



# market monitor

USA, Belgium and Czech Republic: construction and chemicals

Switzerland, Sweden and New Zealand: construction

September 2011

# Firm foundations on shaky ground?

**T**he Swiss economy has fared relatively well over recent years: while other countries fell into deep recession, it saw only a mild downturn. And although the current strength of the Swiss franc may be a concern for Swiss exporters, for the construction sector, with its focus on the domestic market, the strong currency has the advantage of lowering the cost of imported building materials.

With Switzerland's low interest rates driving demand for new housing and civil engineering revenues still high, its good fortune stands in stark contrast to that of the USA's construction industry. The dire consequences of the 'toxic mortgage' crisis steadfastly refuse to go away, with high foreclosure rates and sales, house values and consumer confidence plummeting. As a result, the industry is sitting on a mountain of unsold stock with little signs of it diminishing.

While the US and Switzerland are effectively poles apart, the construction industry in the other countries featured in this month's Market Monitor range from 'relatively healthy' (Sweden and New Zealand) to 'an uncertain outlook' (Belgium) and 'a continuing downturn' (Czech Republic).

We also look at the state of the chemicals industries in the US, Czech Republic and Belgium which, despite some dependence on the home construction markets have performed comparatively well due to increased international demand.

On the following pages, we indicate the general outlook for each sector featured using these 'weather' symbols:



Excellent



Good



Fair



Gloomy



Bleak



## Many key issues continue to hinder the recovery

In 2009, the weakness in construction activity was the single largest contributor (10%) to the US's 2.4% decline in GDP. Combined, residential fixed investment and housing services represented 15.1% of GDP in 2010, compared to 18.5% in 2005 and has continued to decline as a percentage of GDP in 2011. In addition, state, local and federal construction spend has stagnated. Historically, non-residential construction activity lags behind the residential cycle by between 9 and 18 months. This pattern has been fairly accurate over the last four years, but continued weak economic metrics are now dampening sector activity significantly, as a result of which all building materials producers, distributors and retailers are also feeling the pain.

Key issues for construction are, and will continue to be, the ongoing home mortgage debacle; tight credit markets; raw material and energy costs; interest and mortgage rates; consumer confidence; less federal stimulus spending; moderating capital spend; unemployment; and overcapacity.

### US Total Construction Spending (billions of US current dollars – annual figures)

	Actual			Forecast		
	2008	2009	2010	2011	2012	2013
New Residential (% change is year vs previous year)	238.2	141.4	135.8	127.6	136.4	160.5
	-34.2%	-40.6%	-4.0%	-6.0%	6.8%	17.7%
Residential Improvements*	120.7	119.3	116.8	118.7	129.0	142.2
	-13.9%	-1.1%	-2.1%	1.6%	8.7%	10.2%
Non-residential Building	437.4	379.7	290.9	266.8	275.5	301.6
	8.6%	-13.2%	-23.4%	-8.3%	3.3%	9.5%
Non-building (heavy engineering)	270.9	273.7	269.8	261.3	270.8	289.9
	9.3%	1.0%	-1.4%	-3.1%	3.6%	7.0%
<b>Total</b>	<b>1067.2</b>	<b>914.2</b>	<b>813.3</b>	<b>774.5</b>	<b>811.7</b>	<b>894.2</b>
	-7.4%	-14.3%	-11.0%	-4.8%	4.8%	10.2%

\*Residential Improvements include remodelling, renovation and replacement work.

Source: U.S. Census Bureau, Department of Commerce.

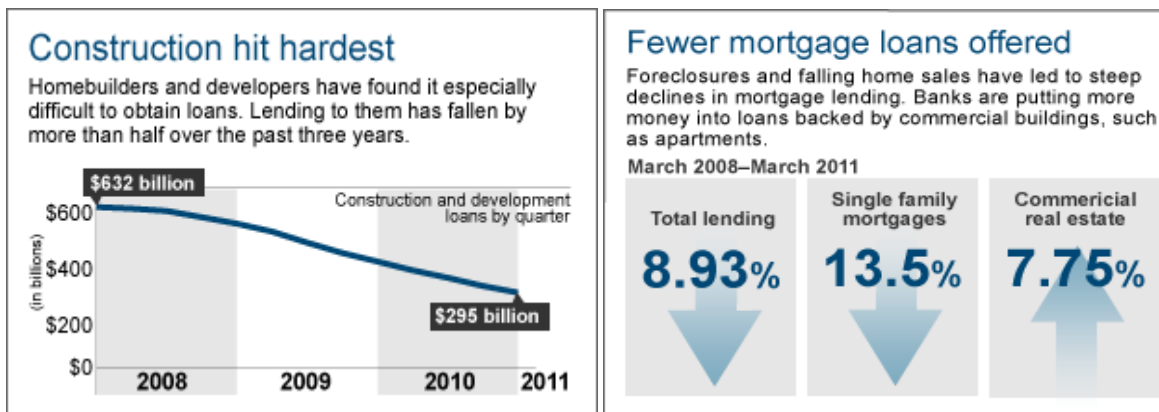
Forecasts and table: Reed Construction Data.

While the slowing economic recovery is hampering any rebound in construction, a continued crisis in the housing market will backfire on the US economy, according to the latest Atradius Economic Outlook study\*. Previous signs of recovery in the property market have given way to renewed weakness, adding pressure on collateral values and credit raising capacity. The downward adjustment in US house prices may partly reflect the expiry of the home-buyers tax credit in 2010, but the current fundamentals point to ongoing weakness in the market. Despite historically low interest rates, US consumers still face a high debt service burden, with foreclosures continuing to rise while

\*downloadable at [www.atradius.com](http://www.atradius.com)



delinquency rates show a declining trend, although they remain at elevated levels. If further substantial write-offs on residential and commercial loans are needed, there will be further downward pressure on bank capital and lending. The resulting subdued credit flows, together with the weakness of house values as a source of financial wealth, will further dampen domestic demand.



Source: American University School of Communication

## Residential Construction

Seasonally adjusted sales of single family housing units peaked at 2,273,000 in January 2006 and have since plummeted to 549,000 units (seasonally adjusted annual rate, SAAR) in May 2011. Preliminary data released for June 2011 indicates that housing starts were up 14.6% from May 2011 to 629,000 units - this unexpected increase reflected by growing demand for rental apartments. Compared to June last year, residential construction was up 16.7%. Sentiment among home builders edged up in July from a nine-month low in June, but with no increase in prospective buyers. Despite the June increase, housing starts are less than a third of their peak during the housing boom.

