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Central & Eastern Europe Insolvencies: Good times come to an end

A favourable economic environment was not enough to reduce company insolvencies in Central and Eastern Europe (CEE). While average GDP growth accelerated to 4.5%, i.e. the highest level in nine years, insolvencies increased by 6.4%. This latter figure ends the improving trend in business insolvencies, which decreased in both 2015 and 2016. 2017 saw an increase in insolvencies proceedings in nine countries[1] and drops in only five[2]. The regional breakdown indicates a wide variety of dynamics, ranging from a 27.1% decrease in insolvencies in Slovakia, through to a slight increase of 2.4% in Estonia and a surge of 40.1% in Croatia.

These events are surprising, given that companies have faced the highest rate of economic expansion since 2008. Moreover, growth was balanced, with a strong contribution coming from rebounding fixed asset investments and household consumption, driven by low unemployment, soaring wages, and improved consumer sentiment. Funds from the new European Union budget fuelled public investments, and high capacity utilisation amid solid demand encouraged companies to expand. On the other hand, good economic times saw new businesses attempting to enter highly competitive environments. Companies often experienced an increase of turnover, but a limited increase of profits, which were constrained by growing costs, such as a gradual increase of wages and higher input costs, as confirmed in accelerating producer price indexes. The aforementioned rebound of fixed asset investments has been supportive for demand for construction; however, companies were not able to respond due to the rapid rise of building material costs and labour shortages[3]. Difficulties in fulfilling vacancies have become a major obstacle for businesses in the CEE region, according to Eurostat's business surveys.

The trend of increasing insolvencies illustrates the end of an economic cycle in the region. CEE countries reached a peak of their economic expansion last year and weaker growth is expected in 2018, followed by a further slowdown in 2019. Nevertheless, it is going to be a slight slowdown with no signs of recession mainly due to ongoing solid demand, although businesses will not be able to enjoy macroeconomic conditions as good as in 2017. Various supply constraints, high competition resulting in low margins or challenges coming from foreign markets where an increased level of protectionism is anticipated affect on businesses in the CEE region. As large companies will be able to take advantage of their negotiating power and a wide presence, insolvencies will mostly apply to smaller entities. Our forecast (based predominantly on GDP growth expectations) assumes that company insolvencies in the CEE region will increase by 10.4% in 2018 and 15.5% in 2019.

1 - Croatia, Estonia, Hungary, Lithuania, Poland, Romania, Russia, Serbia, Slovenia
2 - Bulgaria, Czech Republic, Latvia, Slovakia, Ukraine
3 - Construction companies were widely represented in insolvency statistics across the CEE region.

In 2017, CEE businesses benefited from a favourable economic environment, with average growth jumped to its highest level in last eight years **(see Insert: Economic outlook in CEE)**. Nevertheless, it was not a sufficient factor to spur an improvement of companies' liquidity – at least as shown by a level of business insolvencies, which increased by 6.4% in 2017 in terms of GDP weighted average. This was a reversing of previous trend as 2016 showed a drop of 6% in the number of company insolvencies, following a fall of 14% in 2015. Also contrary to a previous year, in 2017 more countries recorded an increase of insolvency proceedings: nine countries experienced a higher number of insolvencies (Croatia, Estonia, Hungary, Lithuania, Poland, Romania, Russia, Serbia, and Slovenia), and only five countries recorded a decrease of such proceedings (Bulgaria, Czech Republic, Latvia, Slovakia, and Ukraine). The regional breakdown indicates a wide variety of dynamics, ranging from a 27.1% decrease in insolvencies in Slovakia, to a slight increase of 2.4% in Estonia and a surge of 40.1% in Croatia **(Chart 1)**.

The business situation varied across countries and sectors. Nevertheless, the region shared some common reasons for the deteriorating business liquidity that in some cases has resulted in insolvencies. The main reasons include a strong increase of employees' wages, which mostly was not reflected by a respective growth of productivity. In a number of countries, a high level of corporate indebtedness was also a significant concern, especially as interest rates already started to rise in the Czech Republic and Romania, with other countries closely monitoring decisions of the European Central Bank on its exiting from very expansionary policy. Low margins and cash flow management problems also impacted CEE businesses in 2017. Weakening payment behaviour, with rising receivables of their counterparties, continues to be reported by CEE companies.

