



# market monitor

Adapting to the challenging  
economic environment

January 2010

# On the rebound, but major risks remain

**T**he stabilisation of Europe's major economies continues. Germany, the fourth largest economy in the world, has continued its path to recovery in the last quarter, and growth of up to 2% in 2010 is forecast. The contraction of British GDP was lower than expected, and unemployment predictions for this year have been revised downwards. Spain's economy appears to be bottoming out after a serious deterioration in the early months of 2009.

After a slight increase of the October 2009 Expected Default Frequency (EDF) indicator in nearly all major economies, the November EDF returned to its decreasing trend. While, for some large European economies, the November EDF figure was the lowest recorded in 2009, the figures for all the markets monitored were still well above their long-term level. We still expect corporate insolvencies in most major markets to rise in the coming months, albeit less so than in 2009.

Against this background, we still continue to urge caution, not just when embarking on new trading ventures, but also in trade with established customers. Essentially, businesses need to tread more carefully in ALL their sales transactions – monitoring changes in the payment behaviour of current customers and taking extra care in assessing the financial strength of new prospects.

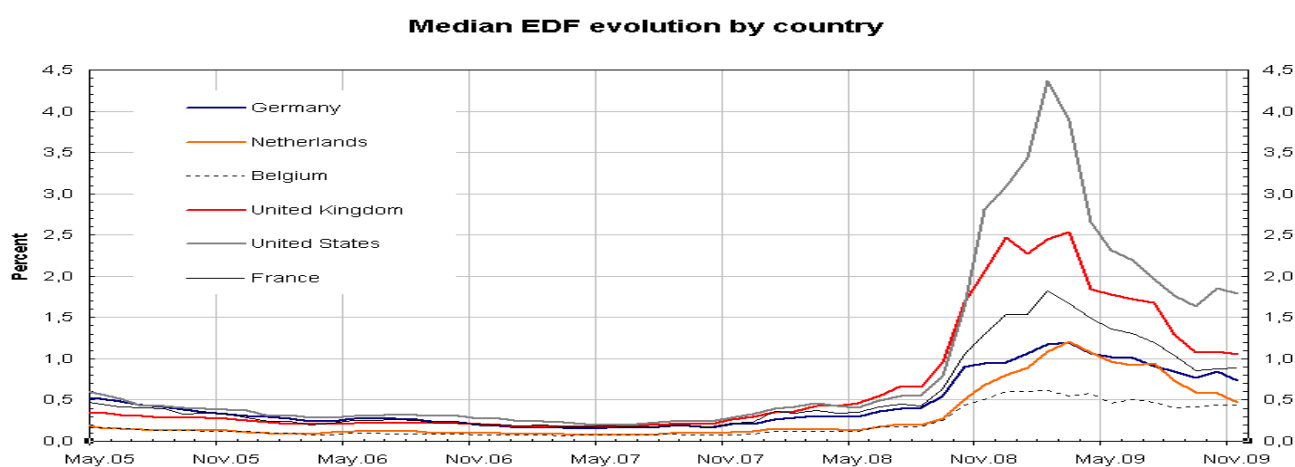
## In this issue...

...we feature the following markets:

- Germany – with a spotlight on the construction and textile sectors
- Spain – with a spotlight on the automotive and metals/steel sectors
- United Kingdom
- Mexico
- Turkey
- Slovenia

# Expected default in Western Europe and USA

One of the most important factors that any business needs to know is the trend in insolvencies in their markets. The following Expected Default Frequency (EDF) chart is based on listed companies in the markets referred to, and the likelihood of default across all sectors within the next year. In this context, default is defined as a failure to make a scheduled payment, or the initiation of bankruptcy proceedings. Probability of default is calculated from three factors: market value of a company's assets, its volatility and its current capital structure. As a guide, the probability of one firm in a hundred defaulting on payment is shown as 1%.



Source: KMV Credit Monitor and Atradius Economic Research

After a slight increase of the October 2009 median EDF in nearly all major economies, the November EDF returned to the decreasing trend we have seen for several months. Germany and the Netherlands showed the highest decrease month-on-month (11 basis points), followed by the US (7 basis points) and the UK (4 basis points). Only France registered the second consecutive monthly increase, and then only by one basis point.

For Belgium, Germany, the Netherlands and the UK the November 2009 median EDF figure was the lowest so far in 2009. However, EDF results for all the markets monitored were still well above their long-term level, indicating high default risk among listed companies.

