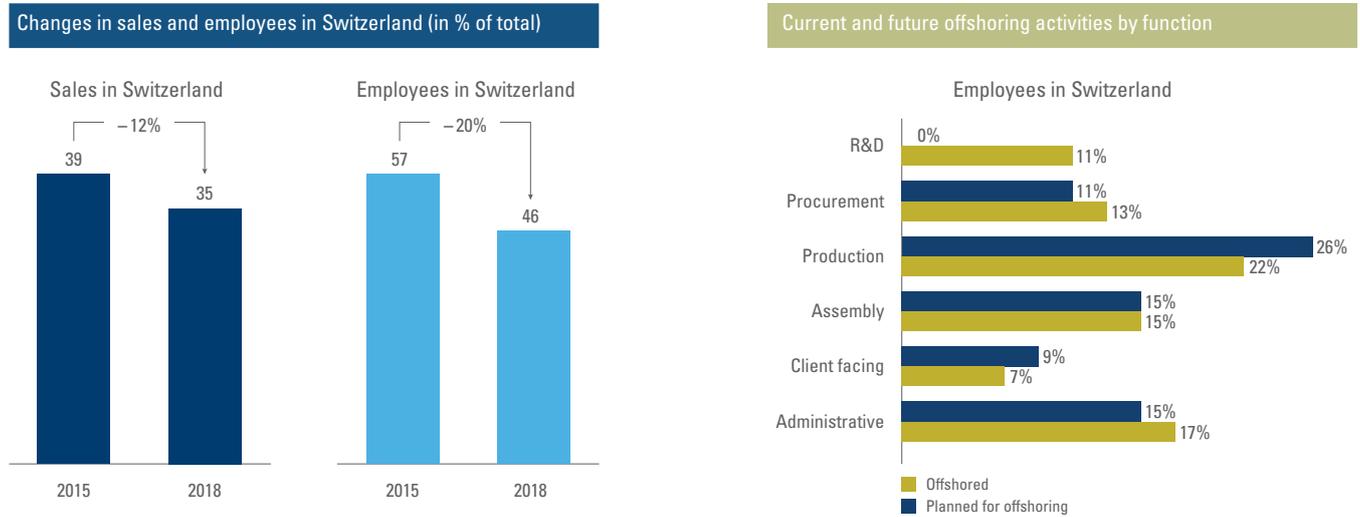
The successful implementation of those measures should result in significant reduction of the currency impact. On average, respondents said they expected a reduction of the negative-margin impact from an initial forecast of 10.7% to about 4%. As with the initial impact of the franc's appreciation, the proportional reduction correlated strongly with business size. Companies with sales of less than SFr500 million expected an approximately 50% improvement from their initial negative projections, and companies with sales of more than SFr1 billion expected an improvement of about 75% from their worst-case forecasts (figure 6). That divergence was caused mostly by smaller companies' relative challenges in achieving improvements and their greater dependence on local markets and local workforces. Furthermore, larger companies usually are more experienced in establishing and implementing corporate performance improvement initiatives. Larger companies also tended to have more resources available to carry out needed adjustments. And they were more diversified across products, customers, and geographies.

Figure 6: Gauging success: How company responses softened the blow after revaluation



Source: AlixPartners

Figure 7: Downsizing and offshoring assume larger roles since the Swiss franc's appreciation



Source: AlixPartners

Despite success, every fifth job in Switzerland is at risk . . .