CHART 1
Insolvencies in Central Europe

	Total Insolvencies	Dynamics	Insolvency rate*	Forecast Dynamics	
	2017	2017/2016	2017	2018	2019
Bulgaria	311	-18.4%	0.08%	-1.9%	4.6%
Croatia	901	40.1%	0.38%	1.3%	5.6%
Czech Republic	1 803	-26.0%	0.36%	2.2%	4.3%
Estonia	343	2.4%	0.16%	7.3%	8.2%
Hungary	16 302	14.4%	3.06%	3.4%	8.6%
Latvia	591	-18.7%	0.26%	6.6%	2.5%
Lithuania	2 951	9.9%	2.83%	8.7%	9.2%
Poland	885	16.4%	0.04%	20.2%	9.3%
Romania	8 256	2.5%	1.68%	-3.1%	5.7%
Russia	11 551	9.7%	0.25%	-0.2%	2.2%
Serbia	6 562	13.1%	4.62%	-5.8%	-1.2%
Slovakia	253	-27.1%	0.10%	-3.2%	4.5%
Slovenia	740	8.3%	0.38%	5.1%	6.2%
Ukraine	1 403	-11.8%	0.22%	-8.3%	2.9%
GDP weighted average		6.4%	0.56%	10.4%	15.9%

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

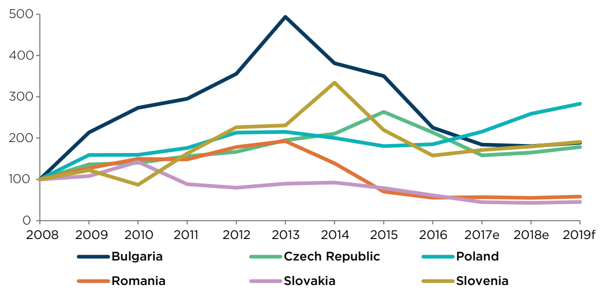
Source: Coface

CEE Economic Outlook

The Central and Eastern European region has experienced improved economic activity in recent years. It was especially confirmed in 2017 when average GDP growth in the region soared to 4.5%, i.e. the highest rate since 2008. Compared to other emerging markets, it is often treated as a safe haven. CEE economic acceleration has been mostly a result of increasing internal demand, with households benefitting from favourable trends on the labour market. Whereas unemployment rates were still at double digit levels in most CEE countries at the beginning of 2013, they have since decreased significantly. At the end of 2017 most CEE countries enjoyed unemployment rates much lower than the EU average, with the Czech Republic's December 2017 rate of 2.4% being the lowest in the entire European Union. Other countries also recorded low unemployment rates, including 3.8% in Hungary, 4.4% in Poland or 4.6% in Romania compared to 7.3% as the EU average. Households also benefited also from solid wage growth, which contributed to an increased propensity to spending. Indeed, high retail sales dynamics have been recorded across various categories, including both durable and non-durable goods. Moreover, internal demand was supported by a rebound of fixed asset investments after their contraction caused mostly by a transition period to the new EU budget. The latter is still a significant co-financing tool in the convergence with Western Europe and especially an increase of public investments elevated countries' GDP growth rates. On the external side, CEE economies benefited from accelerating global trade as they have become active exporters and members of various global (mostly Western European) supply chains.

Despite these positive developments, CEE companies have also experienced difficulties. Low unemployment triggered labour shortages, which have become the main barrier for companies in both normal operations and potential expansion, as reported by a rising number of businesses. Growing wages and a pressure for their further rise has increased companies' operational costs, reducing profits despite soaring revenues. At the same time, households remain price sensitive, and companies have not been able to transfer all rising costs to higher margins. Growth of the latter is also limited due to high competition across various sectors.
Supply constraints – including labour shortages, a high capacity utilisation and rising costs of inputs – are worrying companies doing business in the CEE region. Along with stabilising household consumption and fixed asset investments, a slowdown of growth will likely be experienced. However, its scale will be limited: Coface forecasts that average GDP growth of the CEE region will weaken to 4.1% in 2018 and 3.4% in 2019.

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



Source: Coface

Companies did not have enough time to benefit from economic recovery

For the time being, corporates will continue to benefit from solid economic activity in the region. Nevertheless, its positive impact has started fade out. GDP growth has already begun to weaken in 2018 compared to the strong results recorded in 2017. Companies have not had sufficient time to profit fully from the economic acceleration. As confirmed by the latest Coface Payment Survey[4], average payment delays for Polish companies increased from 51.5 days in 2016 to 62.5 days in 2017, whereas GDP growth accelerated from 3.0% to 4.6% in the same period. Our forecast assumes that the number of company insolvencies in the CEE region will grow further in both 2018 and 2019. The entire 2018 year will bring average insolvencies higher by 10.4% with more countries recording an increase of proceedings than the decrease. Above all, Poland is expected to record business insolvencies and restructuration proceedings soaring by 20.2% whereas a contraction will be experienced mainly by Serbia and Slovakia **(Chart 1)**. Then, weaker economic growth will contribute to CEE average insolvencies expanding by 15.5% in 2019.