On the following pages, we assess the impact of expected default in key markets. As well as the expert view of our underwriters, we indicate the general outlook for each market and sector featured using these 'weather' symbols:



Excellent



Good



Fair



Gloomv



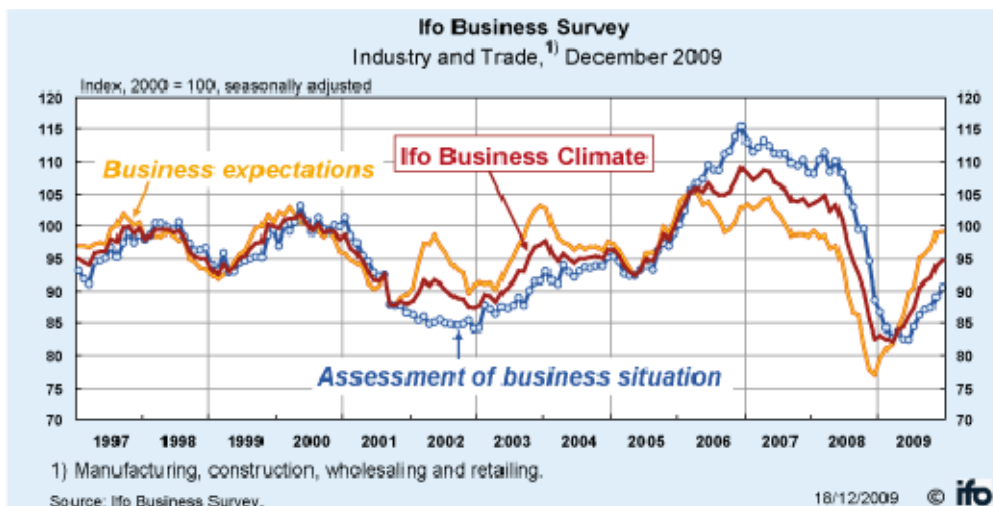
Bleak



## The recovery continues

Germany has continued on its path to recovery with a probable 0.6% growth in the last quarter of 2009, after output rose 0.4% in Q1 and 0.7% in Q2 of 2009. Most economists are moderately optimistic for 2010, forecasting growth this year of between 1.2 % and 2.0%. This underlines that the recovery will pick up speed, although not enough to compensate for the massive slump experienced at the end of 2008/beginning of 2009.

This mildly positive outlook is also reflected in rising business confidence: the ifo business climate for industry and trade continued to rise in December - to 94.7 points: the ninth monthly increase in a row. Both the current business situation and outlook indicators again increased compared to previous months (see chart below). In terms of trade sectors, energy suppliers, pharmaceuticals and food rate their business situation as positive, while metals, engineering and automotive assess theirs as bleak. Looking forward, the chemical industry voices a very positive outlook, while in the engineering and the printing industry pessimism prevails.



However, from January to September 2009, the number of corporate insolvencies increased 11.2% year-on-year, to 24,717 – this was an improvement on the 15.3% increase between January and July. Despite the increased momentum of Germany’s economic recovery, we still expect corporate insolvencies to rise 10%, to about 32,200 companies, for 2009. This trend is expected to persist in 2010 - to 35,500 insolvencies - while the value of outstanding receivables will decline considerably compared to 2009. The sectors mainly affected are automotive, metals/steel, and engineering. Last year, 90 enterprises went insolvent in the automotive supplier subsector alone: an increase of a massive 330% compared to 2008. Metal processing registered a 140% rise and engineering a 100% increase in the same period. Construction, electronics and retail have been less severely affected.

In November 2009, the Expected Default Frequency (EDF) indicator for Germany dropped compared to the previous month (see chart page 2), reaching its lowest level in 2009. While generally decreasing, the current German EDF levels remain nearly twice as high as in the summer of 2008, still indicating elevated default risk among listed companies.



Since mid-December 2009, the German state has made funds available under a counter-guarantee programme to support private insurance companies in providing cover to hedge against the risk of bad debts under contracts for goods, work and services, a concept developed by German credit insurers together with the federal government. The "Top-Up Cover" programme for credit limits is designed to enable additional insurance cover to be granted to suppliers who already have credit insurance.

