Euler Hermes Economic Research

Economic Insight

Insolvencies are back: Keep an eye on the domino effect

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Executive summary

- Euler Hermes forecasts that insolvencies will increase by +2% worldwide in 2016, and again by +2% in 2017. It will be the first rise since 2009. Reasons include too-low-for-too-long growth, increased turbulence in some sectors (commodities is a clear example) and the domino effect of major bankruptcies. In 2015 there were 152 top bankruptcies by companies with turnover above EUR100mn, compared to only 95 in 2014.
- In 2016, Asia Pacific (+13% more business insolvencies than in 2015) and Latin America (+17%) are the hot spots. In the U.S., for the first time in 6 years, bankruptcies should increase by +3%. This major shift is driven by the Metal and Energy sectors, accounting for half of public firms' bankruptcies in 2015.
- Western Europe is the only region where insolvencies are expected to decrease: -5% in 2016, and -3% in 2017. However, the annual number of bankruptcies remains higher than pre-crisis levels in 11 out of 17 European countries. This calls for cautious optimism, as increasing nonpayment risk in emerging markets is having a toll on exporters.

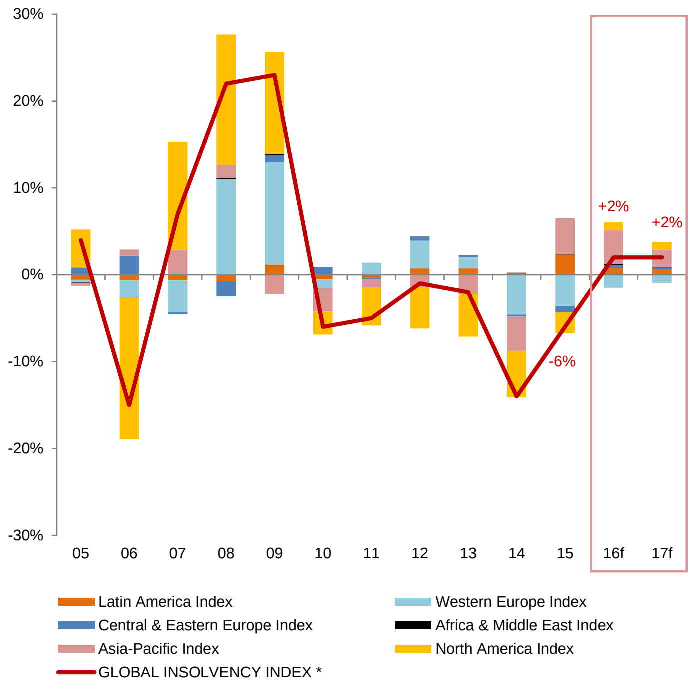
Global insolvency outlook: Beware of the domino effect from top bankruptcies

In 2015, Euler Hermes Global Insolvency Index decreased by -6%, a sharp slowdown after -14% in 2014. More importantly, according to our estimates global business insolvencies will rise by +2% this year and by +2% again in 2017. This will be the first rise after 6 consecutive falls. Slow growth and uneven liquidity, especially in emerging markets and certain sectors (industrial ones e.g.) may push to the edge the companies whose working capital has eroded over the past years.

Three main factors explain the rebound in insolvencies.

First, sluggish growth and trade, as explained in our latest report [Why is global growth a FLOP(s)?](#) Global growth is expected to slow down marginally to +2.5% in 2016, after +2.6% last year as advanced economies will grow moderately (+1.8% in 2016) and emerging markets need more time to bottom-out (+3.6%, a new record low since 2009). As a result, 70% of global GDP will be slowing down or in recession. Global trade is expected to continue to decrease in value terms by -2% this year after -10% in 2015, further pressuring further large companies' revenues.

