



market monitor

Focus on automotive/transport performance and outlook

October 2012

A rocky road ahead

In this month's Market Monitor we look at two trade industries – automotive and transport – both of which present very visible clues to the health, or otherwise, of the economy.

The automotive industry covers the manufacture and sale of both cars and commercial vehicles, including the supply of components. While there's good news for the UK car industry, thanks in large part to strong investment in new models and plant – notably at Jaguar Land Rover and BMW – with sales to non-EU countries now leading the way, the picture isn't so rosy elsewhere.

In France, since the 'Prime à la casse' car scrappage scheme ended, sales have fallen sharply, leading to stockpiling and a domino effect through the supply chain. It's a similar picture in Belgium, where the expiry of incentives for buying low-emission cars has led to a marked drop in sales. Even in Germany, a country synonymous with the automotive industry, last year's rapid growth in production of both cars and commercial vehicles has had the brakes applied by the drop in demand from Europe.

A theme that runs through our reports on the automotive industry is that of intense competition. For instance, in China overstocking result from lower than expected sales has ignited a price war. And in the USA, the likes of GM and Ford are up against fierce competitions from foreign rivals.

There's a theme running through our reports on the transport industry too: that of rising fuel prices. Together with falling demand leading to lower shipment volumes, this is an industry destined to remain in the doldrums for some time yet.

Belgium



Automotive: a structurally downward trend

Belgium has traditionally been an important centre of car production in Europe. However, the level of output has decreased over recent years: Renault closed its Belgian production sites some years ago, and the remaining main car firms (Ford, Opel, Audi, Volvo) are always threatening to leave Belgium and relocate production to countries with lower labour costs. In the 1990s, an average of around 1.1 to 1.2 million cars was produced in Belgium every year but by 2011 that number had dropped to just 595,000. Employment in the industry has fallen from 34,000 in 2000 to 19,300 in 2011, according to the Belgian automotive producers and suppliers' organisation FEBIAC. Besides this structural decline, Belgium is affected by the current drop in production throughout Western Europe resulting from much lower demand.

This trend has also hit the component supply chain, which has seen decreasing production volumes. While suppliers that are part of a larger group face lower risks, small to medium size suppliers and those that are undercapitalised are under severe pressure.

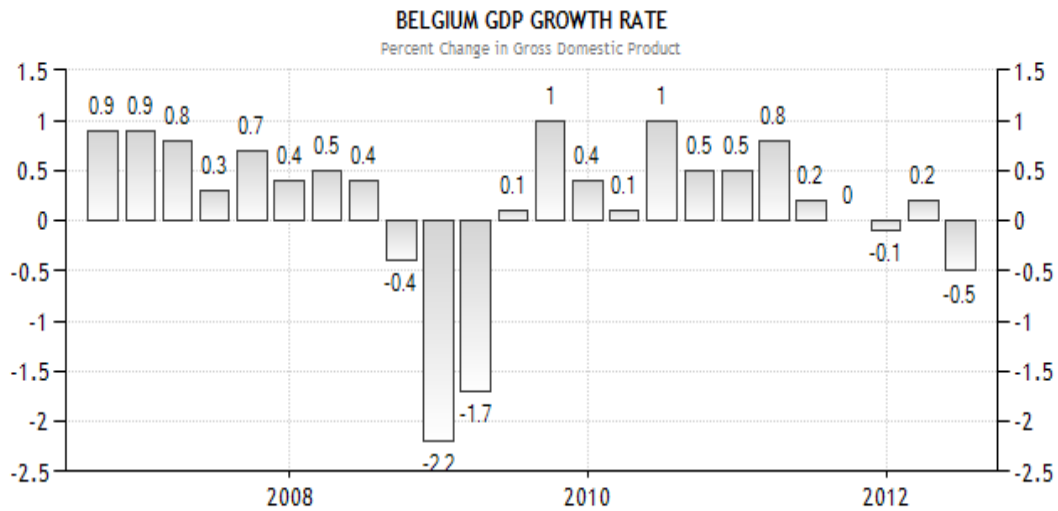
After a solid year 2011, the domestic Belgian car market now faces a steep drop of the number of new registrations, as government incentives have expired: at the end of September 2012, we noted a 17.3% year-on-year decrease in sales. This drop is even steeper for sales of smaller cars with lower CO2 emissions (down by a massive 46.6 % year-on-year in the first half of this year). A major factor is that the eco-bonus – which since 2008 has given a 3% discount on cars emitting less than 150gr/km of CO2 and a 15% discount on those emitting less than 105gr/km – expired at the end of 2011.