## Will tighter lending conditions hamper the return to robust growth?

While many of Germany's macroeconomic indicators are again positive, there is the danger that restrictive bank lending could hamper business and economic growth. Towards the end of 2009, enterprises' complaints about difficulties in accessing loans have increased. According to an ifo institute survey, in December 2009 44.3% of companies stated that bank lending has become restrictive, a 1.4% increase on the previous month, with the construction industry showing most concern (50%).

To counter a potential credit crunch in 2010, the German government convened a high level summit of top-ranking representatives from banks and companies in early December. The outcome was a promise by banks to provide more credit, especially to small and medium-sized businesses (SMEs), and the appointment of a "credit mediator" to foster dialogue between banks and German SMEs that have insufficient access to credit. Additionally it was decided that both banks and the state-owned KfW bank will jointly revive the collapsed securitisation market. We see the latter as a very important step in reviving the refinancing market for banks and enhancing their scope for providing new company loans.

Despite all the politically driven initiatives to avoid a credit crunch, the main issue will be how banks respond to the deterioration of many borrowers' ratings once they have disclosed their 2009 annual accounts. If credit decisions are based solely on 2009 accounts, without taking into account the improved business outlook and (probably) better 2010 interim accounts, a credit crunch may happen. The challenge for banks will be to analyse companies' balance sheets in a forward-looking way, with special attention on lenders' business expectations and outlook in 2010.



## Construction

### **How has the global economic downturn impacted the German construction industry?**

The economic crisis since autumn 2008 has begun to hit the German construction sector 6 months after its start. Between January and September 2009, new orders decreased 7.5% and turnover fell 6.8% year-on-year.

Due to the deterioration in many industries, the commercial construction sector has been hit hardest, with demand shrinking 17.5% and turnover declining 11% year-on-year in the first nine months of 2009. That said, public construction has profited from public spending, with major government investment in infrastructure projects. Turnover is estimated to increase 5% in 2009.

For the whole of 2009, the Confederation of German Construction Industry expects overall construction turnover to decrease 4%. Mainly as a result of the fiscal stimulus packages, construction has been less hard hit by the crisis than many other sectors.

### **What is the current trend in payment delays, payment defaults and insolvencies?**

The payment behaviour of construction companies has not worsened compared to other industries, although recorded payment delays are more frequent in the case of construction enterprises delivering to the public sector, which itself often has rather long payment periods (eg municipalities).

### **What is Atradius' short term outlook for the construction industry?**

We expect the current performance of the construction industry to continue into 2010, sustained mainly by continued public spending. It is estimated that, at -1.5%, the decrease in turnover will be lower than in 2009. Housing construction is expected to recover slightly, while public construction is expected to increase 8%, as many infrastructure and public building projects envisaged in the stimulus package and approved in 2009 will begin in 2010. Commercial construction will rebound only after a sustainable and lasting recovery of the economy. Turnover is expected to decrease further - by 10% in 2010.



## Textiles

### **How has the global economic downturn impacted the German textile industry?**

The number of employees in the textile and clothing industry decreased 10.4% between October 2008 and October 2009, and this trend will continue in the medium-term. Turnover has decreased 16.8%, with pre-producers affected most (-20.6%), while the clothing subsector has been less hard hit (-12%). With declining exports and fewer orders from German retailers, production and orders also declined on a two-digit scale. That said, producer prices have risen gradually in the first 10 months of 2009 – by 0.7% (textile) and 0.9% (clothing).

### **What is the current trend in payment delays, payment defaults and insolvencies?**

Textile retail trade suffered in 2009 from fewer customers and the insolvency of some larger companies. That said, the results of this subsector in 2009 were not that much worse than in 2008, due to the above-average performance of large city centre stores. This development was also helped by robust private consumption in 2009, which increased 0.3% due to higher wage agreements, lower inflation and stimulus packages.

### **What is Atradius' short term outlook for the textile industry?**

Private consumption will probably deteriorate in 2010, due to rising commodity prices and unemployment and a higher saving quota. This could negatively affect the whole textile sector in terms of fewer customers, decreasing turnover and increasing price pressure.



