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Central and Eastern Europe: Less business insolvencies despite temporary headwinds in the construction sector

Despite some slowdown last year, average GDP growth remained at a solid level of 2.9% in Central and Eastern Europe. Economies have been benefiting from the favourable situation on the labour market, with contracting unemployment rates and rising wages. The improving macroeconomic environment has had positive effects on business. Company insolvencies dropped by 14% in 2015 and a further 6% in 2016. Over the course of last year, 6 entities per 1,000 became insolvent. The regional breakdown reveals a wide variety of dynamics, ranging from a fall of 35.6% in proceedings in Bulgaria, through to a minor increase of 2.6% in Poland and a surge of 56.9% in Hungary. Region-wide however, the downturn in construction activities led to companies within this sector being widely represented in insolvency statistics. Construction consequently took first place in the ranking of flop sectors in the CEE region.

Coface forecasts that company insolvencies in the CEE region will decrease by 3.9% in 2017 and by 2.3% in 2018. The acceleration in GDP growth and the rebound in investment activity bring further positive signals for businesses. A new flow of infrastructural projects, stable contributions from household consumption and the exploration of foreign markets will all be economic supporters. Nevertheless, businesses could experience some challenges, subject to the whims of the global economy and political uncertainties. The latter include the eventual negative consequences of Brexit and uncertainties in Western Europe, with unclear election results in Italy. In addition, there have been local political issues, as seen in the Czech Republic, Poland and Romania. The rebound in investments should be particularly beneficial for sectors such as construction, transport and the manufacturing of machinery, construction equipment and construction materials. Nevertheless, labour shortages will remain an obstacle for many expanding businesses.

Despite the slowdown, the economic environment remains supportive for corporates

After peaking to 3.5% in 2015 (its highest post-crisis level), CEE average growth dropped to 2.9% in 2016. Although most CEE countries joined the European Union in the previous decade, their cohesion with wealthier Western European economies is still in progress and they widely use co-financing from the EU budget for investments. This funding is chiefly aimed at reducing economic and social disparities and promoting sustainable development through infrastructure and environmental projects. Although it was therefore already expected that the GDP growth of CEE countries would be affected by switching to the new EU budget and adopting local regulations, the slowdown was deeper and more extended than anticipated. Nevertheless, the fact that economic expansion still shows a solid pace of development, at an annual level of around 3%, provides a supportive environment for corporates in terms of the general macroeconomic perspective. This effect started to become more visible in 2014, particularly with regards to microeconomic activity. 2016 showed a continuing decrease in the number of company insolvencies in the CEE region, which dropped by 6% in 2016 as a GDP-weighted average. Nevertheless, the regional breakdown indicates a wide variety of dynamics, ranging from a 35.6% decrease in proceedings in Romania, through to a minor increase of 2.6% in Poland and a surge of 56.9% in Hungary (chart 1).