Figure 1: Euler Hermes Global Insolvency Index and regional indices



Sources: National Statistics, Euler Hermes' forecasts

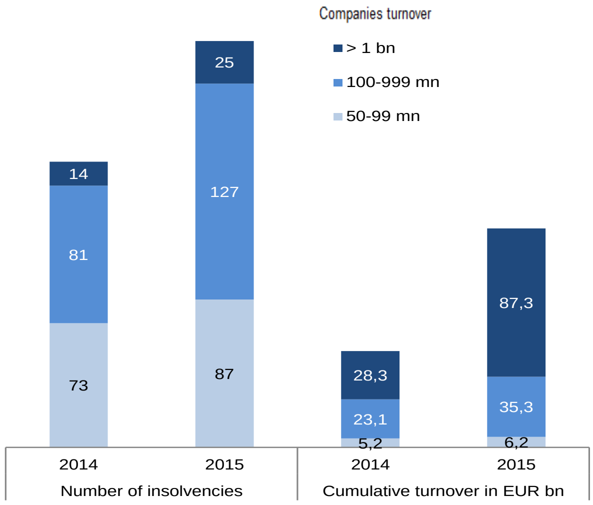
Second, some idiosyncratic shocks have had second-round effects.
The Energy sector is highly impacted by persistent low oil prices. In the U.S., the effect on operating margins is estimated at -USD10bn in 2015. It compounds the average debt-to-equity ratio of the industry to 130% in 2015 up from 90% in 2014. In 2015, 10 energy companies with a cumulative turnover of EUR8.5bn filed for bankruptcy in the US. and 6 others (cumulative EUR3.4bn) ended up in a similar situation in Canada.
Another shock emanates from China, where state support for capital intensive sectors is fading away in favor of SMEs and high-tech research and development, as well as other high-end activities. China's steel industry is particularly affected by this transition as it buckles under overcapacity pressure. The sector reported the largest insolvency worldwide in 2015 with Sino steel, worth EUR26bn, gone bankrupt in October. Conversely, China was the only major economy where not a single firm exceeding EUR10mn of turnover went bankrupt in the Retail sector, confirming the rise of Chinese consumers.

Last and as the corollary of the first two reasons, there is reason to believe that a domino effect is on its way. Top bankruptcies often translate into distress for suppliers if these are not properly hedged. In 2015, 152 firms with a turnover of EUR100mn or more went bankrupt, compared to 95 in 2014 and 110 in 2013. 25 of them (14 in 2014) were above the EUR1bn turnover mark, and accounted for EUR87bn (EUR28bn in 2014).
The spike in the number of too-big-which-failed is worrying and allows for important second-round effects on non-strategic providers.

U.S.: The end of the recovery cycle and struggles in the energy sector are forecast to drive insolvencies upward

After 6 consecutive years of steady decline, Euler Hermes forecasts corporate insolvencies will increase by +3% in the U.S. this year and in 2017.
Part of this U-turn is linked to a structural effect. The high "death rate" of enterprises caused by the 2008 crisis is now absorbed, and U.S. insolvencies have reached what we can call their "natural rate". In 2015, 24,700 corporates went bankrupt, that is to say 2.5 times fewer than in the 2009 peak.
Moreover, the economy is nearing the end of the recovery cycle with GDP growth expected to decelerate to +2.1% this year, 20bps below the estimated equilibrium growth rate needed for insolvencies to remain stable. Financing conditions have also become less accommodative since the FED rate hike last December and the net percentage of banks widening spreads increased to -18% in Q1 2016 – the highest level since Q2 2010.
Last but not least, the perfect storm that hit the energy sector further weighs on the outlook of U.S. firms. Driven down by energy related activities, overall corporate profits decreased by -12% in the country at the end of 2015. The sector also led to a surge in insolvencies of public companies with 79 cases, half of which were in the oil and gas industry, up from 54 in 2014.

Figure 3: Number and cumulative value of turnover of major insolvencies (by size of turnover)

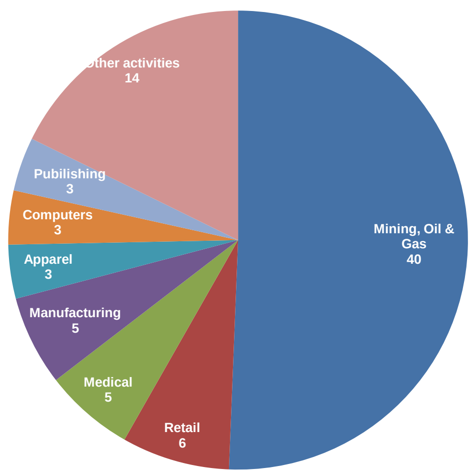


Source: Euler Hermes

Figure 4: Net % of banks tightening (widening spreads) vs. bankruptcies in the U.S.