In the past, the conventional homebuilding sector in the US has been underpinned by various favorable long-term demand drivers including demographic trends, a flexible and liquid mortgage market and accommodating tax policies. However, current economic distress, overcapacity and continuing high unemployment in the US (The Office of Management and Budget recently forecast that the jobless rate will average 9.1% in 2011 and show little change next year) have created a grim scenario.



Source: National Association of Home Builders



Estimates are that it will take almost nine months to deplete the existing new home inventory. Adding the inventory generated by foreclosures exacerbates the glut of unsold and abandoned properties. Banks seized 421,212 homes in the first six months of 2011, down from 529,633 in the same period last year, as lenders are taking longer to act against homeowners who have fallen behind with their mortgage payments. The banks are working through foreclosure documentation problems that first surfaced last autumn and which created a log jam in some state courts. Lenders have also delayed taking action against delinquent borrowers because of this year's slow down in home sales. As the processing delays mount, however, so has the backlog of potential foreclosures — homes that otherwise would have been repossessed by lenders this year. The number of homes with negative equity rose to 16.2 million in Q1 of 2011 from 13.1 million in Q1 of 2010.

The highest distress is in Nevada, which continues to lead the nation in foreclosure rate, with one in every 21 households receiving a foreclosure notice in the first half of this year. Following Nevada are Arizona, California, Utah, Georgia, Idaho, Michigan, Florida, Colorado and Illinois. Consequently, construction companies serving these markets are more likely to face financial difficulties.

Market contraction has had a negative impact on homebuilders' balance sheets and bottom lines, with many hundreds of small and regional builders failing. However, this is a 'boom and bust' sector and the response from established residential builders was quick and generally effective. They shrank inventories, offered buyer incentives, lowered prices (new home prices are dropping at their fastest pace for 15 years), slashed expenses, reduced headcount, managed costs tightly and shored up their balance sheets. Maintenance of strong cash balances and manageable debt maturities have served many builders well during this period and positioned them for a solid rebound.

Even though buying is now more affordable than renting in many US cities, home ownership has lost its appeal (down 9% year-on-year) as fewer believe owning a home is part of their "American Dream". Until employment and delinquency levels stabilize, we are unlikely to see a sustained recovery based on demand. A real recovery in the U.S. housing market is not expected until 2014 or 2015, until which time the residential construction subsector will continue to face challenging conditions.

## Commercial and Non-Residential Construction

Until 2007, these subsectors responded to a solid US economy, stronger corporate balance sheets and increased capital outlays. Spending on commercial projects such as schools, hotels, hospitals, factories, offices, infrastructure and transportation showed considerable strength. However, that trend began to reverse in the latter half of 2007. Meanwhile, innumerable projects have been postponed or cancelled. The slowdown is attributed to many of the same concerns cited above: credit markets retreating; a recessionary economy; volatile energy and commodity costs; no state or local funding as nearly all states struggle with budgetary crises; weak industrial production; continuing consumer frugality; and fast falling commercial property values.



These factors have led to corporate and public efforts to preserve capital and ensure balance sheet and cash flow integrity in the face of uncertain economic conditions. Areas of weakness include retail and office spending – where vacancies are rising to near record levels; state and local build/infrastructure; manufacturing/industrial sectors; and hotels.

Vacancy rates have started levelling off - especially in the multi-family sector where the vacancy rate has fallen. However, the office sector is still struggling with a high vacancy rate of 16.6% due to lack of buyers and financing. For other sectors, rent and occupancy rates were soft and vacancy rates remain flat: 14.3% for industrial and 13% for retail.

The delinquency rate for commercial real estate loans declined by 70 basis points to 8% during Q4 of 2010. High unemployment is one of the biggest problems for the sector: weak demand for jobs and the accompanying stress on consumer spending are both negative factors for the residential market.

## Building Materials

The performance of building materials naturally follows the trials and tribulations of the residential and commercial construction markets and the remodel/renovation markets. A weakened economy, rising costs, poor demand and pricing pressures are putting many manufacturers and distributors at risk. We saw double digit revenue declines in 2008 and 2009, and the ongoing correction to the residential housing market has hit those building materials producers who cater to that industry.

The industry is also very sensitive to energy, transportation and raw materials costs. The transportation of goods to and from the factory is more costly, and there are added raw material and energy costs which must be passed on to the customer for margins to be maintained. However, with low demand, this risks losing customers. While these rising costs affect all subsectors to some degree, the burden is highest for those in retail and the manufacture/wholesale of construction materials.

Depressed home equity values and continuing high unemployment have depressed growth in the renovation and remodel markets. As in the new residential housing sector, construction materials subsectors have contracted their cost structures in line with revenue declines and have reduced capital expenditures in an effort to maintain liquidity and fiscal integrity. Many building suppliers are now turning to emerging markets, notably Asia, as demand for materials such as softwood logs rose 400% year-on-year in China alone. The recent modest growth in the residential repair/remodel markets is expected to continue, albeit tepidly. However, non-residential markets are still slumping badly from previous years' highs and highway/infrastructure spending has yet to have a serious impact. We anticipate that this subsector's conditions will slowly stabilize but challenges remain for the rest of 2011 and well beyond.



## Payment delays and insolvencies are still rising

On average, payments in the construction industry take between 30 and 60 days and, not surprisingly, payment delays have increased over the last year and will continue to do so in the coming months. As economic growth continues to slow, financing for marginal credits becomes scarce and government spending declines, we can reasonably assume a further increase in construction insolvencies which have already shown an upward trend in the last couple of months.

While the industry remains extremely volatile, we impose a very stringent buyer review process for this market, whereby we conduct annual or biannual reviews and require financial disclosure if aggregate exposure exceeds US\$ 250,000. As a result, we are maintaining an extremely cautious underwriting policy. Companies with regional and national diversity which have higher concentration to the repair and remodeling markets compared to new housing starts are better able to weather the storm by remaining prudent with their capital expenditures, reducing inventories, and staying focused on maintaining efficient cost structures. Understandably, our caution about cover in this sector will continue for the foreseeable future, in view of the poor outlook.

