Germany: Recession avoided, but rising credit risk in key industries

December 2019

- Germany barely avoided a recession in Q3 of 2019, but manufacturing will contract by more than 3% this year
- The current woes have led to performance downgrades for automotive, machines, metals and steel
- Rising insolvencies in those key sectors expected in 2020

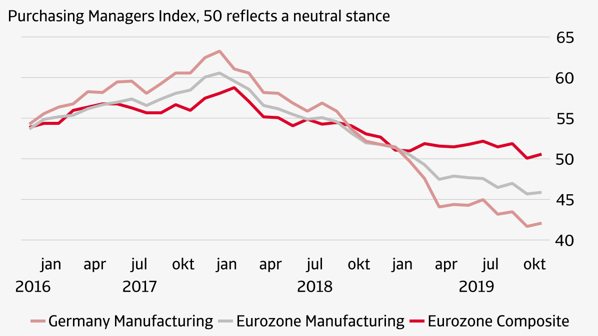
The eurozone economy is slowing down more than anticipated, with GDP expected to expand by just 1.1% both this year and in 2020. This slowdown reflects the prevailing weakness of international trade and global uncertainties, which are weighing on the manufacturing sector, particularly in Germany, the largest economy in the Eurozone.

Among the major eurozone markets Germany faces the biggest slowdown this year, and Q3 of 2019 figures show that a technical recession has just barely been avoided. Weak global trade and cautious businesses are weighing on exports and investment, and tumbling services sentiment means that domestic demand may succumb to the external headwinds. We expect the German economy to expand by only 0.6% in 2019, followed by 0.7% growth in 2020.

German industrial production is forecast to contract by more than 3% in 2019, followed by a feeble 0.2% rebound in 2020. The industry is still struggling with the revised emission standards for diesel-powered vehicles, which has been taking a toll on the automotive sector. Adding to the weakness is the global slowdown in trade, to which Germany is relatively prone.

The Purchasing Managers Index (PMI) of the German manufacturing industry declined significantly over the year, reaching 41.9 in October 2019, which is well into recession territory and its worst performance since the depths of the global financial crisis. Thus far the spill-over from weakness in manufacturing to services has been limited, as can be seen from the composite PMI (including manufacturing and services), but this could change. Uncertainty stemming from potential US car tariffs, Brexit and the US-China trade dispute keep the balance of risks to the downside.

German manufacturing industry in contraction territory



Source: Macrobond, IHS Markit

Increasing woes in major industries

The downturn in manufacturing not only affects the business performance and credit risk of automotive, but also that of other related major German industries like machines, metals, and steel. The current woes have led to downgrades in our sector performance outlook of those key industries, which combined account for almost 10% of German GDP.

Automotive – downgraded from "Fair" to "Poor"

Value added sector growth in the German automotive industry is forecast to contract by more than 9% year-on-year in 2019, followed by a modest 1% rebound in 2020. Besides the short-term fallout from the diesel emission scandal and the challenge of new emissions-testing procedures, the sector is facing fundamental structural challenges (shift to e-mobility, connected driving, increased use of car sharing models). Many original equipment manufacturers are changing their business models, away from focusing on combustion engines (especially diesel).

The challenge to adapt is large for Tier 2 suppliers, especially those active in delivering parts and supplies for combustion (diesel) engines. Many businesses in this segment have a weak solvency and equity position, and pressure on margins is already high. A large number of smaller suppliers could face higher credit risk in the future, as they have difficulty in climbing up the value chain.

We have noticed an increase in payment delays since the end of 2018 and expect this negative trend to continue. We are observing an increasing number of suppliers with worsening financials (declines in turnover and profitability) and covenant breaches, while the number of restructuring cases has substantially increased. It seems probable that during the ongoing process of market adaptation the number of automotive business failures will exceed the average annual German business insolvency level per industry.