Sources: IHS, Fed, US Courts, Euler Hermes

Figure 5: Number of publicly traded firms gone bankrupt in the U.S. by sector in 2015



Sources: BankruptcyData, Euler Hermes

This year has not begun under more favorable auspices. 30 U.S. firms defaulted on their debt in Q1 2016 – up from 12 at the same period in 2015 – out of which 8 in the oil and gas sector. Moreover, 12 debtors with assets and liabilities above USD1bn entered Chapter 11 - the highest number since 2009 – 4 being energy related businesses.

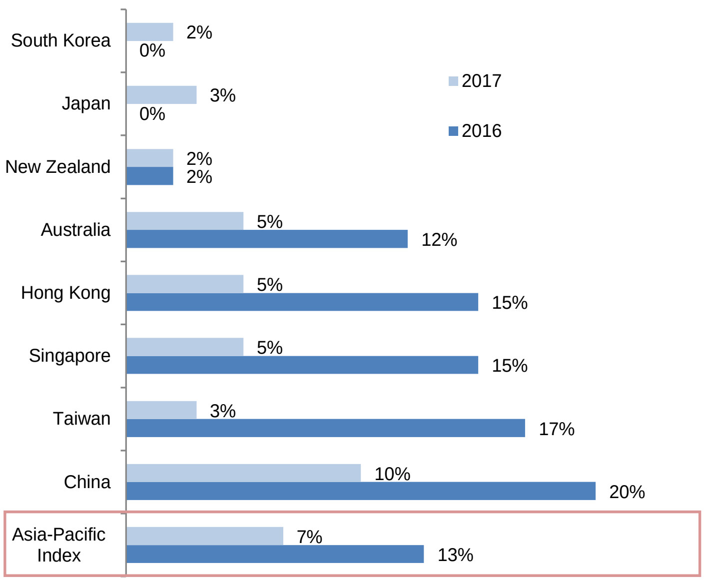
In this context, the service sector should act as a safeguard and limit the rise in insolvencies. Indeed, while services represent more than 30% of total bankruptcies in the country, the sector should stay in overall good shape this year. The ISM services index is well into positive territory (54.5 in March 2016) and employment growth remains dynamic: +2.1% y/y in February 2015 compared to +0.6% for goods related activities.

Asia Pacific and Latin America: Credit risk remains titled to the downside with a double digit increase in business insolvencies forecast in 2016 and 2017

Business insolvencies are forecast to keep increasing rapidly in Asia Pacific. We expect +12% more firms will go bankrupt than in 2015 followed by another +7% hike in 2017.
The whole region suffers from the side effects of China's slowdown. GDP growth in the country is expected to stand at +6.5% this year and +6.4% in 2017, while bankruptcies should increase by +20% and +10% after +24% in 2015. Chinese corporates are facing a rising level of debt which represents 160% of GDP, while profits decreased by -2% in 2015 and no rebound should occur this year. Payment delays are also on the rise with DSO standing at 87 days in 2015, +11 days more than in 2012.
In APAC, hubs acting as service providers for China and commodity exporters are most exposed to the country's rebalancing. This year, insolvencies are expected to jump by +17% in Taiwan and +15% in Singapore and Hong Kong. In Australia, where commodities represent 68% of total exports bankruptcies could rise by +12% this year after +22% in 2015.
Japan and South Korea stand apart from the rest of the region. Euler Hermes forecasts business insolvencies will stabilize in 2016 at historical low levels following years of steady decrease before a slight rebound of +3% and +2% in 2017. In these two countries, corporates continue to benefit from regulations which limit the entrance of foreign enterprises to the national market and enable local businesses to maintain solid profit margins.