### US construction sector

Strengths	Weaknesses
<ul style="list-style-type: none"> <li>• Historically low interest rates for the next two years, as promised by the Federal Reserve, are seen as good news for housing and other borrowers</li> <li>• Condominium, apartment, and rental facilities continue to outperform the industry. Other decently performing subsectors include Heating, Ventilating and Air Conditioning (HVAC) along with repair and remodel</li> <li>• Although debt loads remain high against thin margins, buyers with regional and industry diversity continue to produce modest cash flow and navigate through the extended period of low demand, while realigning their cost structure, refinancing debt maturities, and switching to asset-based revolving credit facilities with minimum financial maintenance as a way to keep access to credit lines</li> </ul>	<ul style="list-style-type: none"> <li>• Residential construction continues to battle weak demand and declining prices due to overcapacity, termination of stimulus programs, high unemployment, low consumer confidence, and declining homeownership appeal</li> <li>• Although spend has increased in 2011, so has the time it takes to place a house on the market and complete the sale</li> <li>• The remaining 30% of the highway-related stimulus money from the American Recovery and Reinvestment Act will run out with additional funding unlikely</li> <li>• Infrastructure spend is likely to remain flat to slight lower through 2012</li> <li>• Bank lending for real-estate construction remains very tight and restrictive since construction and development lending remain the leading cause of bank failures in the US</li> </ul>



## Cost cutting and restructuring helped chemicals to survive the downturn

The US chemicals industry accounts for 19% of the world's chemicals output, and totals US\$ 689 billion. The industry directly employs over 800,000 people nationwide. Nearly 5.5 million additional jobs are supported by the purchasing activity of the chemicals industry and by subsequent expenditure-induced activity. In addition, the US chemicals industry is responsible for 10% of merchandise exports - totaling US\$ 145 billion annually - as well as 11% of all US patents. In the US, there are 170 major chemicals companies operating internationally with more than 2,800 facilities outside the country and 1,700 foreign subsidiaries or affiliates. The chemicals industry itself consumes 26% of its own output.

The recession had hit the chemicals industry hard, with production decreasing 4% in 2008 and 2009. As a result of lack of demand, chemicals companies shelved their growth plans. With plants idled or running at historically low rates, the companies looked for avenues to streamline operations and increase productivity. Accordingly, they resorted to restructuring, plant closures and layoffs. Cost cutting initiatives at industry leaders, such as The Dow Chemical Company and El DuPont de Nemours & Co, helped them save billions of US\$.

With the economic turnaround, the global chemicals industry has recovered from the recession-hit lows. US manufacturing output has rebounded since early 2010, and output grew in many key end-use markets for chemical products, including construction supplies, motor vehicles, electrical equipment, furniture, paper and plastic and rubber products. Domestically, chemicals production volumes increased across all regions of the country in 2010, reversing the steep declines experienced in 2008 and 2009. The largest gains occurred in the Gulf Coast and Ohio Valley regions, boosted by export demand for basic chemicals and plastics.

According to the American Chemistry Council (ACC), US chemicals production rose 2.4% year-on-year in the period January to July 2011 with increased production in all regions (see chart below). Output is expected to grow moderately in H2 of 2011 and continue to improve through 2012, provided that the US economy suffers no further setbacks.

<b>Chemical Production Regional Index, Percentage Change (Seasonally adjusted, 3-month moving average)</b>				
	<i>Current Month</i>	<i>Prior Month</i>	<i>Year/Year</i>	
	Jul 11/ Jun 11	Jun 11/ May 11	Jul 11/ Jul 10	YTD 11/ YTD 10
Gulf Coast	-0.4%	-1.2%	0.8%	2.9%
Midwest	-0.3%	-0.4%	1.9%	1.9%
Ohio Valley	-0.5%	-0.5%	3.7%	3.5%
Mid-Atlantic	-0.3%	-0.1%	2.2%	1.7%
Southeast	-0.4%	-0.4%	3.2%	2.3%
Northeast	-0.3%	0.2%	3.5%	2.3%
West Coast	<u>-0.3%</u>	<u>-0.1%</u>	<u>2.0%</u>	<u>1.2%</u>
<b>US Total</b>	<b>-0.3%</b>	<b>-0.3%</b>	<b>2.7%</b>	<b>2.4%</b>

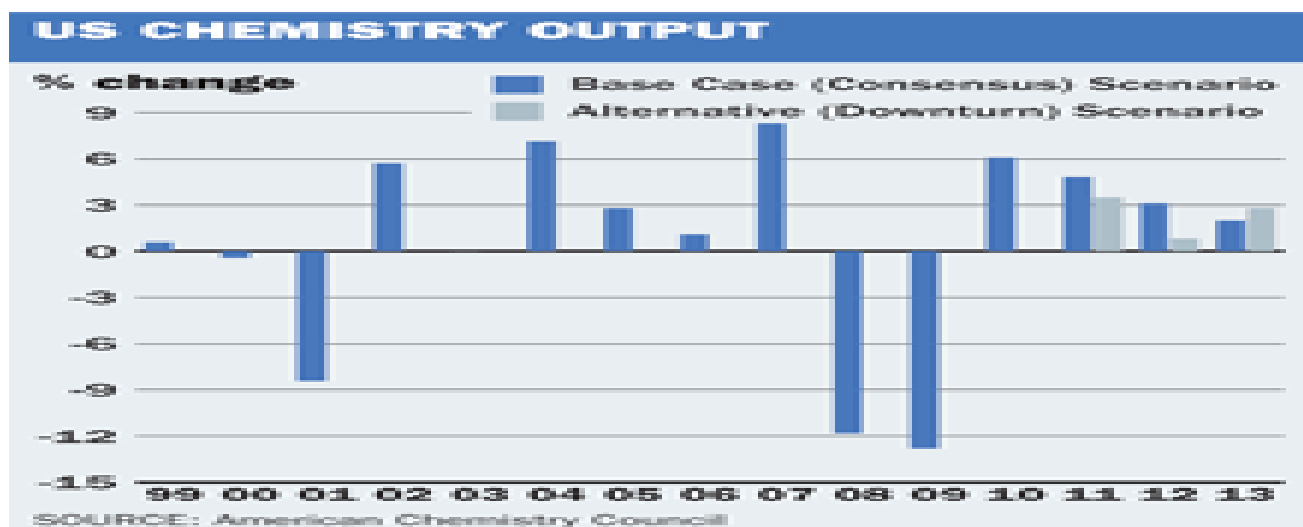
Source: American Chemistry Council



The US home building sector is a major consumer market for the chemicals industry, accounting for about 10% of demand. However, the housing sector remains subdued, and is expected to remain so throughout 2012, making it a weak end-market (see previous article).

Growth in export markets has been driven by several factors. These include favorable energy costs (natural gas) - due to the abundance of newly found shale natural gas - and demand from emerging markets, where recovery and expansion have been the strongest. According to the ACC, US chemicals exports will grow 9.7% in 2011, outpacing the expected 7.8% growth in imports.