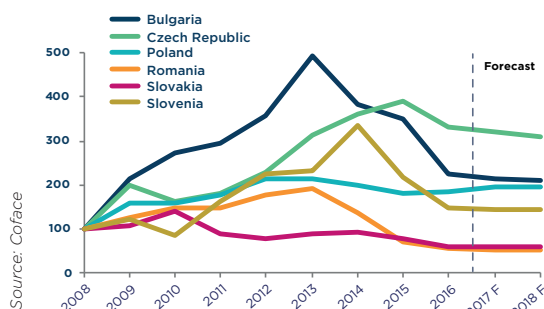
CHART 1
Insolvencies in Central Europe

Country	Total insolvencies	Dynamics	Insolvency rate*	Forecast Dynamics	
	2016	2016/2015	2016	2017	2018
Bulgaria	381	-35,6%	0,10%	-4,7%	-2,8%
Croatia	14 495	**	6,73%	4,3%	-0,2%
Czech Rep.	11 800	-15,0%	0,80%	-3,8%	-3,2%
Estonia	335	-10,9%	0,16%	-2,7%	-4,6%
Hungary	22 671	56,9%	4,49%	3,4%	-2,2%
Latvia	727	-12,4%	0,30%	-5,9%	-0,9%
Lithuania	2 684	35,2%	2,58%	-4,0%	-1,6%
Poland	760	2,6%	0,04%	6,8%	-0,7%
Romania	8 053	-20,8%	1,71%	-2,7%	-1,8%
Russia	10 527	-12,6%	0,22%	-10,1%	-3,2%
Serbia	5 803	13,8%	4,43%	2,0%	-0,9%
Slovakia	345	-22,6%	0,06%	-2,0%	-0,6%
Slovenia	647	-10,9%	0,32%	-3,6%	-1,0%
Ukraine	1 570	22,2%	0,26%	5,4%	-2,3%
GDP weighted average		-6,0%	0,63%	-3,9%	-2,3%

Source: Coface

* Share of insolvencies in the total number of active companies
** Due to law changes dynamics 2015/2016 are not comparable

CHART 2
Evolutions in insolvencies in the CEE region since 2008 (2008=100)



Source: Coface

Despite a general improvement, insolvencies still remain above the pre-crisis levels of 2008 in most countries. Only Romania and Slovakia enjoy lower levels of company insolvencies than before 2008. Nominal insolvency figures vary between countries, 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). This edition of the Coface insolvency report¹ also includes Russia for the first time.

Diversified dynamics of company insolvencies among CEE countries

Insolvency figures varied between countries, 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). This was the case in **Croatia**, where a significant increase in insolvency proceedings was recorded last year. This trend began at the end of 2012, when a new legal form entitled "pre-insolvency settlement procedure" (a judicial composition) was introduced. A new Bankruptcy Law then entered into force in September 2015 which strongly affected the 2016 insolvency figures. Under the new law, the National Financial Agency (FINA) is obliged to start bankruptcy proceedings for any company whose accounts have been blocked for more than 120 days. Before introducing this crucial law, there were around 14,000 companies in Croatia with no employees, which owed almost HRK 15 billion. Since the entry into force of the new law, all of these companies with accounts blocked for 120 days or more automatically become bankrupt, with the FINA opening the procedure within 8 days. More precisely, the requirement to start bankruptcy proceedings is not only a blockage of more than 120 days, but also the fact that a company has not paid its workers for three consecutive months. Bankruptcy proceedings are also initiated in cases of companies having claims higher than debts². As a result of 'cleaning' registers of these dormant companies, the level of bankruptcies in Croatia surged by 6.7% last year - the highest ratio in the entire CEE region.

An increased number of company insolvencies was recorded in 6 out of the 14 CEE countries covered by the study. In **Hungary** they more than doubled in 2016 compared to the previous year. This was mainly due to a higher number of ex officio company cancellations, which were hardly covered by the 2015 statistics. Under Hungary's insolvency laws, if the parties fail to conclude a debt restructuring agreement, or if the arrangement is not in compliance with the statutory requirements, the ex officio tribunal will dismiss the bankruptcy proceedings and consequently declare the debtor insolvent in liquidation proceedings (during which time the tribunal is obliged to order the liquidation of the debtor³). In 2016 the number of ex officio cancellations was comparable to the number of winding-up processes announced in Hungary. Winding-up as a procedure for company liquidation is highly formalised. The process usually lasts for between 6 to 12 months, in order to ensure that the company is closed in the correct manner. A surge in company insolvencies was also experienced in **Lithuania** last year. Similar to as in 2015, the statistics were further affected by the State Tax Inspectorate and Social Fund's process of "cleaning" the market of companies which were theoretically insolvent long ago. Contrary to the above-mentioned countries, the challenging situation of the **Ukrainian economy** and the war conflict in Eastern part of the country have

1 - As the country's economy is nearly as big as the entire rest of CEE countries analysed in the past, the regional GDP-weighted average is incomparable with previous statistics

2 - <http://www.telegram.hr/politika-kriminala/10-promjena-u-stecajnom-zakonu-koji-ce-neke-tvrte-automatski-slati-u-stecaj/>

3 - Baker McKenzie, Global Restructuring & Insolvency Guide, Hungary

led to a difficult environment for businesses. Although the economy recorded a positive growth rate last year, company insolvencies jumped by 20.2% in 2016.