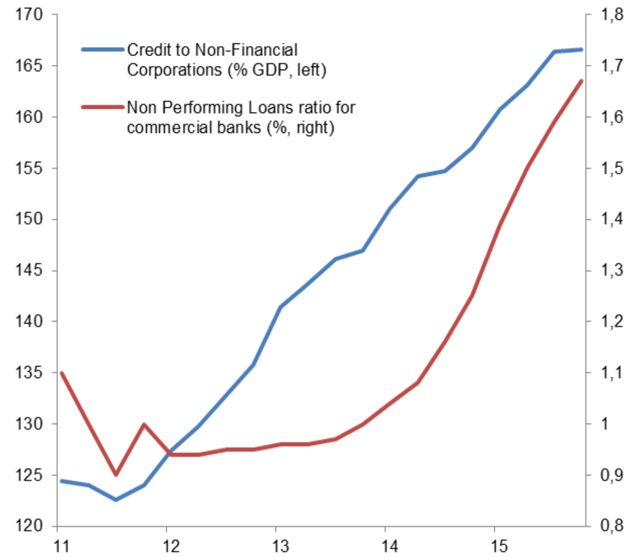
The deterioration will be even stronger in Latin America, which remains in recession. Business insolvencies are forecast to grow by +17% this year and +13% in 2017. In the region, corporates are affected by a strong deterioration of the terms of trade as currencies depreciate and commodity prices remain low.
The most acute situation is evident in Brazil where bankruptcies are expected to rise by +22% this year after +25% in 2015, and hit a 12 year high. Large companies which are most exposed to international trade are the hardest hit. Major insolvencies have doubled last year to 280 cases while small businesses bankruptcies increased by "only" +18%.

Figure 6: : Insolvencies forecast in Asia Pacific



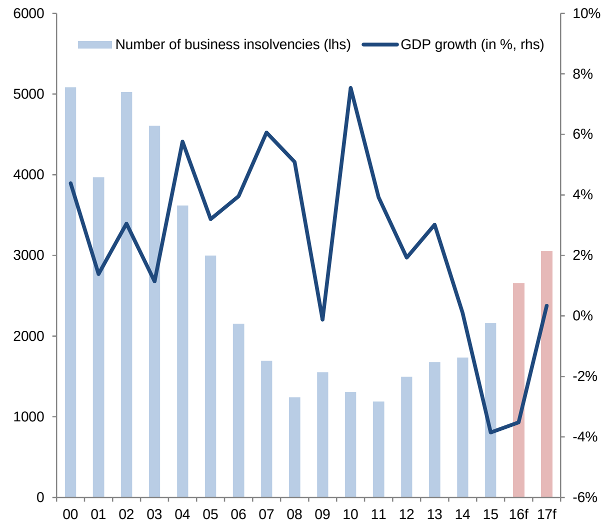
Source: Euler Hermes

Figure 7: Non performing loans and corporate debt in China



Sources: IHS, Euler Hermes

Figure 8: Business insovencies and GDP growth in Brazil



Sources: National Statistics, Euler Hermes' forecasts

Western Europe: Better economic prospects at home but rising nonpayment from foreign counterparts and detrimental political developments are downside risks for corporates

Western Europe is the only region where we expect business insolvencies will continue to decrease, by -5% this year and -3% in 2017, after -13% in 2015.

Last year was marked by a timid but visible recovery in the Construction sector. Real investment grew by +2.0% y/y in Q4 2015, its highest level since Q1 2011, and insolvencies fell by -17% on average across European construction industries. Yet the sector continues to face a sensitive or high level of risk in 11 out of 17 countries and to account for around 20% of total business insolvencies in the region.

The other main improvement was recorded in the Transportation sector where corporates leverage reduced oil invoices to restore their margins. In 2015, the oil bill represented only 22% of total costs for European road transporters compared with 28% in 2014, and insolvencies decreased by -15% on average.

Over the next two years, companies in the Eurozone should benefit from a slight acceleration in GDP growth (+1.6% in 2016 and +1.7% in 2017). The ECB support will also strengthen with the allocation of EUR1.7tn until March 2017 to fight against disinflation.

However, increasing nonpayment risk from trade partners and political uncertainties might darken the outlook for European corporates. Despite the current improvement, the level of bankruptcies in Western Europe remains high with 11 out of 17 countries still reporting more insolvencies than before the 2008 crisis. It is also worth noting that economies across the region perform unevenly.