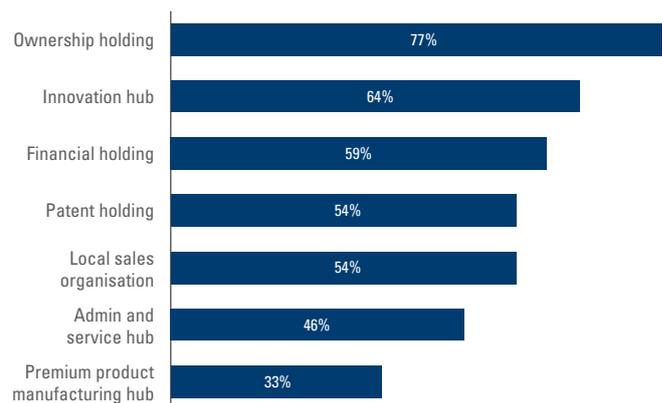
As the global economy's centre of gravity shifts farther away from Europe, companies now frequently adjust their footprints to reflect that change. Overall, Swiss companies expected their shares of domestic sales to drop from 39% to 35% of total, which equals a total reduction of 12% in domestic sales (figure 7). The workforce in Switzerland will most likely be affected even harder and shrink by 20%.

We still doubt that 20% of jobs in Switzerland will be cut over the period of the next three years: Offshoring of functions to other countries requires a significant amount of preparation. Unless blueprints exist, the process will take longer. Additionally, structural adjustments come with significant investments not everybody will be willing to take. While relatively few offshoring plans can be executed in such a short time, these responses reflect the need for structural adjustments and the sense of immediate threat for the Swiss economy.

Today Swiss companies employ a far higher proportion of employees in Switzerland than the volume of goods and services those companies sell locally. Our respondents' expectations implied that the ratio of "% of FTE in CHE ÷ % of Sales in CHE" will improve from 1.5 to 1.3 during the next three years.

Compared with earlier waves of footprint optimisation and offshoring, companies this time performed rigorous examinations of their R&D activities and administrative service functions. Even though those functions have been mostly out of scope in the past, the current environment has often forced managements to reconsider their positions on offshoring—a shift bolstered by growing numbers of companies reporting positive experiences with the offshoring of various aspects of their businesses (figure 7). For all other functions, companies expected an additional offshoring wave of the same magnitude as in the past. On average, that translates to a doubling of existing offshoring volumes.

Figure 8: What type of business thrives in *Werkplatz Schweiz*?



Source: AlixPartners

. . . and, *Werkplatz Schweiz* is still in stormy waters

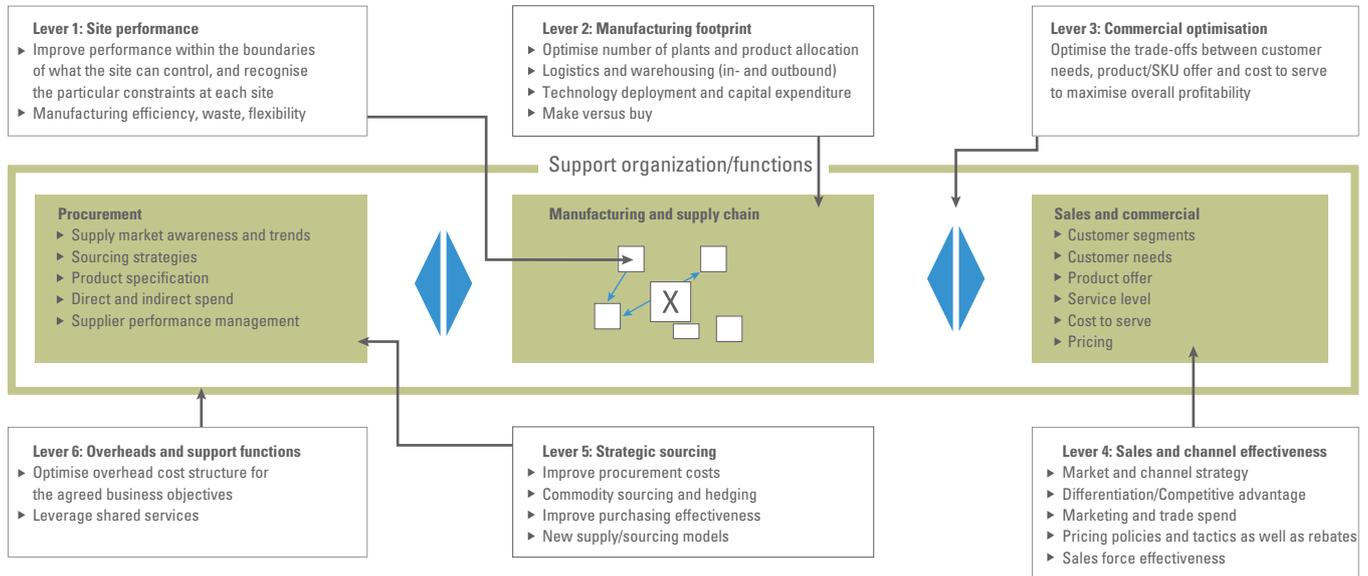
In this context, it is unsurprising that surveyed companies remain sceptical about the future of "*Werkplatz Schweiz*." Surveyed companies said they still regard Switzerland as an attractive location for company holdings in the future, but they express significantly less confidence about keeping an admin and service hub or a premium product manufacturing hub in the country.

