

## FOCUS



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## CEE insolvencies: so far, so good despite an increasingly challenging global economic environment

As seen often in insolvency trends, the economic situation is experienced in statistics of companies insolvencies with a delay. In the Central and Eastern Europe (CEE) region, businesses were able to benefit from solid demand experienced both domestically and externally in recent years. A period of favourable macroeconomic environment has brought effects on solvency of companies in the CEE region. GDP-weighted average insolvencies dropped by 4.2% in 2018, contrary to an increase of proceedings recorded a year prior. 2018 saw a decrease in insolvency proceedings in ten countries, whereas they grew only in four countries. The regional breakdown indicates a wide variety of dynamics, ranging from a 35% decrease in insolvencies in Ukraine to a 42% surge of in Croatia.

However, CEE economic perspectives appear much less buoyant: the eurozone slowdown, the escalating US-China trade war, and the unclear process of the United Kingdom's withdrawal from the European Union are worrying exporters due to the potential impact on both their businesses and CEE economies. In effect, a weaker pace of growth expected in the CEE region will be mostly due to the impacts, both direct and indirect, of slower external demand. CEE average growth is projected to reach 3.6% in 2019 and 3.2% in 2020.

As CEE economies are mostly highly open to external markets, weaker foreign demand will manifest not only in growth rates, but also gradually via insolvency

statistics. In this regard, sectors that are strongly exposed to foreign markets will suffer, such as the automotive industry and ones supplying it with parts and components, namely chemicals and metals sectors. Moreover, transports are going to be hit as well and it mostly applies to countries with a strong presence on foreign markets, like Poland, Baltics, Hungary and Romania. For example, an increase of proceedings in transports has been already recorded this year in Poland.

The domestic side is not free of constraints either. The CEE region continues to experience a strong increase of employees' wages, which is supportive for household consumption but a concern for companies. Labour shortages became the most significant obstacle for companies' current operations, which limits potential expansion. Overdue payments remain a concern for companies and can trigger insolvencies. Even though the retail sector has been one of the main beneficiaries of solid economic activity in recent years (fuelled mostly by household consumption), CEE companies in the retail sector have registered insolvencies. High competition, low margins, and further pressure on wages are among the brakes preventing companies from fully benefitting from the latest economic acceleration. Insolvencies in consumer demand-driven sectors will likely be recorded once again, affecting predominantly smaller companies, who find current challenges harder to tackle than their larger competitors.

## Despite various challenges, CEE economic activity has helped reduce insolvencies

### Regional insolvency trends

The economic acceleration of 2017 and 2018 was beneficial for CEE businesses. Average growth exceeded 4% in both years, reaching the highest level in the last decade (*see Insert*), providing a supportive macroeconomic environment. As it is often the case with insolvency trends, overall data series record a high degree of volatility in emerging markets, and corporate insolvency statistics represent the macroeconomic situation with a time lag. Therefore, despite mounting challenges (especially on external markets), CEE businesses saw a decrease in insolvencies, which dropped by 4.2% in 2018 in terms of GDP weighted average. This was a reversal of the previous increase of insolvencies which jumped by 6.4% in 2017. During that period, companies suffered from weak economic activity and a slump of investments in 2016, and the improvement in 2017 was too early to improve businesses' liquidity. The most recent statistics of 2018 showed that more countries recorded a decrease of insolvency proceedings: ten countries experienced a lower number of insolvencies (Czechia, Estonia, Hungary, Latvia, Lithuania, Romania, Russia, Slovakia, Slovenia, and Ukraine), and only four countries recorded an increase (Bulgaria, Croatia, Poland, and Serbia). The regional breakdown indicates a wide variety of dynamics, ranging from a 35.2% decrease in insolvencies in Ukraine, through a slight drop of 0.2% in Latvia to a surge of 42.3% in Croatia (*Chart 1*).

### Businesses and macroeconomic profiles: similarities and differences across the region

The economic acceleration in 2017-2018 helped to reduce insolvencies back to the pre-crisis levels of 2008 – but only in some countries (*Chart 2*). Not only Romania and Slovakia enjoy lower levels of company insolvencies than before 2008 what was also seen in previous insolvency reports but a sizeable decrease of proceedings enabled to experience the same by Czechia. Nominal insolvency figures were diverse across the CEE region, as they were not only

affected by their economic situations but also by the definitions of insolvency in specific countries (with amendments to insolvency laws, or more widespread use of insolvency procedures).