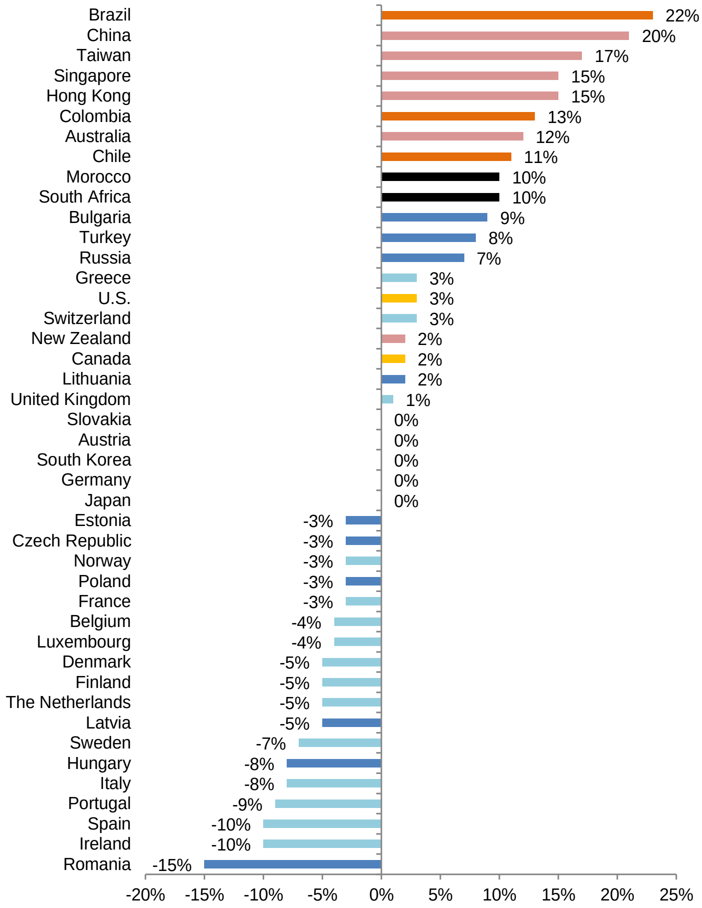
We have thus clustered European countries in four categories based on past performance and expected future trends in each country.

This year, business insolvencies are forecast to continue to *rapidly decline* in Spain (-10% compared to 2015), Ireland (-10%), Portugal (-9%) and Italy (-8%). However, these countries are also the ones recording a particularly high level of bankruptcies, especially Spain and Ireland where bankruptcies stand 3 and 1.5 times above pre-crisis average. Moreover, should the uncertainty stemming from the current political deadlock in Spain persist, it could compromise consumers' and investors' confidence.

In the Nordic countries, Belgium, and France the number of insolvencies should *decrease at a steady but more moderate pace* in line with the regional average. In France this year will mark the first improvement since 2010 with -3% bankruptcies compared to 2015, but still +30% above their pre-crisis level. Note that large French corporates already recorded an improvement last year with 143 bankruptcies involving companies with a turnover above EUR15mn, down from 186 a year earlier.

In Austria, Germany and the United-Kingdom business insolvencies are expected to *stabilize at historic low levels* after years of steady decline. German firms with high export ratios will be increasingly affected by economic turbulences in foreign markets, notably in China, the 4th biggest export destination for the country. In the UK, the

Figure 9: Insolvencies in 2016 (yearly changes in %)



Source: Euler Hermes

Figure 10: Changes in business insolvencies by sector for selected European countries

2015 vs 2014 in %	**Agriculture**	**Manufacturing**	**Construction**	**Retail/ Trade**	**Transportation**	**Services**	Country total (including other activities)
France	-3%	-7%	-3%	-4%	-9%	-1%	1%
Germany	-15%	-6%	-4%	-7%	-13%	-1%	-4%
Ireland	-	-1%	-39%	-4%	-23%	-15%	-10%
Italy	-	-14%	-8%	-6%	-6%	-2%	-6%
The Netherlands	-22%	-39%	-28%	-28%	-34%	-27%	-21%
Norway	-11%	4%	-6%	-11%	-10%	-5%	-7%
Spain	25%	-39%	-34%	-17%	-35%	-19%	-26%
Sweden	-7%	-9%	-17%	-4%	1%	-9%	-10%
UK	-24%	-8%	-11%	-3%	-11%	-6%	-14%
Average change by sector	-8%	-13%	-17%	-9%	-15%	-10%	-13%

Sources: National Statistics, Euler Hermes strong decline reported last year (-14%) should come to an end, challenged by the deceleration of GDP growth (+1.9% this year vs. +2.1% in 2015), a slowdown in the U.S. the most prominent destination for British exports, and the risk associated with the "Brexit" referendum. We expect business insolvencies to increase by +1% in 2016 and +3% next year in our baseline scenario (no exit), and +5% in 2017 if the UK were to exit the EU.