Russia, which is covered by our study for the first time, recorded a 12.6% fall in insolvencies⁴. The economy has already rebounded from a recession, with positive signs shown by various economic indicators. The macroeconomic improvement transferred relatively quickly to the business side, which previously suffered from an increase of nearly 9% in bankruptcies in 2015. Nevertheless, the process of economic recovery has been gradual and businesses still face challenges. Last year over 2 active companies per 1,000 became bankrupt. The main reasons were the decline in consumption following the decrease in real household income, a rise in loan arrears of large and medium enterprises, the stagnation of fixed investments and relatively high interest rates (although these have somewhat stabilised compared to previous levels).

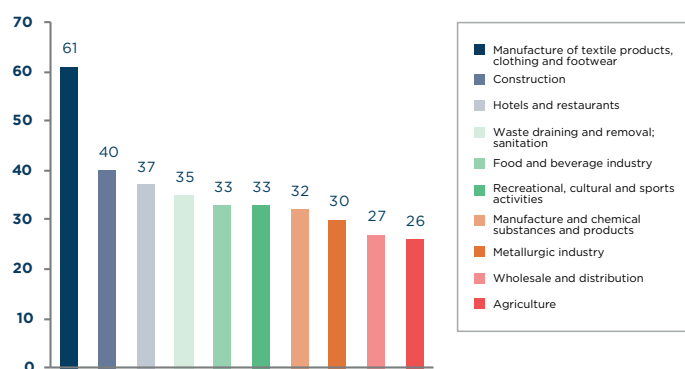
Among the 14 CEE countries covered by our analysis, eight recorded a slump in insolvencies last year. The strongest fall, of 35.6%, was experienced in **Bulgaria** where the pharmaceuticals, IT and education sectors hardly recorded any insolvencies. Nevertheless, although company insolvencies dropped last year, company indebtedness remained high. Non-performing loans are a concern for Bulgarian banks and for companies suffering from difficulties in collecting receivables from some of their counterparties.

Companies from the trade sector account for nearly a fifth of all cases of insolvencies, followed by construction and real estate firms with 15%. The main reasons for these financial difficulties include high levels of indebtedness, poor liquidity management and fewer funding opportunities.

Last year showed a continued period of improvement for **Romanian businesses**. Whereas just three years previously there were nearly 28,000 insolvencies in **Romania**, this figure dropped to 8,053 in 2016. Statistics have already returned to pre-crisis levels. The sizeable contraction of 20.8% in company insolvencies does, however, mask some specifics. This significant decrease is recorded against the backdrop of a base effect and the high weight of insolvencies among very small companies. Among these insolvencies, 84% were companies which were not operational (with zero turnover recorded in 2015) or had revenues of less than EUR 100,000 in 2015. Nevertheless, 2016 also saw the start of a major decrease in insolvencies among large companies. Insolvencies of companies with a yearly turnover exceeding EUR 1 million dropped by 43%⁵. In a sectorial split, construction and the manufacturing of textile products, clothing and footwear, as well as hotels and restaurants, recorded the highest insolvency rates (chart 3).

