

Study: German SMEs and mid-caps have a higher average credit risk than Italian

- Small and medium-sized enterprises (SMEs) and mid-caps pose a much higher credit risk than multinational corporations
- Italian SMEs and mid-caps have lower average cumulative default rates than German firms; credit risks are higher for companies in France and particularly in Spain
- Institutional investors are seeking out alternative investment funds (AIFs), fueling a long-running boom in direct lending to companies in Europe
- Analyses of SME and mid-cap credit risks are highly complex endeavors due to country and industry risk structures

Hamburg, 21 November 2018 – Euler Hermes Rating's latest study finds that SMEs and mid-caps¹ in Italy have a lower average 2-year default rate (2.05%) than their German (2.59%), French (3.05%) or even Spanish (3.67%) counterparts. However, the financial profile leader is Germany's *Mittelstand* (i.e. SMEs and mid-caps). At 32.4%, the German firms have the highest percentage of investment-grade financial profiles (from BBB to AA and higher) of the four countries studied.

"Interest in alternative investment funds is burgeoning as institutional investors seek better returns in today's low-interest environment. The resulting growth in AIFs has fuelled a boom in direct lending by private investors in Europe," said Kai Gerdes, Director Credit Risk at TRIB Rating, the rating service that Euler Hermes Rating launched in cooperation with Moody's to provide internationally comparable ratings for smaller European businesses. "SMEs and mid-caps can be particularly attractive investments, but they present far higher, more complex credit risks than multinational corporations. But it pays to take a closer look. For example, some observers may be surprised to learn that small to mid-cap Italian businesses are less risky on average than German firms that are otherwise reputed to be particularly solid."

According to the study, one possible reason for Italy's lower default rates is the fact that the raw materials manufacturing and wholesale and retail trade sectors have relatively low default rates but account for a large share of the companies studied in Italy. Default rates are relatively high in Spain as a consequence of the international financial crisis that left many companies reeling. Insolvencies soared nationwide. The Spanish real estate and construction industry was hit particularly hard. After a years-long construction boom, the real estate bubble burst in 2008 in the wake of the global financial crisis and drove up default rates in these industries sky-high.

Analyses of European credit risks demand more than ballpark estimates

"Even well-diversified credit funds are exposed to a wide variety of default risks in individual countries and industries," said Gerdes. "Consequently, you have to consider multifaceted, complex issues in order to analyse and assess European credit risks adequately. It's one thing to conduct national multi-sector evaluations. It's something else entirely to perform industry- and company-specific analyses. Ballpark estimates just don't cut it – and could be dangerously misleading to boot."

The study found that the countries have some similarities as well as significant differences. In Germany, as in France, construction, other manufacturing and machinery and equipment manufacturing all have above-average default rates. In Italy, agriculture and mining are particularly risky investments while Spanish SMEs and mid-caps in the construction, real estate and rental industries are especially prone to stop making debt payments. The default rate of the wholesale and retail trade sector is slightly below average in all four countries compared to the other industries. However, Spanish companies in this industry still default more than twice as often (2.82%) as those in Italy (1.38%). That said, risk in this industry also depends heavily on the products being sold.

¹ SMEs and mid-Caps are defined in this study as companies with a turnover between 10 and 500 million Euro and debt not exceeding 150 million Euro.

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Sector volatility and sector outlook directly affect default rates

“Sector volatility, sector outlook and market structure have a tremendous influence on sector risk and, by extension, on default rates,” said Gerdes. “Default rates are almost uniformly relatively low in normally stable sectors such as utilities or public and community services. These industries also benefit from fairly low competition and high barriers to market entry. The exact opposite holds true in more volatile, occasionally highly fragmented industries such as construction, other manufacturing and machinery and equipment manufacturing. Of course, a company’s risk profile also hinges on its ability to respond to cyclical, market or innovation cycles and capitalise on its competitive position.”

Differences are the key to success in investment risk management

In short, the key to success in the fast-growing direct lending segment is to look at these differences in risk profiles. That is especially true when defining investment criteria, selecting individual companies to invest in and managing investment risk overall.

“You can manage a lot of risks through detailed analyses,” said Gerdes. “But some of the risks inherent in alternative investments will remain – no one has a crystal ball, after all. Markets are constantly changing, and future projections have to reflect that fact. However, some developments can’t be easily extrapolated into the future, especially if they are driven by an accumulation of different risks.”

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