After decreasing markedly in 2009 and 2010, truck production rebounded in 2011. However, uncertainties about the European economy mean that this recovery will be limited in 2012 and 2013.

Payment behaviour still satisfactory

Despite the state of the market, around 80-85% of invoices in the automotive sector are still paid by due date. Payment behaviour has always been quite good in this industry, and has even improved in the last couple of months. However, with the general downsizing trend in the market and the subsequent drop in production and sales, we expect a worsening of payment behaviour in the coming months and a slight increase in the number of insolvencies.

The downward trend in car production in Belgium will continue for the rest of 2012 and 2013. Without government support schemes, the automotive industry is suffering from the current difficult economical slowdown in Belgium (see below) and throughout Europe, including a lack of investment. However, we can maintain a normal underwriting approach to the sector because of the average acceptable size and creditworthiness of buyers. However, smaller businesses are underwritten more cautiously.



SOURCE: WWW.TRADINGECONOMICS.COM | NATIONAL BANK OF BELGIUM

Belgian automotive sector

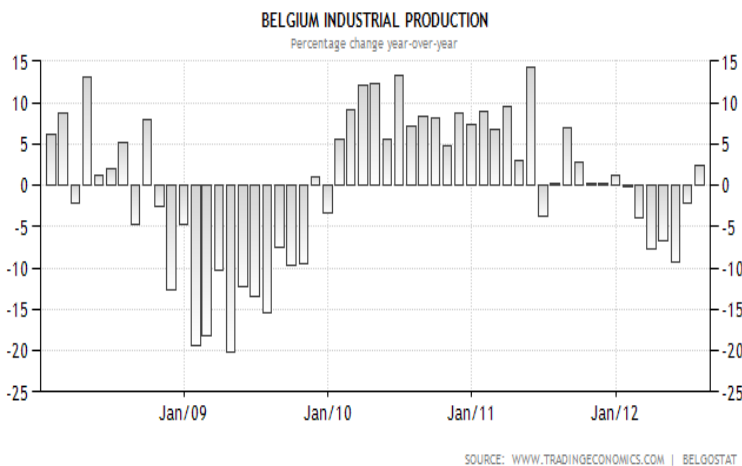
STRENGTHS	WEAKNESSES
Large buyers	Weak market demand
	High production/labour costs
	Relocation of production

Belgium



Transport: road transport faces most troubles

The Belgian transport industry (road, air, rail and shipping) is currently facing huge problems because of two main factors: decreasing activity resulting from the current economical situation (with lower shipment levels as orders decrease) and higher fuel prices which many find hard to pass on. Both aspects are eating into profitability, with road transport the worst hit. Moreover, shipping is a very volatile business, characterised by rapid 'up and down' cycles – and at present the general trend is definitely downwards.



At present, only about 60 % of the invoices in the transport industry are paid on time. With their current problems, many transport firms can't even cover their fixed costs and we are seeing a serious deterioration in payment behaviour within the industry, with a sharp increase in the number of non-payments notified to us over the past year. On average, default rates are worse than in other industries and we expect the number

of insolvencies to increase further in the coming months because of the persistent difficulties in the sector. The ongoing price war that has emerged from the low level of demand will lead to a reduction in the number of companies in the market through increasing insolvencies and consolidation, as firms adopt mergers and acquisitions to achieve sufficient economies of scale.

No rebound next year

We do not expect any rebound in the sector's fortunes before 2014-2015, and therefore our underwriting stance will remain very cautious. While some large groups are beating the trend and reporting acceptable financial results, we are seeing many small and medium-sized companies with a weak financial structure, which does not bode well for them in the light of current and forecast market conditions.

Belgian transport sector

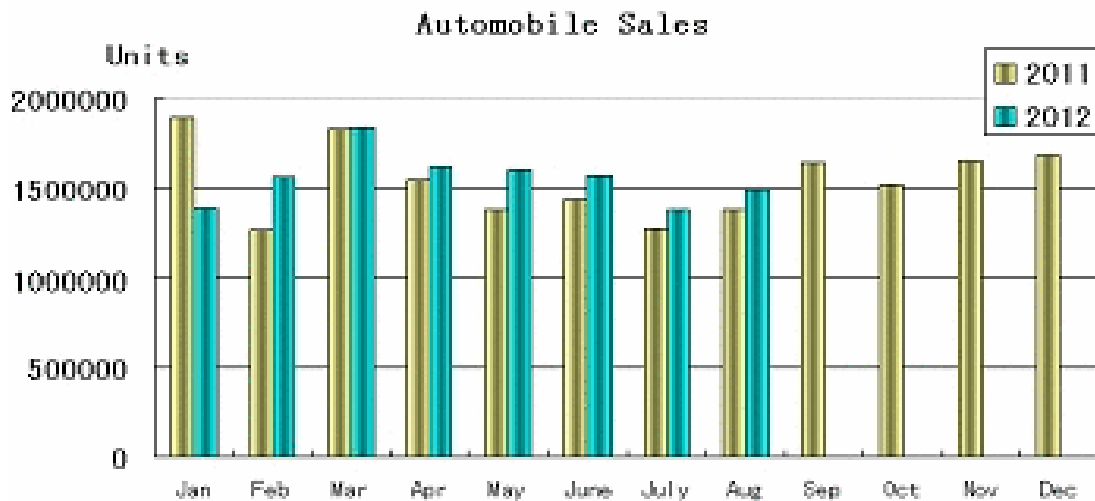
STRENGTHS	WEAKNESSES
	Very weak demand
	High fuel prices
	Average weak financial structure