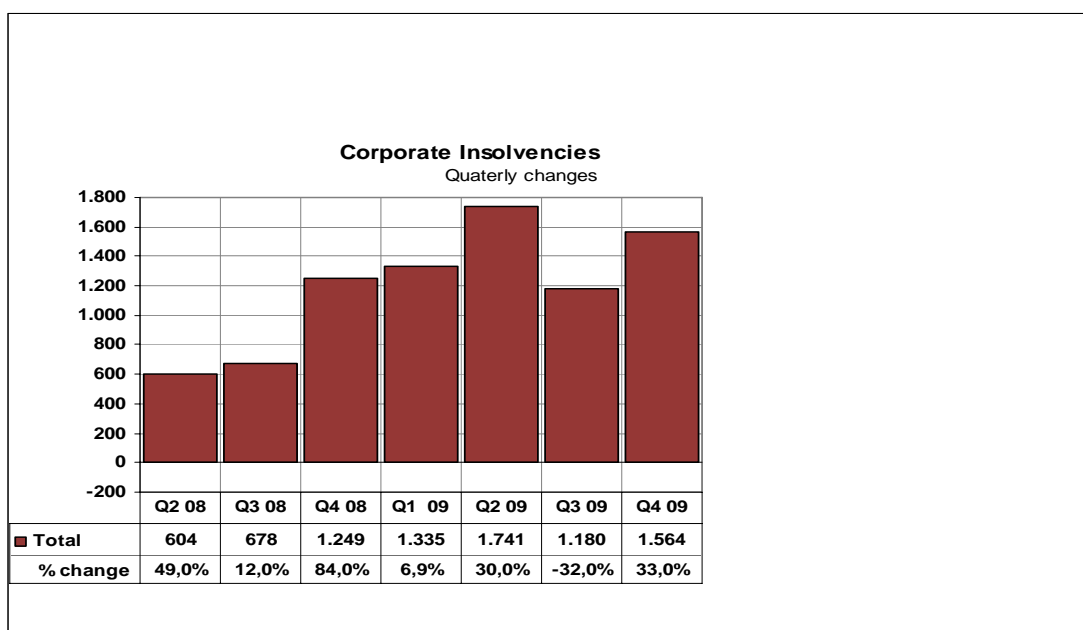
## The recession softens

While almost all major economies show signs of recovery, Spain seems about to hit bottom after serious deterioration in the early months of 2009. Although the main indicators of economic activity and employment still remain negative, the downturn has begun to slow, and Q3 of 2009 seems to have marked a turning point in the decline of the Spanish economy. According to the National Statistics Institute, GDP contracted by just 0.3% quarter-to-quarter compared to 1.1% in Q2 and 1.6% in Q1. The negative impact of declining domestic demand on aggregate growth also began to decrease in the third quarter, helped by fiscal stimulus measures and an improvement in household consumption.

The consumer price index remained negative year-on-year between March and October 2009. In November it turned positive again - to 0.3% - driven mainly by a 1.9% increase in energy prices.

A major impediment to Spain's road to recovery may be the rising public deficit. The combination of a sharp fall in tax revenues (-20.9% year-on-year), rising expenditure on unemployment benefits (24.7% year-on-year) and public anti-crisis measures, has increased the fiscal deficit to 7% of GDP. The government plans to reduce this deficit to 3% by 2013.

The business environment remains difficult, with frequent payment delays and insolvencies. According to our preliminary data, based on figures published by the Official State Gazette (Boletín Oficial del Estado), we expect 1,564 business failures in Q4 of 2009, 33% worse than the previous quarter, but still lower than the insolvency peak in Q2 of 2009 (see chart below).