The business situation varied across countries and sectors. Although insolvencies dropped in 2018, companies experienced various challenges that affected their business liquidity. Most CEE economies are highly open, with exports of goods and services constituting a significant part of countries' GDP. The trade war, unclear process of United Kingdom's exit from the European Union, but mostly the eurozone slowdown have made a gloomy perspective for CEE exporters. Furthermore, the domestic side is not free of constraints for businesses. The CEE region still experiences a strong increase of employees' wages, which mostly is not reflected by a respective growth of productivity. An increasing number of companies has reported labour shortages over last years and such obstacle became the most significant barrier in companies' current business operations limiting also a possible expansion. Weakening payment behaviour, with rising receivables of their counterparties, continues to be reported by CEE companies. Having faced various challenges, some businesses are not able to make payments on time.

### Less supportive economic environment ahead

For the time being, corporates will continue to benefit from solid economic activity in the region fuelled again by fair growth of household consumption. Nevertheless, the GDP growth pace is expected to be lower and the resistance to Western European slowdown is not endless. Consequently, companies are likely to be gradually affected by payment liquidity problems. For example, despite strong GDP growth rates recorded in Poland over the last two years, the latest Coface Payment Survey<sup>1</sup> confirmed that average payment delays for Polish companies are still sizeable, reaching 59.9 days in 2018, i.e. only 3 days shorter than encountered in a previous survey. In Romania, the DSO (day's sales outstanding) lengthened from 175 days up to 192 days, and companies' indebtedness has steadily increased over last years, from 74% in 2010 to 89% in 2018<sup>2</sup>.

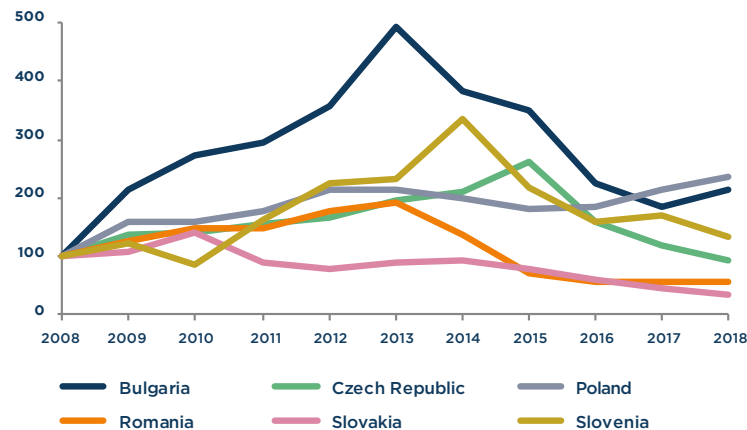
**CHART 1**  
Insolvencies in Central Europe

	Total insolvencies	Dynamics	Insolvency rate*
	2018	2018/2017	2018
Bulgaria	360	15.8%	0.09%
Croatia	1 282	42.3%	0.49%
Czech Republic	1 076	-21.6%	0.22%
Estonia	273	-20.4%	0.13%
Hungary	14 485	-11.1%	2.78%
Latvia	590	-0.2%	0.29%
Lithuania	2 094	-29.7%	1.99%
Poland	975	10.2%	0.05%
Romania	8 177	-0.4%	1.60%
Russia	30 700	-4.7%	0.26%
Serbia	6 891	5.0%	4.70%
Slovakia	206	-18.6%	0.08%
Slovenia	581	-21.5%	0.30%
Ukraine	909	-35.2%	0.14%
<b>CEE (GDP weighted average)</b>		<b>-4.2%</b>	<b>0.51%</b>

Source: Coface

\* Share of insolvencies in the total number of active companies

**CHART 2**  
Evolutions in insolvencies in selected countries  
in the CEE region (2008=100)



Source: Coface

1 - Coface Poland Payment Survey 2019: Robust economic growth has not eliminated payment delays, February 2019

(<http://coface.com/News-Publications/Publications/Poland-Payment-Survey-2019-Robust-economic-growth-has-not-eliminated-payment-delays>)

2 - Coface Insolvencies Study Romania 2019 Q1, Ianca Guda, July 2019

## CEE ECONOMIC OUTLOOK

The Central and Eastern European region has experienced improved economic activity in recent years. In 2017 and 2018, the average GDP growth in the region soared to 4.6% and 4.3%, respectively – the highest rates since 2008. Compared to other emerging markets, it is often treated as a safe haven. The CEE economic acceleration is predominantly thanks to increasing internal demand, with households benefitting from favourable trends on the labour market, such as significantly shrinking unemployment rates over the last five years. The CEE recorded a lower unemployment rate than the EU at the end of 2018: whereas the EU average unemployment rate was at 6.6%, CEE unemployment rates dropped even lower, with Czechia (2.1%), Hungary (3.7%), Poland (3.8%) and Romania (4.0%) having the lowest levels in the region. In parallel with increasing employment, households have also benefited from solid wage growth, which contributed to an increased propensity to spend. Moreover, growth was supported by an increase of fixed asset investments facing solid demand and a high capacity utilisation, as well as co-financing from EU convergence funds that was mostly used for public investments. Finally yet importantly, although Western Europe – the main trading partner of CEE countries – has been falling into a slowdown, CEE exports have weakened but remained positive, in large part due to the region's price and quality competitiveness.

