The Dollar's Impact on US Corporations

The bulk of the U.S. earnings season has past. While many companies missed their revenue numbers, they still achieved, or bettered expectations for earnings. This was accomplished through dramatic costs cuts, especially in labor.

In explaining their quarterly results a number of companies cited the impact of foreign exchange developments. The impact varied from company to company but the net impact was the same: negative.

A quick sampling includes: Coca-Cola said that the dollar's fluctuations helped account for a 14% reduction in operating income. Procter and Gamble said it caused a 9% reduction in net sales. Philip Morris International said the dollar shaved earnings per share by 19 cents, while Johnson and Johnson said it reduced total international sales by 11.9%. McDonalds attributed a nine cent per share reduction to the dollar, while WalMart claimed the stronger dollar reduced earnings by three cents a share.

A recurring issue for institutional and individual investors is if the anticipated movement of the dollar should be taken into account when selecting stocks. Part of the challenge is that companies discuss the impact of foreign exchange differently. If the focus is on revenue, then costs incurred in foreign currencies often go unexplored. Alternatively, if the focus is on earnings, it may include the translation of foreign earnings, which could be largely an accounting entry rather than an economic event, such as repatriation.

Multinationals Aren't Simply Big Businesses

There are four elements which also complicate how one conceptualizes the foreign exchange risk inherent in multinational business.

The first is the role of exports. The United States is among the largest exporters in the world. It will export more than $1 trillion worth of goods and services this year. But, the primary way that American multinationals service foreign demand is by making goods and producing services locally through an extensive network of foreign-based affiliates. The sales by these affiliates outstrip U.S. exports by more than four times.

Second, while there is much talk about out-sourcing, trade itself has been in-sourced. Over half of the U.S. trade deficit can be accounted for by intra-firm trade, the movement of goods and services, not between unrelated institutions, but within the same company. Typically, U.S. companies will export components to foreign affiliates, who assemble and sell the products. However, affiliates of foreign companies operating in the U.S. often provide wholesale and distributional services for the parent.

Third, not all companies compete in the same fashion. For example, Japanese and continental European companies traditionally rely on banks to provide capital. Bank capital tends (yes, plenty of exceptions) to be patient. Hit with an exchange rate shock, these companies are more likely to accept narrowed profit-margins to maintain market share, perceived to be the key to long-term success, because of access to patient capital.

In contrast, American and British companies rely more on the capital markets than banks, to raise capital. The markets tend to be impatient. A company's quarterly results will strongly influence its cost of capital. They are more likely to pass an exchange rate shock on to their customers to protect profit margins.

Fourth, the price of an imported good is not simply the cost of importing it and some profit. When a good enters a country, it is stored, shipped, and marketed. These costs are incurred in the domestic currency. Owing to America's size and competitiveness, these costs (storage, transportation, and marketing) are relatively larger than in many other countries. Some estimates suggest it can be 30%-50% of a good's cost.

The last two elements, different competitive strategies and locally incurred costs, help explain why there is often what economists call limited pass-through of dollar weakness to prices.

Concrete

Going beyond the desire of diversifying one's portfolio, the complexity of deriving individual equity views from a dollar view can be illustrated by comparing companies in the same space, but with different levels of international exposure.

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Recall that the U.S. dollar was generally firm in the second half of 2008 and first quarter of 2009, but has since fallen out of favor and recently fell to new lows for the year against many major and emerging market currencies. Conventional wisdom suggests in a weaker dollar environment companies with greater international exposure likely perform better. The foreign earnings in currencies that have appreciated are translated into more dollars.

As we have done before, we looked at four such company pairs: Coca-Cola and Pepsi, Caterpillar and Deere, McDonalds and Wendy's, and Dell and HP. The former company in the pair has greater international exposure than the later. In terms of stock performance, however, the results are anything but intuitive. (See David Adler's new book *Snap Judgment* for an interesting discussion of intuition and finance.)

Through August 13th, Coca-Cola shares were up 6.3% for the year. North America accounted for a little more than a quarter of its revenues in 2007, the last full year which Bloomberg has data on. In contrast PepsiCo drew 57% of its revenue from North America in 2008. PepsiCo shares are up 3.14% this year. So, conventional wisdom is right, after all.

Not so fast. Investors in Deere, for which North America accounts for nearly 61% of its revenues, are much happier than the holders of the more international Caterpillar shares. North America accounts for a third of Caterpillar's revenues in 2008. Deere shares have risen a little more than 19% this year to Caterpillar's 5.6% advance.

Similarly, McDonalds, deriving more of its revenue from Europe than the United States (42.2% versus 34.3% in 2008), has performed miserably when compared to purely domestic Wendy's. McDonald's shareholders have experienced a 10.3% drawdown. Wendy's investors have gained a little more than McDonald investors have lost.

Although most U.S. companies have reported earnings already, the last company pair has yet to report. HP is expected to announce it earnings on August 18th and Dell on August 27th. The consensus expects HP earnings of about $0.895 a share, which sequentially is up from $0.858 for its Q2 09, and up from $0.833 a year ago. The consensus expects Dell to post earnings of around $0.226 a share, up sequentially from $0.22 the previous quarter, but down from $0.361 in the year ago quarter.

Dell is deriving a little more than half of its revenue from the U.S., while less than a third of HP's revenues come from the United States. Dell's shares are up nearly 40% this year. While nothing to sneeze at, HP shares have risen by a little more than 22%, but are trailing well behind Dell.

Conclusion

How changes in the price of the dollar impact a particular company cannot simply be deduced from first principles. There could be real economic effects and accounting functions, like translating foreign earnings into dollars for a quarterly report but not repatriating the money.

Corporations also have different policies for managing foreign exchange exposures. Many investors may not know or fully understand how a particular company copes with the volatility of the foreign exchange market, which, in absolute terms, may be significantly larger than profit-margins. Often companies regard its foreign exchange policy as proprietary information.

There are no short-cuts to investing. There is no alternative to doing one's homework. Few, if any, can correctly forecast the dollar's movement with any consistency. And even if one could, it does not seem to be a particularly important piece of information that could provide an edge in picking stocks

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Neither Mr. Chandler nor members of his family have investments in the companies mentioned in this piece.