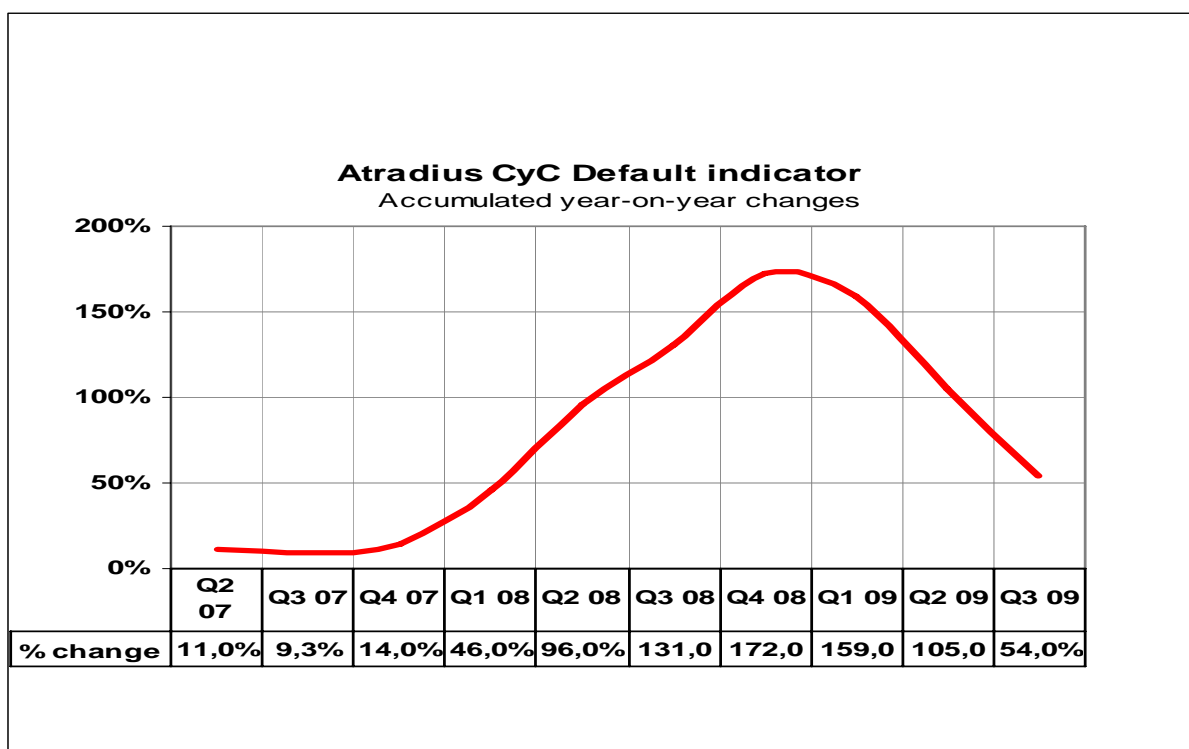
Source: Atradius



In November 2009, the Expected Default Frequency (EDF) indicator for listed companies in Spain dropped compared to the previous month. While generally decreasing, the current Spanish EDF levels remain more than two times higher than in the summer of 2008, still indicating elevated default risk among listed companies.

## Decreasing trend of payment defaults

That said, since our last Market Monitor analysis in October, we have seen further indications of a changing pattern of company payment delays. In the third quarter of 2009, the median of payment default increased by 54% year-on-year, according to the Atradius Crédito y Caucción Default Indicator, continuing the decreasing trend of defaults since their peak in Q4 of 2008 (see chart below). This also indicates that Spanish companies continue to adapt to the adverse environment, putting in place tighter credit management controls.



Source: Atradius

A further improvement in payment defaults in 2010 will depend largely on the strength of the predicted recovery and on companies gaining sufficient access to bank loans to finance the regeneration of their business activities.



## Automotive

### **How has the global economic downturn impacted the Spanish automotive industry?**

The automotive sector, one of the main pillars of the Spanish economy, was worst hit by the crisis between Q3 of 2008 and May 2009. However, its positive performance in the first six months of 2008 mitigated to a degree the negative effects on production, exports and car component fabrication.

The domestic market has weakened as a result of deteriorating consumer confidence, with unemployment rising and consumer credit becoming more restricted. The rising number of new private car registrations since September 2009, compared to 2008, is due solely to direct support/subsidies for car sales given by the state, regional government and manufacturers themselves. In comparison, the situation for the company car and commercial vehicle subsectors continues to deteriorate because of a lack of such sales incentives and financing - and the worsened general business situation. Automotive suppliers have suffered in the same way as car manufacturers. Between October 2008 and October 2009 more than 25 supplier plants were forced to close and a considerable number of automotive supplier creditors had to file for insolvency.

### **What is the current trend in payment delays, payment defaults and insolvencies?**

Payment delays and defaults in this sector reached a peak in 2008, but improved over the course of 2009, although an improvement in the payment behaviour was not registered until April 2009. Insolvencies have decreased since March 2009 - in numbers and volume.

### **What should companies selling products into the automotive industry pay particular attention to?**

Besides scrutinising their customers' solvency and payment behaviour, suppliers should take into account their customers' subsectors - i.e. private cars, commercial vehicles or car parts/component producers. The latter are the most vulnerable due to their high dependency on car producers and their (shifting) business strategies. Companies with only localised production and a strong concentration on only a few clients are the most susceptible to problems.