Despite these positive developments, CEE companies have also had trouble. Low unemployment has triggered labour shortages, which have become the main barrier for companies in both daily operations and potential expansion, as reported by an increasing number of businesses over last years. Growing wages and a pressure for further raises has increased companies' operational costs, reducing profits despite soaring revenues. At the same time, increasing wages has not reduced households' price sensitivity, and companies have not been able to transfer all rising costs to consumers. Margins are also constrained due to high competition across various sectors.

Supply constraints – including labour shortages, a high capacity utilisation, rising costs of inputs, and the impact of external slowdown (direct and indirect) – are worrying companies active in the CEE region. Household consumption is expected to remain the main driver of growth, although limited acceleration of fixed asset investments and weaker exports will abate GDP growth. Nevertheless, the scale of slowdown will be limited: Coface forecasts that the average GDP growth of the CEE region will weaken to 3.6% in 2019 and 3.2% in 2020.

## Will household consumption remain solid enough to support companies?

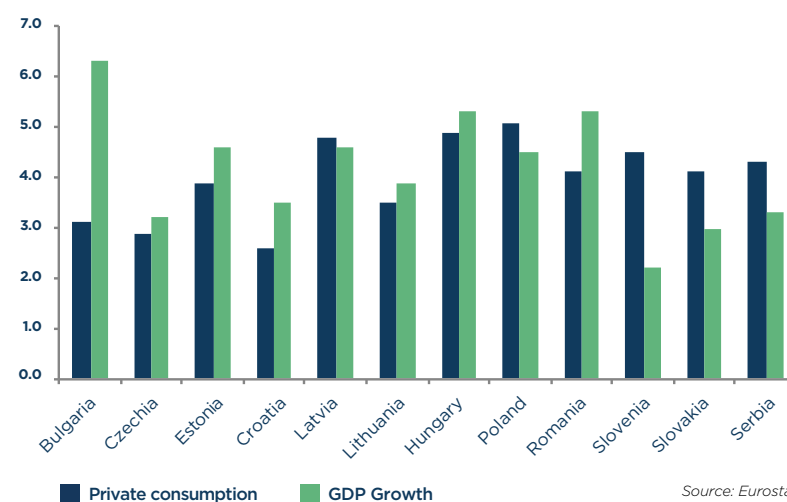
As mentioned above, private consumption has become the main driver of GDP growth in CEE countries, and has even expanded more dynamically than GDP growth rates in a number of economies (Chart 3). Decreasing unemployment reaching an all-time low in many countries, as well as growing wages supported also by subsequent minimum wage increases, have together boosted consumer confidence. A higher propensity to spend has been seen with both daily necessities and durable goods. Household consumption is worth a significant part of countries' nominal GDP levels: last year it reached 69% of GDP in Serbia, 61.7% in Romania, 57.5% in Poland, 47.2% in Hungary, and 46.8% in Czechia.

Robust private consumption has increased companies' turnover, especially for those who dependent direct on consumer demand. Nevertheless, the trade sector is widely present in insolvency statistics. This is partly due to the large number of trade entities, but insolvency rates confirm that bankruptcies are also high as a share in a total number of active companies in the sector. In 2018, this was notably the case in Bulgaria, Estonia, Lithuania, and Poland. Despite the positive effects of buoyant demand, trade companies face various challenges, such as rising labour shortages and pressure for wage increases, in an environment where significant competition prevents them from increasing their margins in line with their costs. At the same time, although households are becoming wealthier, they are still price cautious. Insolvencies mainly affect small companies whose negotiating power with manufacturers and suppliers is much lower than their large competitors.

Facing a weaker economic growth rate, businesses' liquidity is unlikely to improve. There is not much room for a further improvement on the labour market to the same extent as in previous years, and household consumption will be less vigorous. Moreover, anticipated further wage growth and mounting labour

deficiencies will continue to exert pressure, especially in the face of a projected decrease of the working age population across all CEE countries. Therefore, GDP growth in the CEE region will continue to be fuelled by solid private consumption, but companies' profits will not fully reflect the fair economic environment. These operational challenges will lead, in extreme cases, to applications for restructuring or even insolvency. As has previously been the case, small entities are likely to have less resilience to such business conditions – but this does not mean that large companies will be spared. Lower profitability and liquidity, as well as changing consumer needs, forces companies to evolve their strategies. By way of example, Tesco has recently announced it will re-focus its business in Poland towards its best-performing smaller store formats, and sell eight of its largest hypermarkets.