Any major market disruption (e.g. US import tariffs, an escalation of the Sino-US trade dispute, a global recession) could decisively weaken businesses financials – just at a time when major investments are needed. This downside risk could lead to a major shake-up of the industry, with a sharp increase in payment delays and insolvencies, especially in the suppliers segment.

Our underwriting stance remains open to neutral for OEMs and Tier 1 suppliers, which usually have good access to capital markets and a low default risk, despite the major challenges ahead. However, we have recently tightened our underwriting stance on Tier 2 businesses and the car dealers sector.

Performance forecast along subsectors

OEMs & Tier 1	Tier 2 producers	Car dealers
		

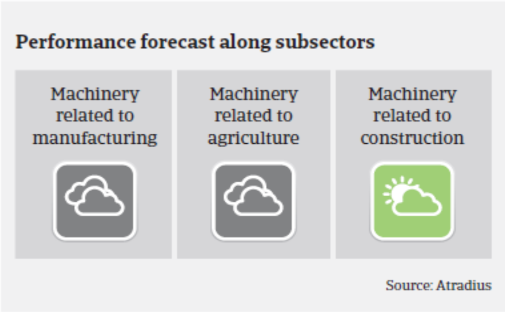
Source: Atradius

Machines/engineering- downgraded from "Good" to "Fair"

As a major buyer sector for machinery, the current issues in the German automotive industry have an immediate impact on the performance of the machines/engineering sector. Additionally, domestic machinery demand suffers from decreasing capital investments in wind energy and power stations.

Due to its export ratio of more than 70% German machines/engineering is highly susceptible to increased geopolitical risks, trade disputes and rising protectionism, which has led to subdued business sentiment and lower fixed investments in many export markets. Orders decreased 8% year-on-year in January-September 2019, and valued added growth is forecast to contract 2.4% in 2019. This puts additional strain on businesses margins, which have already come under pressure in recent years due to rising competition (especially from Asia).

Our underwriting stance remains open for machinery businesses delivering to the construction industry. However, we have generally tightened our approach from 'open' to 'neutral' for companies delivering to the manufacturing sector, closely scrutinising the financial strength and order situation of individual businesses.



Metals and steel - downgraded from "Fair" to "Poor"

The downturn in the domestic automotive and machinery sectors seriously affects the performance of many German metals and steel suppliers, while exports are impacted by subdued global demand. Especially metals and steel component suppliers to the automotive industry are facing decreasing sales (down between 10% and 20% in H1 of 2019) and deteriorating results. Added value growth in both the metals and steel sectors is forecast to contract in 2019, by 4.4% and 3.0% respectively, with further declines expected in H1 of 2020 at least.

Besides decreasing demand, many metals and steel businesses suffer from elevated commodity prices (e.g. iron ore) which are difficult to pass on to customers, higher transport, labour, and energy costs, overcapacity and strong competition. The steel industry is impacted by additional steel inflow redirected from the US to the EU (due to the US import tariffs), putting pressure on sales prices.

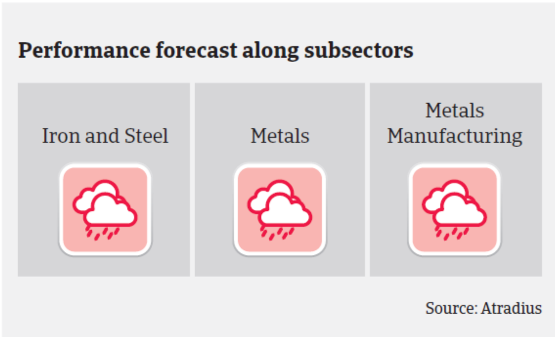
Due to all this, pressure on margins has increased in an industry where many businesses have already shown low profitability in the past. Profit margins of metals and steel businesses are expected to deteriorate further in 2020.

We have not yet noticed major changes in the payment behaviour of metals and steel businesses over the past couple of months. Payments take, on average, between 30 and 45 days. However, increasingly the trend of extending payment terms up to 60 days is noticeable.