### **What is Atradius' short term outlook for the automotive industry?**

The individual car scrapping schemes and stimulus packages launched by many European countries led to a recovery in the Spanish automotive sector in the second half of 2009, while there are still uncertainties over the future of some Spanish manufacturing locations. That said, as with other European national car industries, the Spanish automotive sector is heavily dependent on these schemes, and only if they remain in place will a continued recovery be guaranteed.



## Metals/steel

### **How has the global economic downturn impacted the Spanish metals/steel industry?**

Besides the overall fall in international demand, the sharp deterioration in the Spanish construction industry and declining activity in the automotive and electronics industry have negatively affected the Spanish metal/steel sector. The industry has been forced to adjust stocks and production due to reduced demand but, with the ongoing recovery of the global economy and the automotive sector (sustained by stimulus packages), the industry has registered some improvement of its orders in hand, with increased demand for metal/steel products in the last quarter of 2009.

### **What is the current trend in payment delays, payment defaults and insolvencies?**

Payment delays and defaults in this sector were highest between Q4 of 2008 and Q1 of 2009. Since then, both have improved. Insolvencies in this sector were highest in the first four months of 2009 and, since then, a decreasing trend has been registered in both numbers and volumes.

### **What should companies selling products into the metals/steel industry pay particular attention to?**

The metal/steel sector is structurally dependent on global economic performance, especially on (currently decreased) demand from the automotive, construction and electronics industries. Therefore, besides checking the creditworthiness of single companies in the metal/steel sector, suppliers should also take into account the state and outlook of the overall economy.

Additionally, the size of a company in the metal/steel sector may influence its solvency. Companies with less market weight often lack bargaining power in price negotiations with their customers, making them vulnerable to commodity price increases which they cannot pass on.

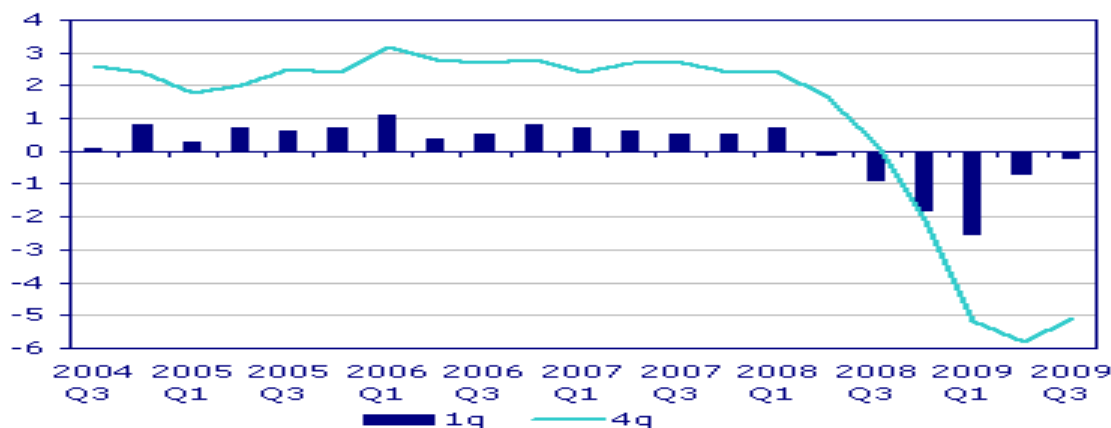
### **What is Atradius' short term outlook for the metals/steel industry?**

Because a comprehensive recovery in the construction sector is not probable in the short and medium term, any increase in demand for metal/steel products depends on a recovery in the electronics sector and the continued rebound of the automotive industries - the latter dependent on governmental stimulus packages. Many companies in the metals/steel sector have already, in 2008/09, aligned their production structures (staff and manufacturing facilities) to the new market conditions, making them more likely to perform better in 2010.



## GDP contraction lower than expected

The initial estimate of a GDP contraction of 0.3% in the third quarter of 2009 was revised to show a more moderate decline of 0.2% (see chart below). This slight improvement in outlook was predominantly due to better than expected performance by the construction industry. However, the services sector underperformed against expectations and we will continue to monitor this sector closely. We anticipate a period of growth in Q4 of 2009, technically confirming that the UK has emerged from recession. While this is good news, it needs to be kept in perspective: the forecast GDP is still 5% lower than when the UK entered recession.