The chemicals industry is a large consumer of oil and natural gas, which are widely used as energy and feedstock inputs. As commodity prices rise, chemicals manufacturers are seeing their raw material costs increase. While these are usually passed onto consumers, there can be a lag, and thus margin compression is common in a rising price environment. Oil prices moved upward throughout 2010 and in April 2011 crude oil prices averaged around US\$ 111 per barrel, although they have since come down to less than US\$ 100. Global economic conditions were improving, and generally continue to do so in emerging markets; though recent concerns have emerged due to the eurozone crisis and doubts about a sustainable recovery of the US economy. During the second half of 2011, this is likely to lead to lower oil and gas prices, but also to potentially lower demand for chemicals as economic activity declines.



Consolidation within the sector is fairly common as companies try to expand their product offerings and geographic reach. The chemicals businesses are looking at mergers and acquisitions as an option to grow in the current economic environment. The companies are focused on exploring growth opportunities in emerging markets with strong performance in the fast-growing regions of Asia-Pacific and Latin America, particularly China and Brazil.

Mergers and acquisitions have picked up in 2011, due to the increase in available capital and improved financial results. The largest deals include Berkshire Hathaway's acquisition of Lubrizol for US\$ 9.7 billion and DuPont's acquisition of Danisco for US\$ 5.8 billion in cash and the assumption of US\$ 500 million of Danisco's net debt. This



marks the company's largest acquisition since its US\$ 7.7 billion buy of Pioneer Hi-Bred International in 1999. The deal will enable DuPont to expand the company's offerings in more specialized areas like bio fuels and food enzymes.



## Outlook remains uncertain

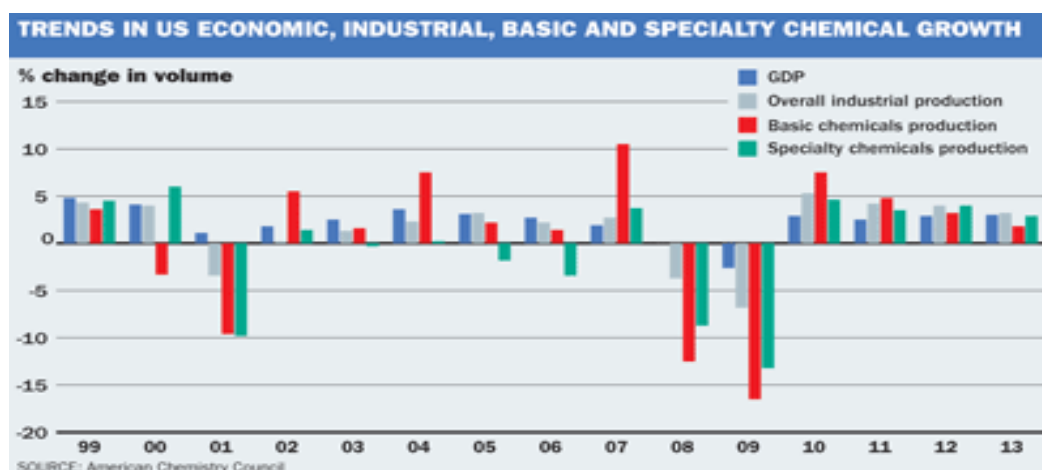
End-markets for chemical products have shown strong growth during the first half of 2011, although there is greater uncertainty for the second half. This growth has been reflected in the earnings releases of most chemical companies for the first quarter of 2011. Combined with the restructuring and cost saving programs that many chemical companies implemented last year, output growth is driving high earnings across the sector, to the extent that many companies are confident of out-performing full-year forecasts. Cost containment measures, such as plant shutdowns, aggressive cost cutting and production improvements, should continue to bolster industry-wide margins. The resultant large cash flows could then be leveraged for growth opportunities.

On average, payments in the chemicals industry take between 45 and 60 days, and payment delays have decreased since 2008, which was a particularly bad year. While we expect a fairly steady performance, the chemicals sector is cyclical and heavily tied to the overall health and strength of the US economy. Therefore, any deterioration could also lead to increased payment delays. Insolvencies have not increased in the last couple of months and, assuming the situation in the housing and auto industries does not worsen, this should continue. But, if the US does dip back into recession or the eurozone crisis worsens, we could see insolvencies increase in 2012. There is still a danger that a soft patch in the economy could evolve into an outright downturn. Persistent higher energy prices, the collapse of housing, supply chain problems emanating from Japan, the European debt crisis, US debt issues, and general uncertainty all work against recovery. The growth outlook for the US economy has been revised downwards several times of late. Real GDP growth for 2011 is expected to be 1.6%, after 3% in 2010. For 2012, anemic growth is expected to continue, with real GDP up by just 1.8%.



Chemicals producers may face other hurdles, such as pending rule changes within US regulatory agencies. The US Environmental Protection Agency (EPA) has proposed a sweeping new rule that could impose stricter limitations on hazardous air pollutant emissions and other requirements on operators of new and existing boilers and process heaters. According to EPA’s calculations, compliance with these rules would cost boiler owners US\$ 12.2 billion to implement and, annualized, cost US\$ 4.1 billion after accounting for savings - and could result in mill closures.

Due to growing uncertainty about the future direction of the economy, our underwriting approach to the chemicals sector remains cautious. As the sector is highly fragmented, we have to scrutinize single subsector trends and end-markets. Access to financial information is still a challenge, but is essential in considering larger dollar amounts. We are reviewing more accounts on a quarterly basis and adding more buyers to our ‘watch’ list.



## US chemicals sector

Strengths	Weaknesses
<ul style="list-style-type: none"> <li>Favourable US\$ exchange rates and growth in emerging markets will drive US chemicals exports up</li> <li>Mergers and acquisitions are an option to grow in the current economic environment</li> <li>Business conditions have improved, with corporate profits and investments rising and production showing solid gains</li> </ul>	<ul style="list-style-type: none"> <li>US producers have responded to competitive pressures by streamlining operations and relocating manufacturing facilities to low cost regions closer to end-markets. But being more flexible in responding to market opportunities is not always easy to accomplish</li> <li>The recent surge in commodity prices is adding to feedstock costs for many producers and margins will be under pressure</li> <li>Given the industry’s sensitivity to the global economy, growth outlook will be negative, and the recent turmoil in Europe and its impact on global growth remain sources of short-term uncertainty</li> </ul>