Diversified dynamics of company insolvencies among CEE countries

Despite the economic acceleration, 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).

Croatia recorded the highest increase of insolvencies in the CEE region (40.1%). The figure is still affected by law changes that entered into force in September 2015. Under the current Bankruptcy 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[5]. Before introducing this crucial law, there were around 14,000 companies in Croatia with no employees, which together owed almost HRK 15 billion. Since the entry into force of the new law, all of these companies automatically become bankrupt, with the FINA opening the procedure within eight days. Bankruptcy proceedings are also been initiated in cases of companies having claims higher than debts. "Cleaning" registers of such dormant companies strongly contributed to a surge of proceedings in Croatia.

A high increase of proceedings was also recorded in Poland. They surged by 16.4% and this figure includes insolvencies and restructuration proceedings. Statistics are still affected by legal changes that were implemented on the 1st January 2016, when separate laws were introduced to cover insolvencies and the restructuring of companies which are experiencing payment problems. The main goal of the revised legislation was to enable debtors to restructure their businesses and thereby prevent their liquidation, preserving jobs and allowing for the uninterrupted execution of contracts. Companies in financial difficulties are entitled to use various proceedings for restructuring. Over last two years, restructuring procedures have gained popularity with companies suffering from liquidity problems. Whereas during the initial months after introducing the revised law, businesses were only just becoming familiar with the new regulations, restructuration procedures started to become more frequent afterwards. The number of restructuration proceedings has been rising and reached a 39% share in total proceedings at the end of 2017. The number of insolvencies, on the other hand, has been relatively stable over last year increasing slightly (1%). 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.

By contrast, the strongest decrease of insolvencies was recorded in Slovakia and the Czech Republic, by 27.1% and 26%, respectively. The number of insolvencies in the Czech Republic was partially affected by the amendment of insolvency law that entered into force on the 1st July 2017. One of the most significant changes introduced by the amendment relates to the coverage gap[6], which aims to protect debtors with a promising future, despite their poor current situation, and save their businesses[7]. Nevertheless, the economic environment was supportive for Czech businesses. GDP growth accelerated to 4.3% in 2017 after 2.6% in 2016. Favourable economic situation with household demand supported by the lowest unemployment in the EU has brought brighter prospects for companies. Similarly, Slovak businesses took profit of supportive economic developments. As Slovakia will likely enjoy an accelerating economy also in next years, company insolvencies should drop further, both in 2018 and 2019. In contrast, nominal numbers of insolvencies in Slovakia are the lowest in the CEE region and even slight changes result in sizeable moves of statistics.

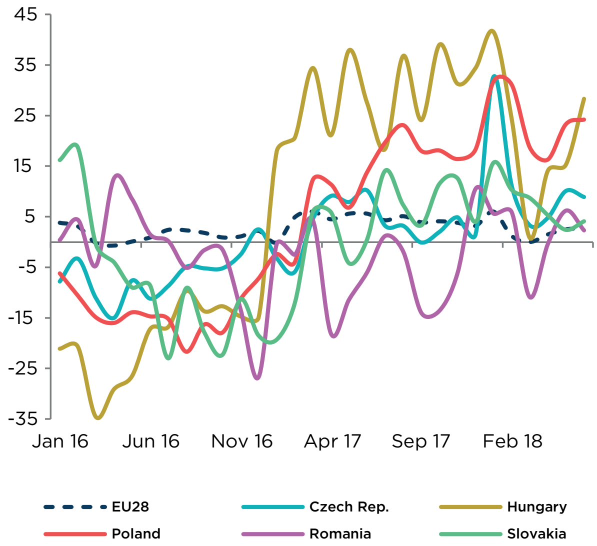
Construction – a flop sector

The sectorial split reveals the diversity across the CEE region. However, common features can be found in insolvency dynamics. Among "flop" sectors[8], construction companies continue to face liquidity problems, with their insolvency rates being significant. On the macroeconomic side, the construction sector benefited from strong improvement. The year of 2017 was a period of rebound after a significant contraction recorded especially in 2016, so during a transition period to the new EU budget. The latter is still a significant part of various investments, especially public infrastructure projects. Due to sizeable value of such investments, it also affects GDP growth rates. As a result, developments in the construction sector are mirrored in a weak growth of CEE countries in 2016 and its acceleration in 2017.