China



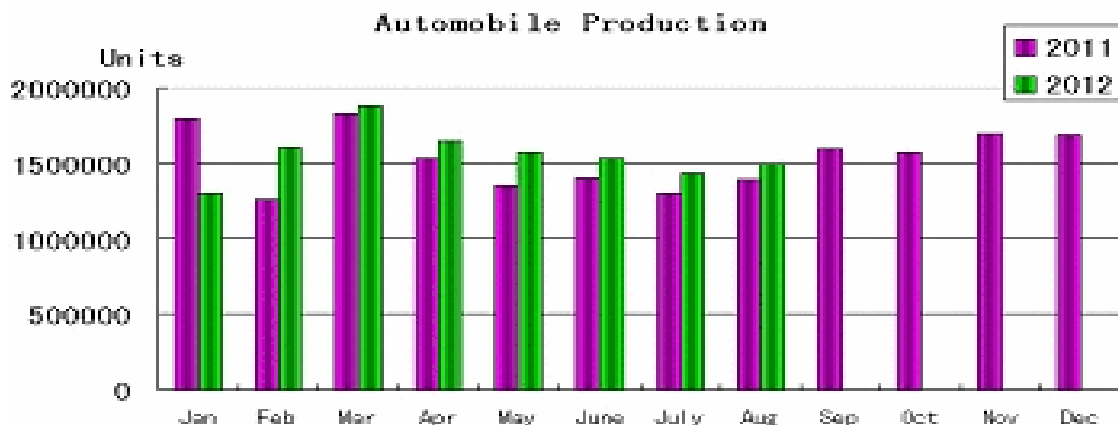
Automotive: sales to pick up again in 2012 and 2013

In 2011, growth in China's total production and sales of vehicles was much lower than the 30% year-on-year increase seen in 2010, with production up just 0.8% (18.4 million units) and sales 2.5% (18.5 million units). The reason was the combined effect of the expiry of the 'Cars to countryside' and 'Old for new' schemes, the withdrawal in late 2010 of purchase tax concessions on low-displacement passenger vehicles, and new restrictions on the number of new vehicle registrations in certain large cities such as Beijing.



Source: CAAM

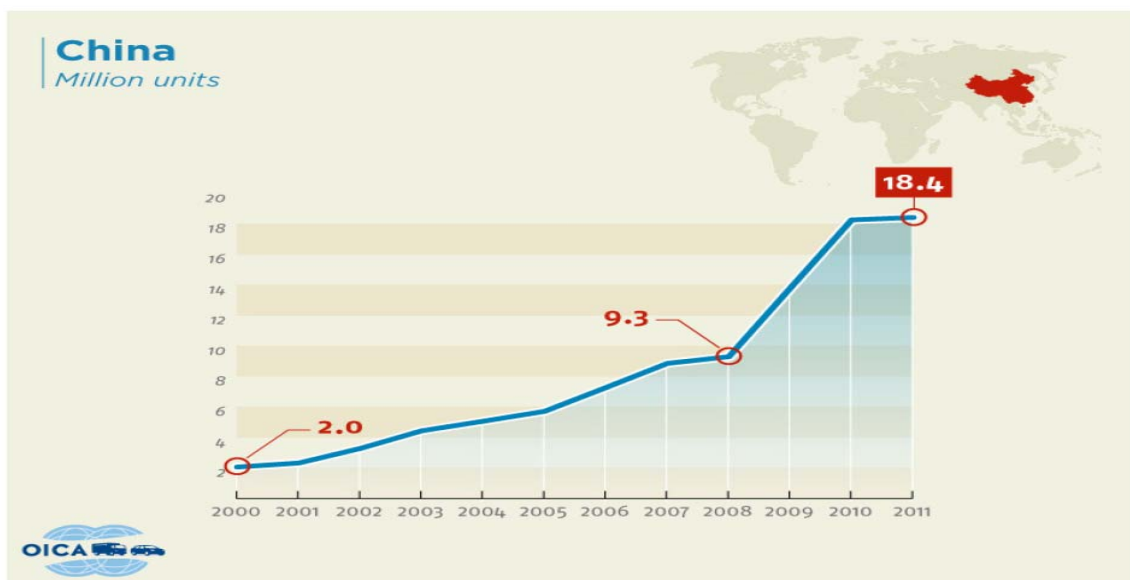
According to the Chinese Association of Automotive Manufacturers (CAAM), in the first half of 2012 total vehicle production rose 4.08% year-on-year to 9.53 million units while sales rose 2.93% to 9.6 million units. Production of passenger vehicles increased 7.87% to 7.6 million units and sales by 7.08% to 7.61 million units. However, production of commercial vehicles declined 8.59% to 1.93 million units while sales declined by 10.4% to 1.98 million units. In the passenger vehicles subsector, China's own-brand vehicle sales reached 3.15 million units, accounting for 41% of total sales, but this was still a 3% year-on-year loss in total market share against foreign-brand vehicles.



