

## Non-payments in Italy: It's not over... Yet!

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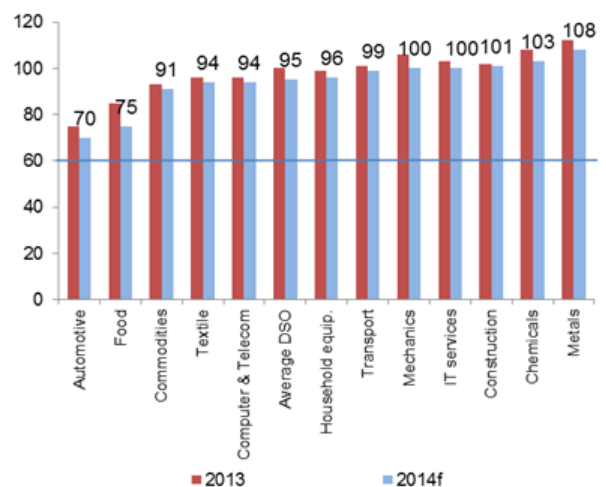
### Executive summary

- Days Outstanding Sales (DSOs) are expected to moderate slightly to 95 days in 2014 but remain significantly above the regulatory threshold of 60 days.
- At the end of H1 2014, in spite of fewer and less severe non-payments year-on-year, the number of payment incidents remains 43% above 2007 levels. Domestically, the private sector continues to suffer from a sluggish demand and tight financing conditions. In addition, a remaining EUR40bn is still due from the public sector. Abroad, timid recovery in major trade destinations and geopolitical tensions could cause higher risk of non-payment.
- Some sectors are nonetheless starting to fare better: (i) the transport and automotive sectors experienced fewer and less severe non-payments abroad in H1 2014; and (ii) Household equipment, machinery and equipment, and chemicals sectors started to slowly recover with fewer and less severe domestic-driven non-payments in H1 2014.

### A steady improvement in firms' payment behavior is expected, but payment delays remain very high across all sectors

The Days Outstanding Sales (DSOs) are expected to moderate slightly in 2014 but remain significantly above the regulatory threshold, at 95 days on average against 97 in 2013. In addition, divergence across sectors continues to be very high. The steel industry remains by far the sector with longest payment terms at 108 days in 2014 vs. 121 days in 2013 (see Chart 1). Indeed, total production in the sector decreased by 25% compared to pre-crisis levels and currently stands at EUR24mn tons. The main determinants are the fall in output for the construction sector (40%) and the drop in automotive production (total production shrank from 1.5mn to 400,000 units). On the other end of the spectrum, the DSOs in the automotive sector stand at the lowest level – mainly because of the internationalization of the sector - but remain higher than in Italy's peer countries across Europe.

Chart 1: DSOs by sector in 2013 and 2014



Source: Euler Hermes

Note: the figures above the bars refers to levels forecast in 2014

On top of the relatively weak economic developments exemplified by the contraction in domestic demand (-12% since the peak in Q1 2008) and low investment flows by non-financial corporations (27% below pre-crisis levels), DSOs in Italy have also been negatively impacted by the ongoing credit crunch. Although credit contraction has moderated over the past months, the credit crunch remains an issue for the private sector in Italy: credit to non-financial corporations fell by -1.8% y/y in June 2014 (vs. -3.8% in February). In addition, non-performing loans doubled to EUR121bn in 3 years and this remains a strong constraint for bank lending. However, financing conditions should become less constraining by year-end: first, the ECB Bank Lending Survey shows that the expected demand for credit to firms in Q3 is positive for the second quarter in a row; and secondly, higher deflationary pressures throughout the euro area continue to call for more action from the ECB in the coming months such as ABS purchases towards the end of the year.