Source: Office for National Statistics

In November 2009, UK retail sales rose by 1.8% on a like-for-like basis compared to the previous year, when sales had dropped 2.6%. In total, sales rose 4.1% against a 0.4% decline in November 2008. Early indicators suggest that the Christmas trading period saw consumers returning to the high street and many retailers are showing some strong results. However, the situation may change over the next few months as consumers lose the 'feel good factor' of Christmas and the impact of the VAT increase, back from 15% to 17.5%, kicks in.

Net lending to businesses by UK-resident banks and building societies remained subdued in November, but was stronger than in preceding months. The rate of contraction of foreign bank lending eased in October on a three month annualised basis after its sharp deterioration since the financial crisis began.

In Q3 of 2009 there were 4,716 compulsory liquidations and creditors' voluntary liquidations in England and Wales: a 14.6% increase year-on-year, but a 4.7% decrease compared to the previous quarter (see chart overleaf).





## Less GDP deterioration towards the end of 2009

According to the Mexican statistics office INEGI, Mexico's GDP continued to contract in Q3 of 2009 - by 6.2% - albeit less than in the previous quarters (Q1: -7.9%, Q2: -10.1%). As a result of the recession, unemployment rose further in October 2009 - to 7% - (6.2% in August 2008): the highest in 13 years, but still low in relation to the high proportion of informal activity. The consumer confidence index continued to fall in November - to 78.2: its second lowest level in 2009.

Remittances (the funds that expatriate workers send back to Mexico and which feed into the economy) are expected to decrease 14% in 2009, compared to an annual average growth of 16% over the last 10 years. Bank consumer credit shrank 20% in November 2009 after an average 35% annual growth since 2001. Both of these factors have taken considerable liquidity out of the economy.

All this has an immediate impact on companies' payment behaviour, reflected in the steady increase in the Expected Default Frequency (EDF) score for listed companies since September 2008, to levels not seen since 2005. This indicator peaked at the end of Q1 of 2009 and subsequently showed a slight improvement, but increased again in October and November 2009.

In the construction sector, declining employment, increased interest rates and the tightening of credit availability resulted in a 42% decrease in housing demand. The credit crisis is severely diminishing the ability of third parties to raise long-term capital to finance infrastructure projects.

In the electronics sector, the total volume of production requests recovered by the end of 2009, but the level is still slightly below the numbers registered in July 2008. Consumer confidence remains low and the industry still shies away from important capital expenditure.

The automotive sector has not yet fully recovered, despite recent improvements in production. It still depends heavily on the US market, and domestic demand remains limited. The aftermarket subsector at least will continue to be stable. Imported tyres will no longer attract import tax: a positive sign for tyre traders but bad news for the domestic tyre manufacturing industry.

In the textile sector, our claims experience has been negative, in view of the still low US and domestic demand and fierce competition from Asia - both legal and illegal (over 56% of the market in garments is illegal). However, the footwear industry has recently reported some encouraging export figures.



## Modest recovery and less volatile exchange rate in 2010

GDP growth is forecast to rebound to about 3% this year. Mexico began 2010 with a series of tax hikes on income, consumer goods, and phone service, along with a rise in fuel prices to ease a budget deficit sparked by last year's financial crisis and reduced oil production. As a result, inflation is forecast to rise to 4.8% in 2010 (from 4.1% in 2009). The peso-US\$ exchange rate shows less volatility than in previous periods, and is forecast for the fiscal year end (FYE) 2010 to close between MXN 13.1 - US\$ to MXN 13.5 - US\$.

Claims received by Atradius remain high. It's therefore worth noting that obtaining promissory notes (pagaré in Mexico) is a key element in recovering the debt either for pre or post claim payment, especially as the vast majority of claims paid are due to protracted default – the buyer's unwillingness to pay – with very few due to insolvency.



## Improvement of macroeconomic indicators

Turkish GDP continued to contract in Q3 of 2009 - by 3.3% - although less than in the previous quarters (Q1: -14.7%, Q2: -7.9%). Industrial production is still negative, with the September 2009 figure showing an 8.6% contraction. That said, capacity usage and consumption figures for Q2 and Q3 of 2009 show slight improvements. Turkey's structurally high current deficit and inflation, traditionally areas of concern, are less so now as a result of a slowdown in consumption and investment and a devaluation of the Turkish Lira by more than 20%. The factors that could now impede a quick recovery are unemployment, which varies between 13% and 16%, and low consumer confidence.