**CHART 3**  
Dynamics of private consumption  
and GDP growth in 2018 (annual growth)

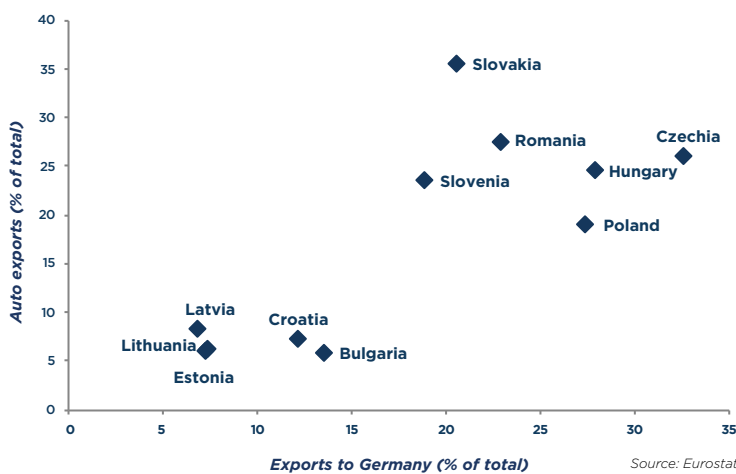


Source: Eurostat

## How will rising difficulties in the automotive sector impact insolvencies?

According to Coface forecasts, the global economy will slow in 2019, with global GDP growth falling from 3.1% in 2018 to 2.7% in 2019 before remaining at the same pace in 2020. The automotive sector is a good reflection of the current vulnerabilities of the global economy. It suffers from the cyclical slowdown, increased protectionism, and structural industrial changes, including investments into innovations and changes in consumption behaviour<sup>3</sup>. The deterioration of the sector

**CHART 4**  
Exports of CEE countries



**CHART 5**  
Coface Sector Risk Assessments - Q2 2019

Sector	CEE	CZECH REP.	POLAND	ROMANIA
Automotive	High risk	High risk	High risk	Medium risk

● Low risk ● Medium risk ● High risk ● Very high risk

Source: Coface

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has knock-on effects on Western Europe countries, such as Germany, where automotive production has been significantly contracting. This poses a direct risk for CEE companies, as Germany is the main trading destination for most CEE countries, and the automotive industry has become a pillar of exports (Chart 4). In July 2019, Coface downgraded its sector risk assessment of the CEE automotive sector to "High Risk"<sup>4</sup> (Chart 5). This was also the case for the individual country sector assessments: the Czech and Polish automotive sectors were downgraded to High Risk, and the Romanian one was lowered to Medium Risk.

Whereas the industrial production dynamics in Western Europe turned negative in late 2018 and continued this trend in the first half of 2019, they have grown over the same period in the CEE region, with Hungary and Poland delivering the highest increases. Despite soaring wages, CEE countries still offer attractive labour cost levels, especially when compared to Western Europe. This, coupled with the high quality of labour, boosts the region's competitiveness, and combined with a sizeable stock of foreign direct investments in the region in recent years, are allowing manufacturing to keep increasing. It is likely that the current global slowdown and the ongoing uncertainties will support the CEE region as a location for competitive production. Moreover, solid internal demand is also an important support. Nevertheless, the CEE resilience is not endless: business sentiment indicators confirm that the external downturn is a concern for businesses in the CEE region.

Various manufacturing industries were already represented in 2018 insolvency statistics. Decreasing demand for vehicles on the main export market will further affect the liquidity situation of automotive companies and businesses cooperating with them. In the case of Poland, insolvency and restructuring proceedings of companies manufacturing machines and equipment increased by 33% in 2018. Data for the first months of 2019 also showed that other sectors dealing with the automotive industry experienced an increase in insolvency proceedings, including manufacturers of plastics and rubber products, which recorded a sizeable annual increase. Therefore, the impacts of weaker global economic activity - mostly the eurozone slowdown - will gradually be perceived by CEE businesses, and manifest as increased insolvencies. It therefore remains to be seen whether the region's competitiveness would make this impact softer. The sectors that will mostly suffer include those that are strongly exposed to foreign markets, i.e. the automotive sector and those that supply it with parts and components, such as chemicals and metals. So far, it is predominantly the CEE transport sector that has suffered from the slowdown of export markets. This includes freight transport companies with a strong presence in Western European countries, including notably companies in Poland, the Baltics, Hungary and Romania. Indeed, insolvency and restructuring proceedings of transport companies in Poland soared by 40% in 2018, and this trend has so far continued to deteriorate in 2019.

3 - Coface Barometer Q2 2019: Trade tensions return to the forefront of the global economy, July 2019 (<http://coface.com/News-Publications/News/Coface-Barometer-Trade-tensions-return-to-the-fore-front-of-the-global-economy>)

4 - Each quarter, Coface publishes its Country and Sector Risk Barometer, which assesses risk levels for 160 countries, and 13 economic sectors in 27 countries that represent 87% of the world economy.