## Recovery, but uncertainty remains

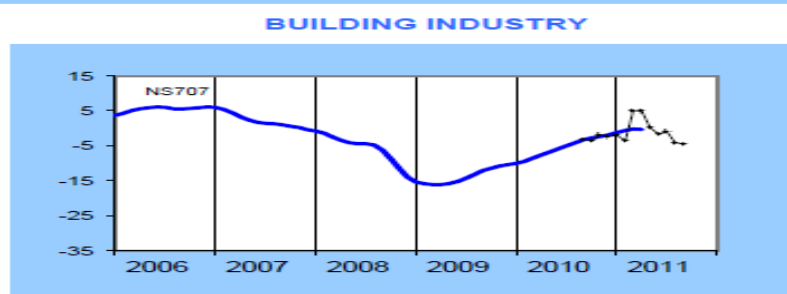
Residential building is the largest subsector of the Belgian construction industry, accounting for 39% of activity, and is followed by non-residential construction (22%), public building (16%) and civil engineering (17%). Overall, activity in the sector increased 0.3% in 2010 - compared to a contraction of 3.3% in 2009 - achieving turnover of € 45 billion. However, this recovery compares poorly with that of the Belgian economy as a whole, which fell 2.7% in 2009 but increased 2.1% in 2010. In context though, the construction industry does typically lag behind the rest of the economy, and so for this sector the recession did not end until mid-2010. Construction has also been adversely affected by two bad winters in 2009 and 2010, both of which hindered building activity. The overall investment climate is still negative and new building projects are scarce. Government measures to stimulate residential building introduced in early 2010, such as the easing of VAT, have ended and subsidies for the installation of solar panels have been cut more rapidly than expected.

In general, construction businesses' profit margins and equity are continuously weak. With fierce competition in the industry, the many small and medium sized companies that dominate the market struggle for turnover as they vie for the few projects on offer. There is some consolidation by bigger groups to achieve vertical integration but they then have the problem of filling their production capacity efficiently as well as competing with large foreign groups entering the Belgian market.

On average, payments in the construction industry take 60 days, although we have noticed increasing payment delays in the last six months: a trend that will probably continue. However, so far the deterioration is not cause for alarm. In particular, government bodies, with the exception of a few local administrations, make every effort to pay on time. Nevertheless, the lengthy administrative process can put pressure on construction companies' working capital.

## Insolvencies increase above average

According to Statistics Belgium, business insolvencies increased 2.1% year-on-year in the period from January to the end of July 2011, while business failures in the construction sector rose 9%. We expect this trend to continue throughout the rest of the year, not just because of the overall shaky economic climate but also as there is no sign yet of a substantial improvement in orders, turnover and margins in the construction sector. Orders did slightly improve in 2010 but it is uncertain whether 2011 orders will attain the same levels. While business confidence in the construction sector increased earlier this year, it has deteriorated since then (see chart below)



Source: National Bank of Belgium



The renovation and civil engineering subsectors are expected to grow at the same pace as last year. Renovation is quite a stable market as, for instance, energy saving measures remain popular. A permanent reduced tax regime for renovation was recently introduced, adding some comfort to this subsector. Civil engineering should benefit from the municipal elections in 2012, although the government is expected to introduce a cost cutting programme. The most important driver for growth in 2011 will probably be the construction of houses given the go-ahead in 2010, and for residential building there is a positive outlook for both new houses and renovations. The effects of the state-sponsored 're-launch' programme will however gradually fade, and in the longer term the demolition and reconstruction subsector will gain in importance. Developments in the project market (offices, stores, industrial buildings) will depend on the economic climate. Low levels of activity in this market segment tend to increase competition in other construction markets as contractors shift from one market to another.

We retain a cautious underwriting policy towards the construction industry. In terms of subsectors we are particularly cautious towards:

- Manufacturing metal structures/parts,
- Demolition and wrecking of buildings
- Civil engineering
- Installation electrical wiring/fittings
- Joinery installation
- Floor and wall covering
- Wholesale wood/construction materials

When underwriting SMEs, whose financial standing is limited, we focus on payment behaviour to suppliers and social security and monitor the liquidity of their buyers. As the project and order portfolio of construction companies tend to be short-term, we also seek to review interim figures and order books. In general, we focus on the following criteria for underwriting construction:

- type of business to predict level of activity and competition
- dependence on one type of business or diversification
- concentration of risk towards a single customer
- most important ongoing projects and most important projects in the order portfolio
- issues with projects (delays, technical problems etc)
- market position, networking qualities, skills/reputation/experience
- financial standing: liquidity, solvability, rotations, cash flow etc
- Sufficient working capital to cope with slow payments from government, disputes etc.
- financial policy: profit reservation

## Belgian construction sector

Strengths	Weaknesses
<ul style="list-style-type: none"><li>• Demographic evolution</li><li>• Energy saving investments</li><li>• Governmental support in times of recession</li></ul>	<ul style="list-style-type: none"><li>• Fierce competition</li><li>• Tight market</li><li>• Weak financial structure</li></ul>



## Last year's recovery continues in 2011

Although Belgium is one of Europe's smallest countries, it is among the world's largest chemicals producers. In fact, the chemicals industry is Belgium's second largest manufacturing sector and accounts for 34.5 % of all exports.

After a massive deterioration in 2009 (-17.2%), turnover increased 15.2% in 2010: to € 52.5 billion. Among the industry's subsectors, soaps, detergents and cosmetics increased 11% year-on-year; plastics and rubber processing 15%; paints, varnishes and inks 9%; and basic chemicals 27%, while fertiliser and pharmaceuticals decreased 7%. Expenditure on Research & Development reached record levels, increasing 6%, and overall chemicals exports rose 16%, as international demand for chemicals products rebounded in the wake of the global economic recovery.

The Belgian chemicals sector is heavily dependent on world economic performance, as 80% of products are exported: mainly to other European countries and the US. Domestically, the construction sector is its most important customer.

The Belgian chemicals association Essenscia forecasts further turnover growth in 2011, and, while lower than in 2010, production and turnover are still expected to exceed their 2008 pre-crisis level. Compared to other Belgian sectors, the general equity strength, solvency and liquidity of chemical companies remains above average. Payments in the industry currently take around 30 days from invoice date. This has remained unchanged for the past couple of months, and we expect payment behaviour to remain good for the rest of the year.

## A relaxed underwriting policy

On average, compared to other Belgian industries, the chemicals default and insolvency rates are also very good – one of the best in the Belgian market - and we see no reason for this to change in the near future unless exceptional circumstances, such as wars or natural disasters, provoke a sharp increase in commodity/oil prices. The chemical sector has one of the lowest claims ratios in Atradius Belgium.

As a result, our underwriting stance is relaxed, with normal monitoring: buyers are reviewed at least once a year on the basis of new accounts or when new information is received. The latest balance sheet is always requested and we also seek interim results. We review sensitive cases or companies with a high exposure on a monthly basis. When underwriting credit limits on companies that have been operating for less than a year, we look in particular at their starting capital and their subsector.