Source: CAAM

The overall upward trend this year has been driven largely by a price war waged by major automotive producers. Faced with high stock levels brought about by over-ambitious production capacity expansion, they have been forced to cut prices to boost sales. In September, there were signs of a relaxation of the price war as dealers had by then destocked.

Chinese car production



Source: OICA

Automotive suppliers recorded higher growth rates than producers last year, due to increased demand for replacement parts and a growing export market. Export volumes grew 27% year-on-year, to US\$ 46.63 billion (EUR 35.87 billion), while import volumes grew 8.6%, to US\$ 25.11 billion (EUR 19.32 billion). However, momentum declined in the first half of 2012 as a result of the slowdown in China's economy and lower external demand, with export volumes increasing just 14.36% and import volumes actually declining by 0.03%.

Decreasing net profits

Between January and September 2012, listed automotive producers saw their revenue rise 12.47% year-on-year, while net profits passed on to shareholders decreased 3.59% due to the impact of price competition and rising raw material and labour costs. In the first half of the year, 17 of the 23 listed automotive producers experienced a fall in net profits and this has also taken its toll on automotive suppliers: in the first half of 2012, 80% of suppliers suffered a reduction in net profits.

The overall equity strength of automotive producers is still relatively solid as most market players are large corporations, usually with a state-owned background, or joint ventures with multinationals. Own-brand suppliers and joint ventures/foreign-owned suppliers each account for 50% of the supplier market. Joint ventures/foreign-owned suppliers command 70% of export turnover.

Generally, the solvency and liquidity of automotive producers and suppliers is better than that of other industries like steel, textile and real estate. However, own-brand vehicle producers are feeling the effects of a reduction in their

market share, with lower profitability and worsening solvency and liquidity. The same goes for small own-brand suppliers.

Rising payment delays?

On average, payments in the Chinese automotive industry take 90 days, but we expect payments to take longer in future because of liquidity pressure on suppliers. Payment defaults in the automotive sector are on a par with other Chinese industries and automotive businesses in general will see their profitability hit by more intense competition. Domestic SME suppliers will come under particular pressure because of their poor equity strength, which could give rise to insolvencies in this segment.

Risks to future growth prospects will come from a further slowdown in China's economy and the growing number of cities that are limiting the number of licence plates. However, against the current low penetration rate, rising incomes, urbanisation and the rush to buy cars to beat restrictions will ensure growth in the coming months. As a result, CAAM expects the Chinese car market to grow 5% year-on-year in 2012. This expectation is also underpinned by the gradual implementation of the CNY 1 trillion (EUR 128 billion) worth of new infrastructure projects and the gradual easing of monetary policy, both aimed at countering the current slowdown in economic growth. 2013's growth rate may even outperform that of 2012.

When underwriting the Chinese automotive sector, we assess buyers on case-by-case basis, with the main criteria of shareholding background, business portfolio, and financial performance. We are more cautious in the case of SMEs with massive external borrowing, in view of concerns about tighter banking policies.

While there are fewer restrictions on large businesses, strong groups, and state-owned enterprises with sufficient exposure capacity, we require trading experience records to back large credit applications for these segments.

In general, we are more cautious about export-oriented businesses, because of the uncertain global economic situation and the possibility of import tariff barriers (e.g. in September 2012, the US complained to the WTO about China's subsidies to its automotive parts suppliers).