High positive dynamics of construction output was recorded especially in Hungary and Poland last year **(Chart 3)**. In some months of 2017, those dynamics exceeded 30% growth annually in Hungary and 20% in Poland. Other countries also experienced a significant acceleration. A large part of this improvement was attributed to a statistical base effect, i.e. comparing results with a deep slump recorded in a prior year. On the other hand, construction activity increased last year. This concerned mostly public investments, which were elevated in some countries thanks to forthcoming elections, like in Hungary or Poland where parliamentary and municipal elections, respectively, were scheduled

4 - Coface Poland Payment Survey 2018: Payment delays mounting amid robust economic growth, March 2018 (http://coface.com/News-Publications/Publications/Poland-Payment-Survey-2018-Payment-delays-mounting- amid-robust-economic-growth)
5 - 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.
6 - According to Bankruptcy proceedings in the Czech Republic, Accacce, the concept of a coverage gap helps to indicate the moment when companies have become insolvent. The coverage gap is the difference between due liabilities and disposable funds of the debtor. A company will be considered solvent if its coverage gap is less than one tenth of its due liabilities.
7 - According to Czech Republic: Coverage Gap – A new principle in Czech insolvency law, by Libor Basl, Martin Hovorka, and Baker McKenzie, Czech basically law recognizes two types of insolvency: "over-indebtedness", occurring when a debtor has multiple creditors and at the same time such creditors' aggregate debts exceed the value of its assets, and "classical" insolvency (inability to pay due debts).

CHART 3
Construction output dynamics in largest CEE economies (YOY changes)



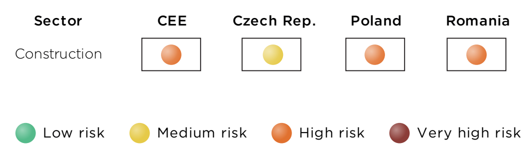
Source: Eurostat

for 2018. High dynamics of construction output conceal challenging liquidity situation of construction. Not all companies where able to benefit from a boost of infrastructural investments. The response to the high demand has been dampened by labour shortages, with the construction sector having one of the highest rates among all CEE sectors. Additionally, the profitability of some contracts became doubtful facing a sizeable increase of various building materials. In Croatia and Slovenia, insolvencies of construction companies constituted around 30% of total proceedings; in Hungary and Romania, such share reached 19% and 15%, respectively. Moreover, available preliminary data confirms expectations that insolvencies of construction companies will increase, affecting total statistics for 2018. The ongoing solid demand on new housing cannot compensate the challenges perceived in other parts of the construction sector. Some local differences apply here: for example, the Czech Republic relatively outperforms other countries in terms of payment behaviour in the construction sector. On the other hand and as a point of comparison, the Russian construction sector, which is not able to benefit from an inflow of EU funds, also recorded an increase of insolvencies. A tepid recovery and weak improvements in fixed assets investments' made it impossible for the sector to leave the list with the highest share in all insolvencies. Such share exceeded 20%.

Coface sectorial risk assessment evaluates the CEE construction sector at High Risk[9] **(Chart 4)**. Liquidity problems of the construction sector are not only reflected in insolvency statistics but also in payment experiences: according to the latest Coface Payment Survey[10], payment delays in the Polish construction sector widened in one year by 32 days to 115.6 days in 2017.

The supportive situation on the CEE labour market with all-time low unemployment rates and an ongoing growth of wages contributed to accelerating turnover of trade companies. 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, which are able to benefit from their stronger capabilities for negotiation. The retail and wholesale sectors are still widely represented in insolvency statistics. They constitute above 30% of total insolvencies in Lithuania, Croatia, and Russia. On the other hand, there are a high number of trade businesses in the CEE region, and when taking all active companies into account, insolvency rates in the trade sector have not become alarming. Retail and wholesale insolvencies mostly concern smaller entities. As confirmed by the latest Coface CEE Top 500 Ranking[11], the turnover of the largest businesses in the sector rose by 10%. However, the pressure on margins was also experienced here as net profits decreased by 6.7%.

CHART 4
Coface Sector Risk Assessments – Q2 2018



Source: Coface

8 - Flop sectors: sectors which recorded high insolvency rates
9 - 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.
10 - Coface Poland Payment Survey 2018: Payment delays mounting amid robust economic growth, March 2018 (http://coface.com/News-Publications/Publications/Poland-Payment-Survey-2018-Payment-delays-mounting-amid-robust-economic-growth)
11 - Coface CEE Top 500 Ranking, August 2018

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