## Belgian chemicals sector

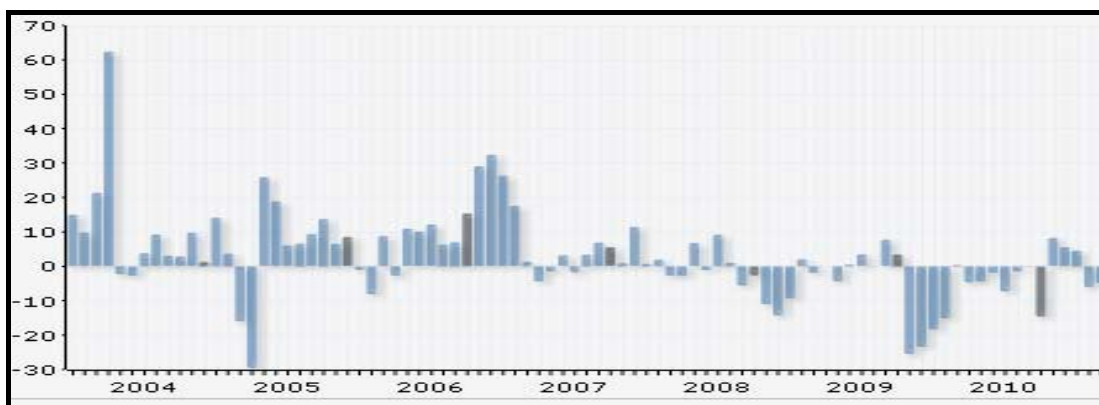
Strengths	Weaknesses
<ul style="list-style-type: none"><li>• Belgium is one of the largest chemicals manufacturing countries worldwide. Antwerp is the second-largest chemicals hub in the world</li><li>• High investments and high level of R&amp;D</li><li>• Belgium is localised in the heart of Europe; highly export-oriented (80% of production). Positive trade balance of more than € 25 billion.</li></ul>	<ul style="list-style-type: none"><li>• Lack of competitiveness due to the fact that labour costs are the highest in Europe</li><li>• The majority of the total investment value originates from foreign-based parent companies</li><li>• Sensibility to commodity prices (mainly oil and derivatives) and strong € against US\$ exchange rate</li></ul>



## No end of the downturn in sight

According to the Czech Statistical Office, construction output - at constant prices - decreased 7.8% in 2010, with building construction down 8.4% and civil engineering 6.7%. The value of public construction orders declined 37%: to CZK 122.2 billion. The largest decrease - 75.7% - was seen in the construction of transport infrastructure. This decline has continued into 2011. In Q2, construction output decreased 5.7% year-on-year, with building construction declining 2.5% and civil engineering construction 11.7%. While the number of construction contracts for businesses with 50 or more employees grew 21.1%, to a total of 13,690 contracts, the total value of these contracts decreased 29.1%, reaching CZK 41.2 billion.

### Construction production index y-o-y change in %



Source: Czech Statistical Office

For the whole of 2011, a 1.1% decrease in output is expected, followed by another 0.2% drop in 2012. Business confidence remains very low and profit margins continue to deteriorate while general equity strength is only average.

## The rise in business failures continues

On average, payments in the construction industry take between 90 and 120 days, and we have noted an increase in payment delays in the past couple of months. The same is true for insolvencies, and we expect business failures to increase further in the coming months across all subsectors, as orders continue to decline and infrastructure projects are cancelled. Additionally, a VAT increase is expected in January 2012, which will affect construction companies' margins as they will not be able to pass on this extra cost in full to their customers. The situation hasn't been helped by the fact that, in 2010, the new government rapidly decreased state support for building savings programs. Against this backdrop, our underwriting policy for the construction sector naturally remains highly cautious. We are unable to consider any new cover without the most current financial information and, together with the transport sector, we assess construction to be the riskiest of Czech industries.

### Czech construction sector

Strengths	Weaknesses
	<ul style="list-style-type: none"> <li>• Long payment terms/ rising insolvencies</li> <li>• Lack of orders</li> </ul>



## Chemicals outperform other sectors

The chemicals industry holds a formidable position in the Czech economy. In 2010 its total sales represented 15.5% of overall industry sales and 13.7% of overall gross value added. In terms of employment and exports, its share of total industrial production was 10.9% and 12.4%, respectively. In 2010, the chemicals sector outperformed the industrial sector as a whole, with a 21.7% rise in sales, compared to 13.5% for the industrial sector. A significant number of chemicals businesses (especially in the rubber and plastics subsectors) deliver to automotive suppliers, which have experienced a strong recovery since the slump of 2008-2009, with local car production currently reaching record heights. Growth rates of 33% were achieved in oil refining and manufacturing of basic chemicals, with rubber and plastics adding 13% and pharmaceuticals 4%. While, in 2010, the volume of new orders rose 14.2%, so far this year there has been a further increase of 14.2% in Q1 and another 3.0% in Q2. Sales have continued to grow although there is an apparent slowdown – a natural consequence of sharp increases in the corresponding quarters of 2010. In 2010, the gross value added generated by the chemicals industry was up by 14.1% year-on-year. Gross value added margins in respective subsectors in 2010 were: oil refinery 3.1% (3.3% in 2009); chemicals and pharmaceuticals 25.1% (25.3% in 2009); and rubber and plastics 27.7% (29.6% in 2009). The chemicals sector's general equity strength, solvency and liquidity are above average.

## Only fuel wholesalers face problems

The average time taken to make payments in the chemicals industry varies by subsector: ranging between 15 and 60 days. Payment behaviour is generally good, and we do not foresee any deterioration in the coming months. On average, compared to other Czech industries, the chemicals insolvency rate is very good. However, we have received some large credit insurance claims in the fuel wholesalers' subsector in the past: they operate with thin margins and weak balance sheets (high leverage). A significant increase in excise tax on petrol, introduced in 2010, led to a decrease in demand for petrol, as road hauliers prefer to fill their tanks in neighbouring countries whenever possible.

Our underwriting strategy for the chemicals sector is generally positive. Most companies have sound balance sheets and show good results. It also helps that some of the largest businesses are consolidated in strong groups like Unipetrol/PKN Orlen and Agrofert Holding. The future performance of the Czech chemicals sector depends largely on external factors: in particular on the oil price but also on the prices of agricultural commodities - which affect the fortunes of agricultural businesses and consequently producers of fertilizers - and demand for new automobiles. All these factors are of course closely connected to the health of the global economy, which at the moment looks somewhat uncertain.