### Fewer non-payments since the start of the year but still 43% above the pre-crisis levels

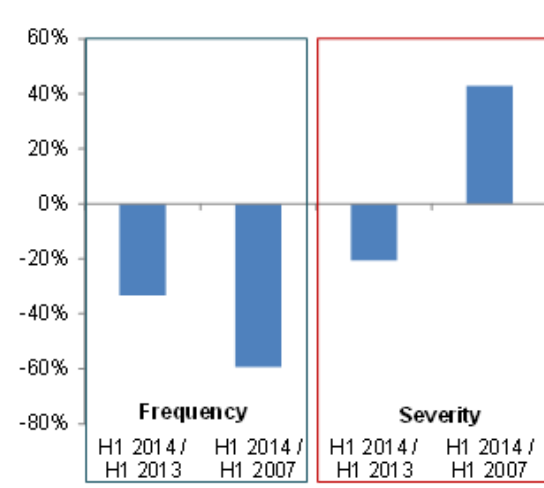
In H1 2014 there has been a notable moderation in the number (frequency) of non-payments registered by Italian companies (-30% compared to H1 2013). However, the most important indicator observed is the cost of these non-payments (severity). Indeed, the total amount of non-payments fell by 20% in H1 2014 compared to H1 2013. This rather good news can unfortunately be largely explained by the reduced turnover (and amount of trade receivables) for many companies. Further, non-payments remain 43% above 2007 levels suggesting that the 2008 shock has not been fully absorbed (see Chart 2).

### Weaknesses on the export side

The number of non-payments related to export activity fell by -19% in H1 2014 compared to H1 2013, and have been less severe (-31% over the same period). However, non-payments related to export activity remain more severe than prior to the crisis as average amounts stand 43% above the 2007 levels (see Chart 3).

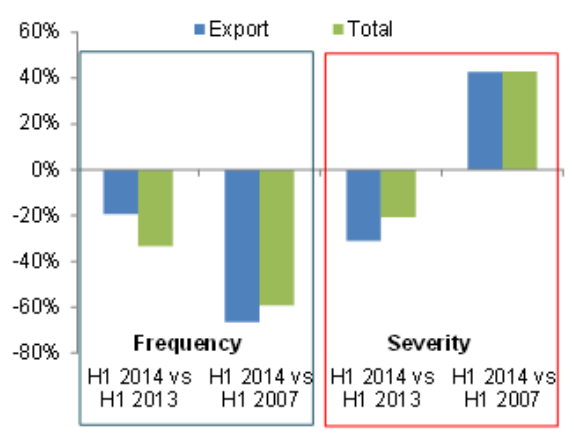
Italian exports weakened in Q2 2014 (+0.1% q/q) on the back of slowing growth in some of Italy's main trade partners, notably in France, and softer activity in the emerging markets. The sanctions imposed on Russia by the West in July are expected to have a negative impact on Italian export activity as Russia represents 2% of total Italian exports, one of the highest exposures to Russia across the eurozone. Overall, we expect that the sanctions imposed on Russia will have a cumulated impact of 0.2pp on Italian GDP growth by end-2015 mainly through reduced trade flows.

Chart 2: Total non-payments registered by Italian companies in H1 2014



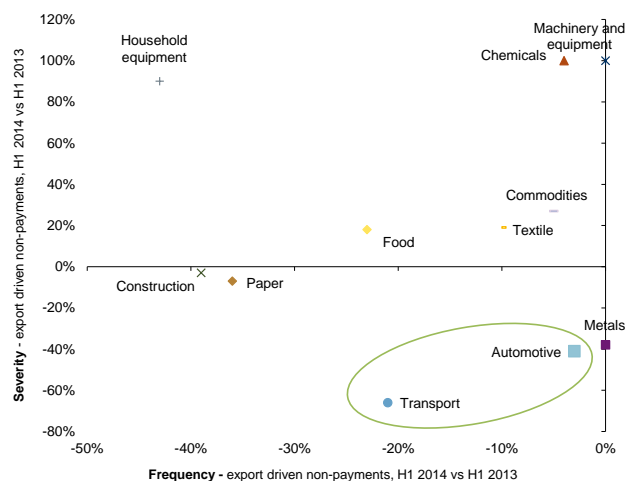
Source: Euler Hermes

Chart 3: Total non-payments registered by Italian companies – export activity vs. total



Source: Euler Hermes

Chart 4: Export-driven non-payments – frequency vs. severity



Source: Euler Hermes

Across sectors, average non-payments remain above 2007 levels for chemicals, computers and commodities in H1 2014. However, a positive trend is starting to be visible in the transport and automotive sectors, where non-payments have decreased both in terms of frequency and severity in H1 2014 compared to the same period of the last year (see Chart 4). Nonetheless, these sectors remain the most impacted by the confidence shocks and mellow business environment (fiercer price competition, weak activity in the Eurozone, slower growth emerging markets).