Despite intentions to offshore R&D activities, participants expected Switzerland to retain its role as an important innovation hub in the future (figure 8).

Some tough choices lie ahead

Though the Swiss franc has weakened slightly in the past several days, it would be unwise to assume that that situation will continue; and even with an exchange rate of SFr1.10 to the euro, companies in Switzerland will still be navigating stormy waters. That's why, in light of an uncertain global economic outlook, CEOs face challenging questions, such as:

Figure 9: We consider six key levers for transforming operational performance



Source: AlixPartners

- ▶ How much did we benefit from existing long-term contracts and low oil prices? Will that situation continue in 2016?
- ▶ Are our already implemented measures sustainable, and do they suffice? Will they also suffice if the global economy slows down further in 2016?
- ▶ Where else can additional sources of productivity increase and structural improvement be derived?
- ▶ Which part of our company's value chain needs to be positioned—and in which geography? Where should I locate administrative services?
- ▶ Can I run businesses that can no longer contribute to value creation at our company under the new economic realities?

Answering those questions will be difficult, and acting on the answers will certainly put additional strain on all key stakeholders of companies in Switzerland. Still, success in a low-growth world—despite unfavourable currency conditions—hinges on abilities to anticipate challenges and to quickly respond to both existing challenges and challenges that will arise. To further create value, companies must achieve excellence in executing all six aspects of operational transformation as follows (figure 9).

Summary: An achievable adjustment for **Werkplatz Schweiz**

The currency shock affected 90% of the Swiss economy and is expected to reduce company profit margins by 10% on average. Within the first six months of the revaluation, large companies showed significantly higher resilience to the effects of currency valuation than did their smaller peers, which were affected more than twice as severely by losing sales and seeing costs surge. Companies in Switzerland reacted quickly, and

despite significant implementation obstacles (especially for smaller companies) they have been able to introduce myriad performance improvement measures. According to respondents' expectations, such rigorous action should reduce the impact of the currency shock to a negative-margin impact of 4%. Again, larger companies had a distinct advantage and generally reduced the initial impact by 75%, whereas smaller companies were able to recoup only about 50% of their expected declines after taking corrective measures.

Despite a successful initial adjustment phase, many companies expected a more expensive Swiss franc to require further adjustments to their businesses. Even though operational cost reduction activities have peaked for most respondents, global supply chain optimisation—as well as product and price adjustments—will continue to drive corporate agendas. And even though head count reduction and workforce restructuring seem more or less complete, 20% of jobs in Switzerland remain at risk because of an expected increase in offshoring activities across all functions. Future offshoring will likely include a wider scope of business functions, including R&D activities and some administrative services.

Swiss companies are well aware of the challenges they have yet to face, and handling them will require additional comprehensive actions, but there is little doubt that Switzerland will remain an attractive business location if companies navigate this period of adjustment and sustain operational excellence.

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