### Czech construction sector

Strengths	Weaknesses
<ul style="list-style-type: none"><li>• Good financial conditions in general</li><li>• Consolidation in strong groups</li></ul>	<ul style="list-style-type: none"><li>• High dependence on automotive sector</li><li>• High excise tax on petrol</li></ul>



## Robust performance in 2010 and 2011

The Swiss construction sector is composed mainly of small companies with a focus on domestic business. About 80% of construction workers are employed by companies with a workforce of fewer than 50 people. Around a third of employees in this sector are involved in primary construction or civil engineering. Roughly 30% work in installation trades and 18% in conversions and extensions.

Construction industry performance was robust in 2010 and in the first quarter of 2011. The State Secretariat for Economic Affairs (Seco) estimates the growth in construction investment in Q1 of 2011 to be 2.7% on the previous quarter and 8.1% year-on-year. For the whole of 2011 Seco expects construction investments to increase 5%.

According to a quarterly research study by Credit Suisse and the Swiss Contractors Association, so far in Q3 of 2011 the construction index has remained at a high level - 129 index points. Both the structural engineering and civil engineering indices have maintained the previous quarter's levels. The medium-term growth potential of the sector is satisfactory.

For the whole of 2011, Seco expects a real increase in construction investment of 5% year-on-year, followed by 2% in 2012. A slowdown in construction activity is unlikely before the first quarter of 2012 because construction companies have good order positions due to high demand. Switzerland's strong domestic demand for construction in the transportation and infrastructure sectors has helped stabilise civil engineering revenues at a high level. However, civil engineering investment will decrease in the mid-term, as pressure for balanced budgets is forcing federal, cantonal and municipal authorities to be more economical with their resources. The residential construction subsector is driven by immigration and lower interest rates. It is expected that the high volume of residential construction project approvals will continue, ensuring a strong inflow of new orders. Commercial construction is expected to rebound after several quarters of deterioration.

Due to its strong domestic focus, the construction industry, in stark contrast to many other major industries, has remained largely unaffected by the strength of the Swiss franc. In fact, the strong franc has had a positive effect by lowering the prices of some imported commodities and building materials.

The construction sector's development depends largely on interest rates, demographic trends and investment cycles. Wages are the biggest cost factor in this labour-intensive industry, with the prices of commodities and subcontracted services tending to rise faster than construction costs, making margins volatile.



## Decreasing payment defaults and insolvencies

Average payment behaviour in the construction sector is good, and we have been notified of only a low number of non-payments in the last six months. Thanks to the improving business performance we expect further improvement in payment behaviour in this sector. This optimistic business outlook will also lead to a decrease in insolvencies in the coming months, while, compared to other Swiss sectors, the construction sector's default and insolvency rate is already good.

Given both the positive outlook for the construction sector in 2011 and the low number of reported claims and non-payments, there are no special restrictions on our underwriting policy for this sector. One general problem, however, is that of getting regular balance sheets and financial figures, as many construction companies are small or family-owned businesses. This does add to the task of judging a company's financial strength.

### Swiss construction sector

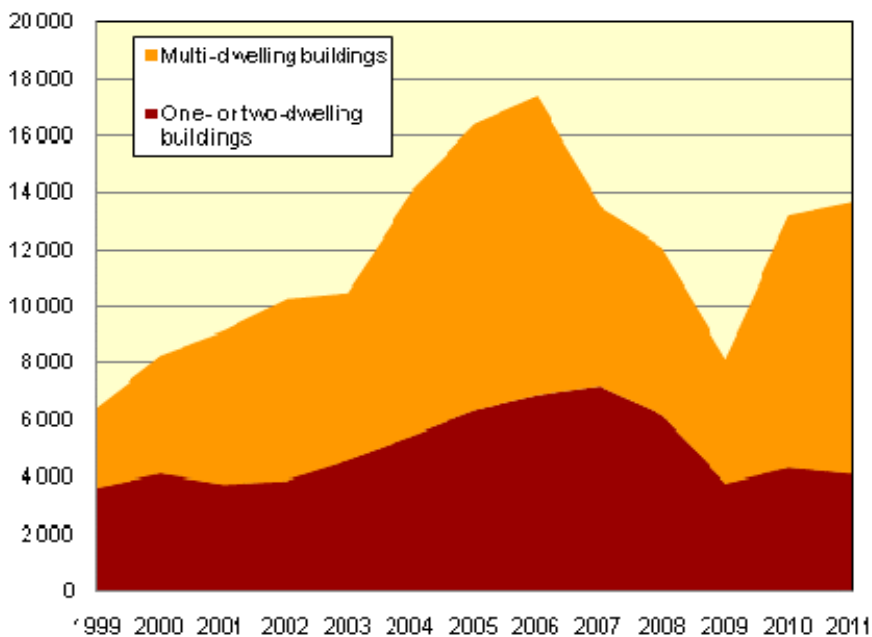
Strengths	Weaknesses
<ul style="list-style-type: none"><li>• Low number of notifications of non-payment and claims</li><li>• Good payment behaviour</li><li>• Positive outlook for the industry. No negative effects from strong Swiss franc</li></ul>	<ul style="list-style-type: none"><li>• Lack of financial figures from mostly small buyers</li></ul>



## Improved turnover and more orders

The Swedish construction sector has rebounded from its slump of 2009, with activity picking up again and new residential construction up 8% year-on-year in the first half of 2011. Most companies in this sector are achieving increased turnover volumes and orders. Compared to 2009, profit margins have improved and both solvency and liquidity are generally adequate in all subsectors. Overall, construction businesses' equity strength ranges from 25% to 40%.

### Number of dwellings commenced 1999-2011



Source: StatisticsSweden

On average, payments in the construction industry take 30 days. However, we expect an increase in payment delays in the coming months as the business environment may become more uncertain, with a knock on effect on the construction sector.

## More insolvencies of one-man businesses

Overall, we expect Swedish business insolvencies to level off in 2011 after a 4.4% decrease last year. In contrast to this general trend, construction insolvencies have increased in the last couple of months, especially at the lower end, i.e. one-man businesses. As bankruptcy is quite an easy process in Sweden and there is a 'grey market' in this sector, it is quite likely that some bankruptcies are deliberate ploys to avoid paying taxes etc. There is also the factor that one-man business owners may lack the management and business skills to see them through tough times.



In the residential construction subsector we expect underlying demand to continue because of the shortage of homes in the larger Swedish towns. While higher interest rates and lending restrictions may prove a hindrance, we still foresee that this subsector will remain strong. In the non-residential (private and public) subsector, performance depends on the overall economic development, which is currently difficult to forecast because of the uncertain future impact of the eurozone crisis and problems in the US economy. The most probable outcome is slightly less activity than at present.