In **Poland**, which recorded a slight increase of 2.6% in proceedings, insolvency statistics are affected by legal changes that were implemented last year. On 1st January 2016, separate laws were introduced to cover insolvencies and the restructuring of companies which are experiencing payment problems. The aim of introducing these updated regulations was to encourage greater use of insolvency procedures – especially as a recovery tool for companies facing temporary liquidity problems. In the past, Polish companies were reluctant to use insolvency proceedings and the share of judicial compositions accounted for only one sixth of all announced insolvencies. The main goal of the revised legislation is to enable debtors to restructure their businesses and thereby prevent their liquidation. This support for the continuity of businesses should help to preserve jobs and allow the uninterrupted execution of contracts. Companies in financial difficulties are

CHART 3
Romania: sectors with the highest number of insolvencies per 1,000 active companies

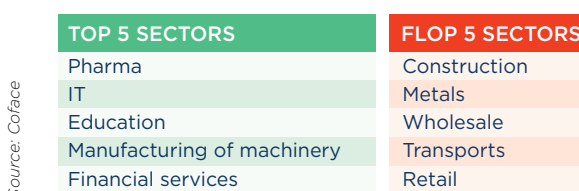


Source: *Insolvencies in Romania 2016, Coface*

entitled to use various proceedings for restructuring. These include the procedure of approval of a plan after creditors' votes, accelerated arrangement procedures, ordinary arrangement procedures and rehabilitation proceedings. Over the last year, restructuring procedures have gained popularity with companies suffering from liquidity problems. Whereas during the initial months of 2016, businesses were only just becoming familiar with the new regulations, restructuring procedures started to become more frequent over the rest of the year. The number of restructuring proceedings has been rising and reached a 27% share in total proceedings at the end of 2016. The number of insolvencies, on the other hand, has been decreasing. At the same time, although changes in legislation made the total number of proceedings higher than a year before, Poland still recorded the lowest insolvency rate in the CEE region.

Construction impacted by weak investment activity

CHART 4
Top and flop sectors in CEE



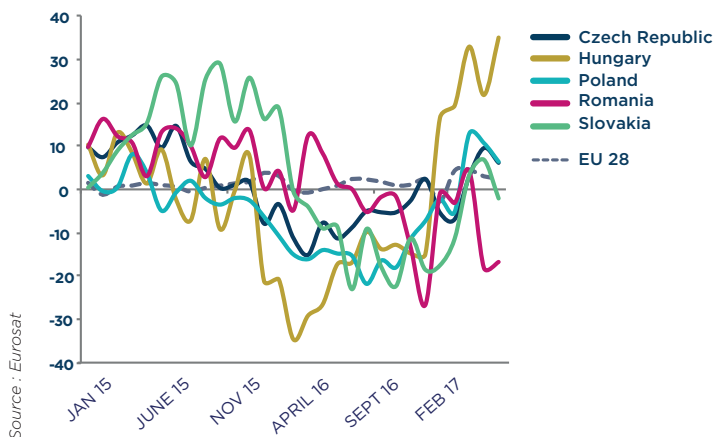
Source: Coface

A sectorial split shows that there were some sectors that enjoyed an improvement last year, while others experienced challenges with liquidity. This varied across countries, although there were some common trends across the whole region. The **construction** sector was clearly the one that experienced the most difficult business environment. As previously mentioned, CEE economies were impacted by the switching to the new EU budget and lower investments last year, with a slower pace of GDP growth. In terms of construction output, most countries recorded a significant slump in activity which led to deteriorated liquidity situations for construction companies. In some countries, including Estonia, Hungary and Russia, insolvencies of construction companies exceeded 20% of the total number of proceedings, while they also accounted for significant shares in other countries. Towards the year-end, the construction sector began to rebound in line with the debut of additional projects from the new EU budget.

4 - The analysis covers the initial stage of bankruptcies in Russia i.e. 'supervision' which is analogous to preliminary insolvency proceedings under German law (Beiten Burkhardt, Bankruptcy in Russia)
5 - Insolvencies in Romania 2016, Coface

Nevertheless this improvement has only been gradual so far. More tangible improvements in the financial situation and liquidity of construction companies will be more perceptible later this year. For the time being, the positive dynamics of construction output have been chiefly fueled by the base effect of comparing results to the slump recorded last year (chart 5).