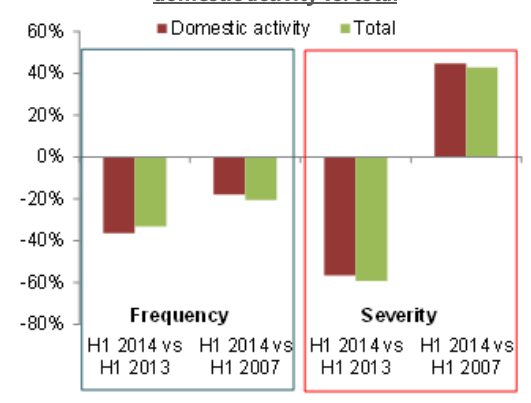
### The lethargic domestic market did not help solve fully B2B payment hurdles

Domestically, there were 37% fewer non-payments in H1 2014 than in H1 2013. Similar to the export activity, severity on the domestic market has also moderated (-18%), although less.

However, average non-payments related to the domestic economy stand 45% above the 2007 levels (see Chart 5). Indeed, the Italian private sector continues to be hurt by the ongoing crisis mode. Firms' cash balances are less robust and turnover has decreased around 10% on average since 2011. Non-financial corporations' margins stand at record low levels (39.4% in Q1 2014, i.e. 5pp below 2007 levels) with gross operating surpluses down 13% since 2008 (see Chart 6). The repayment of EUR68bn in government arrears owed by the state to private sector companies by year-end could be a game changer, as it would free additional cash flow for firms. To date about EUR26bn have been paid to the businesses.

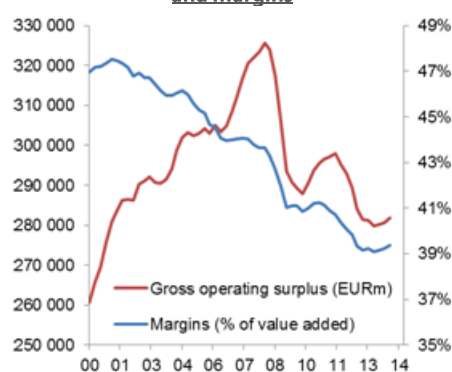
Average non-payments remain above 2007 levels in the automotive, commodities and construction sectors for the domestic market. However, a positive trend recently became visible in the household equipment, machinery and equipment, and chemicals sectors where non-payments have decreased both in terms of frequency and severity in H1 2014 - compared to the same period of the previous year (see Chart 7).

Chart 5: Total non-payments registered by Italian companies – domestic activity vs. total



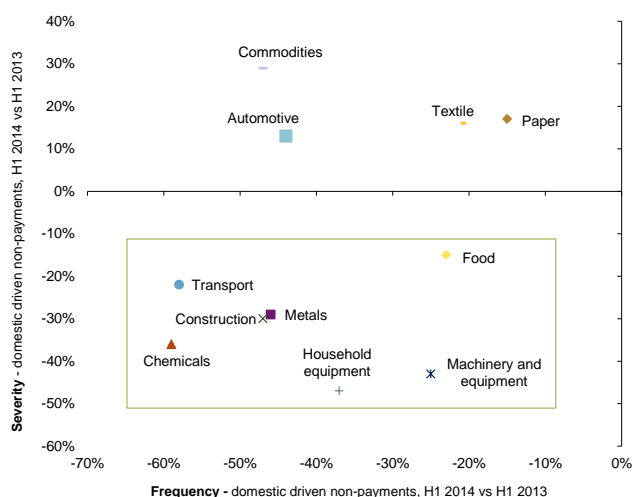
Source: Euler Hermes

Chart 6: Non-financial corporations - gross operating surplus and margins



Sources: Eurostat, Euler Hermes

Chart 7: Domestic-driven non-payments – frequency vs. severity



Source: Euler Hermes

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