While the level of metal and steel business failures was low over the past twelve months, insolvencies have started to increase.

We have tightened our underwriting stance for the iron and steel producer segment. We are also more cautious with steel service centres, as this segment could see increased write-offs at the end of the fiscal year due to weak sales, well-stocked inventories and lower steel prices. Smaller steel traders often face strong competition and low margins; especially those without additional business, like prefabrication. Additionally tube and pipe producers are impacted by lower demand from the energy sector, due to the current oil/gas price development.

We have tightened our underwriting stance on metal manufacturing, especially on those businesses that depend heavily on sales to the automotive sector. Many companies in this segment have a weak solvency and equity position. Pressure on their margins is already high, and they have to make additional investments to adapt to the changing market environment (e.g. e-mobility). Some suppliers have already implemented cost reduction measures (e.g. short-time work and redundancies) in order to cope with market uncertainty. Other businesses have issued profit warnings, or even started comprehensive restructuring processes. This leads to a higher and intensified requirement of buyer information (interim/forecast/re-financing data) in order to anticipate the future performance.



More business failures expected

It is expected that insolvencies will increase by 2%-3% year-on-year in 2020 in each of the industries mentioned above. While this increase may not appear overly high, one has to bear in mind that over the past couple of years the number of automotive, machinery, and metals and steel business failures was low, either remaining unchanged or decreasing. At the same time, the outlook for those sectors is bucking the overall corporate insolvency trend in Germany, forecast to level off in 2020 after a 1% increase in 2019.

German industries performance forecast

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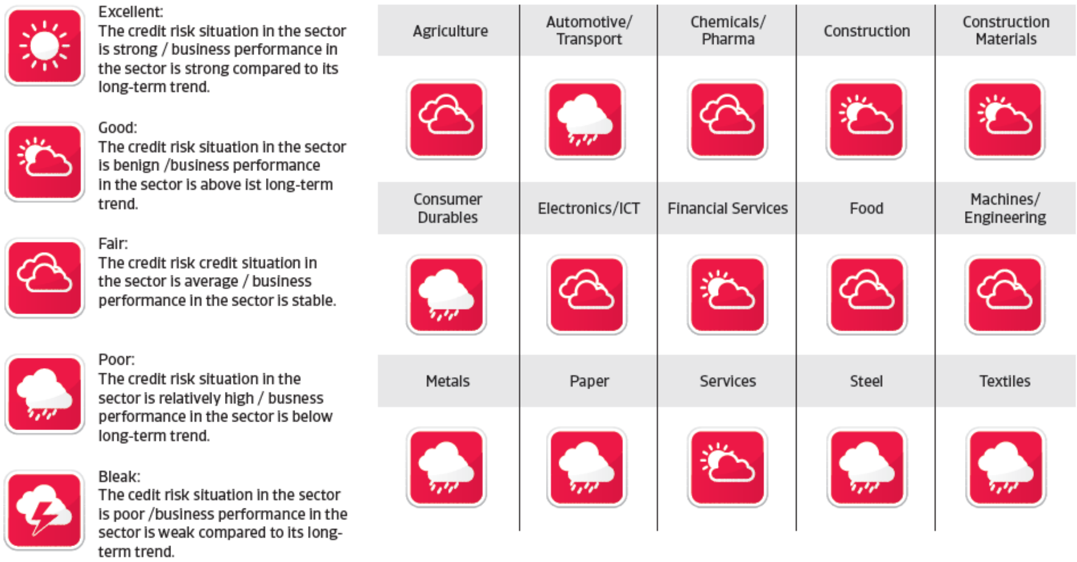

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Atradius N.V.
David Ricardostraat 1 – 1066 JS Amsterdam
Postbus 8982 – 1006 JD Amsterdam
The Netherlands
Phone: +31 20 553 9111