CHART 5
Construction output dynamics (y/y changes)



The list of flop sectors also includes **trade – both wholesale and retail**. On the positive side, trade companies have been benefiting from the positive situation of the CEE labour market, with unemployment rates breaking previous lows and rising household incomes. Nevertheless, this increased demand cannot completely counteract the significant competition which is affecting the sector's margins. Smaller entities in particular find it more difficult to be as competitive, as their larger counterparts are able to benefit from their stronger capabilities for negotiation. Nevertheless, stable demand from household consumption should support favourable perspectives for the trade sector (chart 4).

CHART 6
Biggest insolvencies in the CEE region in 2016

Country	Company name	Sector	Town
Bulgaria	SI DI DEVELOPMENTS EAD	Business sport service activities	Sofia
Croatia	DUBROVAČKE VILE d.o.o.	Construction	Zagreb
Czech Rep.	OKD a.s.	Mining of coal and lignite	Karviná
Estonia	MARENOS GRUPP OÜ	Wholesale of automotive fuels	Tallinn
Lithuania	BAVALDA UAB	Renting and operating of real estate	Vilnius
Latvia	KVV LIEPĀJAS METALURGS	Manufacturing	Liepāja
Poland	HW Pietrzak Holding S.A.	Metal production	Katowice
Romania	ELECTROCENTRALE BUCURESTI SA	Production and supply of electric and thermal energy, water and gas	Bucuresti
Russia	OOO «Tekhnomark»	Financial intermediation	Moscow
Slovakia	Nexis Fiber a.s.	Textiles, leather and clothing	Humenné
Slovenia	GESI LS	Agriculture, meat, agrofood	Slovenske Konjice

Source: Coface

Further improvements on the cards

Growth in CEE economies is expected to regain strength following last year's slowdown. Coface forecasts that the average Central Europe GDP growth rate will increase from 2.9% in 2016, to 3.4% in 2017 and 3.3% next year. Both 2017 and 2018 will be fueled by stable growth in private consumption, supported by continued improvements on the labour market. Households have already experienced an increase in prices. This shows a reversal of the deflationary period recorded in many economies over previous quarters. As a result of weaker real growth of wages, consumers could become more cautious on spending. Despite this, Coface does not anticipate that an increase in inflation (which will remain low anyway – mostly in line with central banks' inflation targets) will have a diminishing effect on household consumption, but it will probably not grow as rapidly as previously. The rebound in fixed asset investments will stimulate the construction sector.

Coface consequently anticipates less insolvencies in the construction sector in 2017 and 2018. The corporate side will also benefit from an increase in exports – particularly with the stable recovery in Western Europe (which remains the region's main trading partner); along with rising exports to emerging markets. If CEE countries are efficient in the absorption of EU funds and/or household consumption strengthens significantly, economic activity will achieve even better momentum. Improvements on the macroeconomic side have been spreading over quite rapidly to the corporate sector. Coface forecasts that company insolvency proceedings will fall by 3.9% in 2017 and a further 2.3% in 2018. This would not constitute a major change, as growth last year was already relatively balanced – even with the exemption of contributions from fixed asset investments. With these investments now returning, growth will strengthen to the benefit of several sectors, including construction, transport and the manufacturing of machinery, construction equipment and construction materials.

Many companies in other sectors will operate in a similar business environment to last year, benefiting from the growth in private consumption which remains the biggest component of nominal GDP for CEE countries. Nevertheless, labour shortages are a growing barrier to business operations and company expansions. Chart 1 illustrates Coface's forecast for company insolvencies in 2017 and 2018. Increases in insolvency proceedings will mainly stem from changes in legislation that will affect statistics. In Croatia and Poland, amendments to insolvency laws that have already been implemented will continue to trigger a rise in proceedings. In Hungary legislation has already increased the number of situations where ex officio cancellations can be used by courts instead of a more costly and time-consuming winding-up (most notably when there are not enough assets to cover the costs of winding-up). Moreover, the Hungarian Parliament has approved legislation to extend the mandatory capital increase requirement for limited liability companies operating in Hungary. Both of these factors will lead to an increase in insolvency proceedings in Hungary until the end of this year.

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