Our underwriting approach to the construction sector remains relaxed. However, we pay closer attention to the building materials subsector, which is subject to fierce competition. When underwriting construction companies our main focus is on profitability; solvency; cash flow from operations; track record; operating margins and order books. In general, we have seen only a small number of problems in this sector over recent years because of its ability to adapt to changes in demand.

## Swedish construction sector

Strengths	Weaknesses
<ul style="list-style-type: none"><li>• Focus on core market Sweden</li><li>• Larger companies have a good financial standing</li></ul>	<ul style="list-style-type: none"><li>• Small home market</li><li>• Foreign companies trying to compete, leading to fiercer competition and lower margins</li></ul>



## Recovery has stalled since mid-2010

New Zealand's economy entered recession in 2008, due to the effects of a drought and high fuel and food prices, with GDP shrinking 0.2%. When the global financial crisis intensified, GDP fell even further in 2009: by 2.1%. To put things in perspective though, the depth of the recession compared favourably to that of other nations, and a combination of low interest rates, fiscal stimulus and rising exports pulled the country out of recession in 2010 with moderate 1.5% GDP growth. However, the recovery has stalled since mid-2010, reflecting weak domestic demand, as households concentrate on reducing debt, and the adverse effect of two major earthquakes (in September 2010 and February 2011) which caused substantial damage - to both property and confidence.

The economic outlook is uncertain - depending on the extent and timing of reconstruction following the earthquakes. The IMF has stated that in the near term, the earthquakes will slow activity, with real GDP growth projected at 1% in 2011. For 2012, growth is projected to rise to 4%, led by reconstruction. Risks are tilted to the downside, including a faltering of emerging Asia's rapidly growing demand for commodities and a possible rise in long-term interest rates.

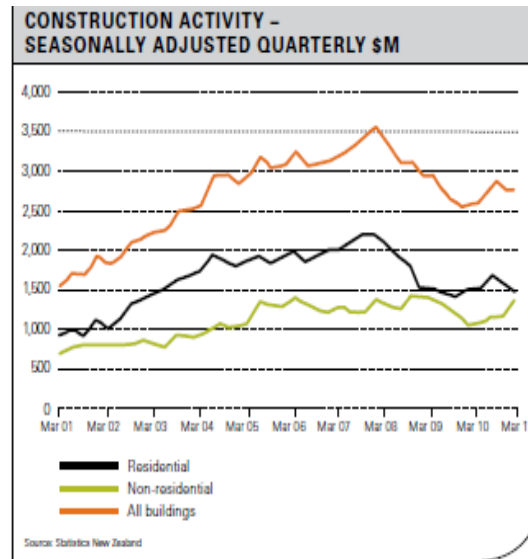
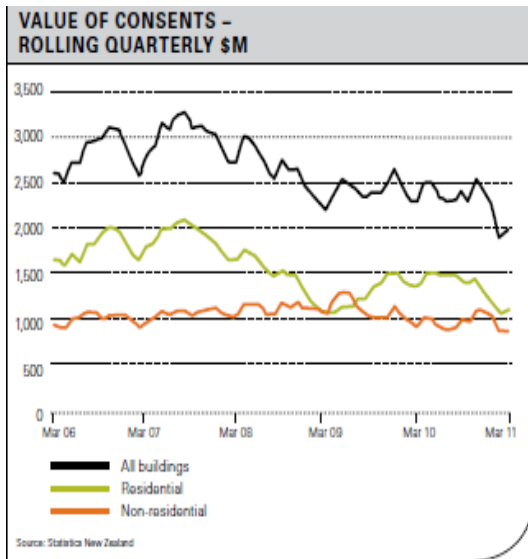
## Residential construction: better prospects in 2012

Residential building activity declined around 13% in the second half of 2010 and this trend continued into early 2011. The decline reflects the relatively low number of residential consents in the first half of 2010 and a sharp drop in early 2011 when consents hit historic lows. This will depress construction activity until the end of 2011. The drop in consents is largely a demand problem, the result of unemployment, low wage growth and general economic uncertainty. Immigration is unlikely to boost housing demand in the near term since the number leaving the country in early 2011 has exceeded arrivals. Prospects of a 2012 recovery in the sector are better, supported by the earthquake reconstruction, low interest rates and emerging evidence of reviving demand evidenced by rising house sales.

## Non-residential construction more resilient

Non-residential building consents have held fairly steady over the last few years. The weakness in the private sector-dominated segments such as farms, office, retail and industrial has been compensated by strong government funded building in the education and health sectors.

Non-residential building activity continues to be more resilient than residential. Robust growth in this subsector's activity - 18.8% in 2010 - was driven by a surge in health and, possibly, Rugby World Cup related work: as New Zealand will host this forthcoming sporting event. However, the outlook remains subdued. Domestic businesses are continuing to reduce debt, even in those industries that are performing well - such as agriculture - creating a spending-averse business market that hampers growth. Non-residential consents stabilised at a low level in early 2011, as a result of which construction activity will be slow in 2011 before a stronger cyclical recovery in 2012, supported by the earthquake reconstruction.



Source: NZ Department of Building and Housing

## Construction material costs

The cost of building materials (machinery, materials and services) has begun to rise: by around 4% in the 12 months to March 2011. However, a strong New Zealand dollar has partly offset strong global commodity price increases, such as steel and crude oil. The short-term outlook is for further upward pressure on world commodity prices driven by increased demand from Asia and post-disaster reconstruction in Japan (tsunami) and Australia (floods). As a small market, New Zealand is likely to be at a disadvantage in negotiating good prices, although its larger builders will be better placed to negotiate. In addition, the earthquake rebuilding in 2012 is expected to lead to some increases in building costs as both labour and materials become scarcer and interest rates rise.

## Atradius experience and underwriting stance

Payment terms for construction materials are usually between 30 and 60 days. In terms of payment delays reported to us over the last 12 months, half of these by value were attributable to the construction and construction material sectors. Therefore we consider construction to be a relatively high risk industry. Naturally, cover is more restrictive on buyers who don't provide financials either to the New Zealand Companies Office or to Atradius. For buyers on whom recent financials are available, creditworthiness is judged on the merits of their financial strength.

## New Zealand construction sector

<b>Strengths</b>	<b>Weaknesses</b>
<ul style="list-style-type: none"><li>• Non-residential construction has held up fairly well in the last few years.</li><li>• In 2012 construction will benefit from earthquake reconstruction.</li></ul>	<ul style="list-style-type: none"><li>• Residential construction has been weak in 2010 and early 2011 and is likely to remain so for the rest of the year.</li><li>• The sector's credit risk is considered to be relatively high and has the highest value of payment delays in the country</li></ul>



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