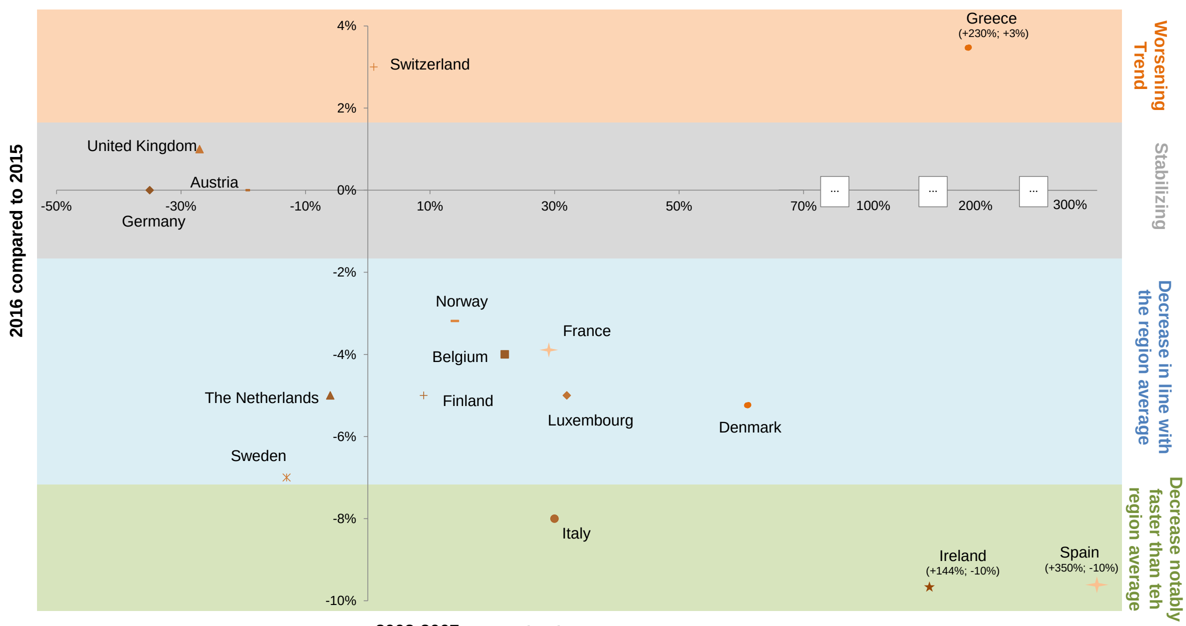
Switzerland and Greece were the only countries to report a substantial *increase in corporate bankruptcies* in 2015 with respectively +7% and +8%. For the former this rise stems from persistent challenges on firms' export competitiveness due to high currency valuation. For the latter it is in line with a recession due to continue in 2016 with -0.6% after -0.3% in 2015. In both countries, we expect the situation to keep deteriorating with +3% more insolvencies this year.

Figure 11: Major insolvencies registered in Western Europe in 2015

Rank	Name of the company	Annual Turnover (EUR mn) *	Sector	Country
1	Ilva S.P.A.	6 026	Metal	Italy
2	Royal Imtech N.V.	3 898	Services	The Netherlands
3	Abengoa SA	1 176	Services	Spain
4	Sahaviriya Steel Industries UK Ltd	1 086	Metal	UK
5	Imtech Deutschland Gmbh & Co. Kg	905	Construction	Germany
6	Macintosh Retail Group N.V.	871	Retail	The Netherlands
7	Imtech Uk Ltd	645	Construction	UK
8	Kaai 12	641	Retail	Belgium
9	V&D Group Holding B.V.	618	Retail	The Netherlands
10	Ludendo	507	Retail	France
11	M. Business S.R.L.	493	Retail	Italy
12	Mexx Lifestyle B.V.	453	Retail	The Netherlands
13	Zielpunkt Gmbh	444	Retail	Austria
14	Air Mediterranee	410	Transportation	France
15	Mark Group Ltd	301	Construction	UK
16	Groupe Gadol Optic 2000	300	Retail	France
17	Pixmania	295	Retail	France
18	Stefana S.P.A..	293	Metal	Italy
19	Robert Horne Group Ltd	281	Paper	UK
20	Fram	276	Services	France

(*) last known turnover
Source: Euler Hermes

Figure 12: Western Europe Insolvencies Overview
(2016 compared to 2015 y-axis; 2016 compared 2003-2007 x-axis, in %)



Sources: National Statistics, Euler Hermes' forecasts

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