Despite the low debt ratio, public finance has been deteriorating as a result of lower tax income, subsidies and public expenditures designed to support economic activities. However, Fitch upgraded Turkey's rating by two notches to BB+ in December 2009, based mainly on its successful public finance management compared to many other emerging markets and Eastern European countries.

The banking sector is still strong, with a high capital adequacy ratio of over 18%, high profitability and a transparent loan portfolio which does not involve mortgage products. That said, non-performing loans rose to 4.6% in August 2009 from 3.8% in March 2009 and 'bounced' cheques increased by 28% in the first eleven months of the year: both indications of a continued deterioration in the payment cycle. However, to put this in perspective, there is a slowdown in the number of bounced cheques, which had shown an increase of 43% in the first five months of 2009.

All sectors have been affected by the economic downturn, especially those connected to retail. As was the case when Market Monitor reviewed Turkey six months ago, textile, electronics, chemicals and construction remain relatively higher-risk sectors due to the dramatic fall in consumption, shrinkage in borrowing opportunities and worsening liquidity conditions.

**Textiles:** This sector remains particularly vulnerable, due to a combination of excess capacity, lack of branded production, low capitalisation, diminishing domestic and export demand, Far East competition, and non-performing bank loans of around 13%.

**Automotive:** As Turkey's second largest export sector and an important customer of several other industries, the outlook for automotive is not that promising: almost all the main manufacturers have periodically suspended production during 2009 and early 2010.

**Electronics:** As consumer confidence is still low, manufacturers, distributors and, especially, retailers face liquidity problems and suffer from narrowing margins as a result of fierce competition in a shrinking market.



## New IMF stand-by programme likely

Despite the improvements in macro economic indicators, as confirmed by the upgrade of the country rating by Fitch, the deterioration in payments and liquidity in many sectors remain a major worry.

Negotiations with the International Monetary Fund (IMF) for a new stand-by programme are continuing, but cannot yet be finalised because of the required strict control on public expenditures. In the event of a failure to reach agreement, Turkey may face difficulties in revolving the external debt carried by its private sector. However, recent government statements suggest that an agreement is likely in near future.



## The economic slowdown continues

Slovenia's export-driven economy experienced a significant downturn in 2009. Real GDP growth turned to recession and our forecast for 2009 is a contraction of around 4%. The economic slowdown has meant rapidly increasing unemployment, expected to rise to 8.9% in 2009 (compared to 6.7% in 2008). The budget deficit is expected to reach 6.6% of GDP in 2009 and 7% of GDP in 2010, exceeding the EU-mandated limits for eurozone member states. However, in November 2009 the European Commission acknowledged that Slovenia's budget deficit is a result of the crisis and has given the country until 2013 to cut its budget deficit to below 3% of GDP, to meet to the European Monetary Union target.

Domestic demand will weaken sharply in 2009 as businesses and households cut back on investments and consumption. Industrial output contracted 16.1% year-on-year in October 2009, as the recession in the eurozone slashed demand for Slovenian exports. Serious though that is, it is still an improvement on the contraction of 19.5% experienced in Q1 of 2009.

## Massive state support for the banking sector

Slovenia's financial industry has not escaped the economic crisis either. The banking sector has faced refinancing difficulties since the last quarter of 2008. Both foreign and domestic banks had borrowed abroad in recent years to finance a credit boom that outstripped the growth of domestic deposits. As a consequence, the total amount of short-term debt to be refinanced within a year has reached € 5.5 billion, about a sixth of Slovenian GDP, forcing banks to hold cash and restrict loans to both households and firms. But the government and the Bank of Slovenia took measures at the beginning of 2009 to support bank liquidity: the government used its higher credit rating to borrow €1 billion and deposited most of the proceeds in bank accounts. Household confidence in bank deposits has not been affected, thanks to the removal of the ceiling on the state guarantee for deposits.

As was the case when Market Monitor last reported on Slovenia in July, we have seen an increase in reported payment problems, but still with no clear pattern emerging in any sectors. However, it is important to be extra careful when dealing with companies in the automotive industry, construction or construction materials, engineering, ICT, iron steel and metal manufacturing, textiles, timber and transport.

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