Chinese automotive sector

STRENGTHS	WEAKNESSES
The domestic industry is still developing from a low penetration rate, with rising income and urbanization	The fierce market competition and rising raw material cost will undermine profitability in the sector
Major players are large corporations usually with state-owned background or large joint ventures with multinationals	The sluggish global economy has led to trade dispute between major economies, increasing export problems with potential import tariffs

China



Transport: weaker demand and tighter monetary policy have dampened growth

In the first half of 2012, freight volumes in all subsectors (road, waterways, rail and air) continued to rise. However, the pace of growth was generally slower - the result of weaker export demand from the US and Europe, coupled with tighter monetary policy and corrections in the domestic housing construction market. This all contributed to slower economic growth in China: 7.6% in Q2 of 2012 after 8.1% in Q1.

Road

Road freight increased 15.1% year-on-year in 2011 - to 25.55 billion tons - followed by 13.8% from January to August 2012. Despite dominating the country's freight transport mix, the road freight sector consists mainly of many small players with poor equity strength competing on price rather than service quality, and thus achieving low profitability. Since last year, profits have also been affected by rising fuel prices, rent and labour costs, all of which have had an adverse impact on solvency and liquidity.

Against this background, and despite an increase in overall market turnover, the road transport companies may find it hard to maintain their profitability. Their situation would be improved by a stabilisation of China's economic performance and the widening of VAT reform. In January this year the Chinese government started a pilot programme in Shanghai to relief the tax burden and avoid double taxation of the logistics sector. This programme is due to be extended to another eight provinces and municipalities in the coming months.

Shipping

The Chinese shipping sector continued to be hit hard in the first half of 2012, with the Baltic Dry Index (BDI) - a measure of shipping costs for dry bulk goods - averaging 943 points: a 31.3% year-on-year decrease resulting from massive overcapacity and poor global demand. The extent of this catastrophe can be seen in that 2,000 points on the BDI is generally considered to be the break-even point for operators. In context, dry bulk shipping capacity increased 15% in H1 of 2012 while demand rose only 6.2%. Moreover, falling shipping rates outpaced the drop in fuel prices, plunging operators into a second consecutive loss-making year after the huge losses seen in 2011. So far this year, shipping businesses' equity strength, solvency and liquidity situation have deteriorated significantly.

Domestically, the economic slowdown has led to reduced demand for coal and steel transport while high coastal shipping capacity has put downward pressure on shipping rates. China's Coastal Bulk Freight Index was also below the break-even point for shipping operators.

Growth in waterways freight turnover slowed between January and August this year. With lower global demand, overcapacity and high operating costs, shipping carriers' equity strength, solvency and liquidity situation will

deteriorate further in the coming months and into 2013. This in turn will generate more insolvencies, defaults and payment delays.

Rail

Rail development was hindered by the high-speed train disaster in Wenzhou, Zhejiang province in July 2011 and the Ministry of Railways' serious debt problems. In 2011, total fixed assets investment into railway development - including infrastructure construction, upgrading and train procurement - decreased to CNY 590.61 billion (EUR 73.77 billion). It fell further - to CNY 177.75 billion (EUR 22.2 billion) - in the first half of 2012: down 36.1% year-on-year. This slowdown in investment contributed to declining profitability, high stock and payment delays in the railway infrastructure and equipment sector.

However, railway infrastructure and development are now expected to profit widely from a government stimulus initiative worth CNY 1 trillion (EUR 128 billion) to boost infrastructure investments, including airport, road, and subway construction, as part of the central government's efforts to regenerate growth. In August, this year's goal for total investment in fixed assets for railway development was revised to CNY 610 billion (EUR 76 billion): up 24% from the beginning of the year. While this has led to an investment spree, in the medium term development of the rail sector is dependent on the financial strength of Ministry of Railways: i.e. its ability to keep debts under control.

Aviation

In 2011 China's aviation industry achieved a total freight tonne kilometres (FTK) of 57.7 billion - a 7.2% year-on-year increase - of which passenger freight turnover contributed 40.3 billion (+12.2%) and cargo freight 17.4 billion (-2.8%). Overall market growth was driven primarily by the booming air passenger market while domestic and international cargo demand was lower. Airline carriers took advantage of market growth to post annual revenue growth of 21.2% - to CNY353.2 billion (EUR44.72 billion). However, net profits were down 17.7% to CNY 27.8 billion (EUR 3.5billion) because of high fuel costs and competition from the expanding high-speed rail network. In the first seven months of 2012 the industry saw only modest FTK growth of 5%, with the cargo business declining further. Rising fuel costs and the low appreciation of the renminbi against the US dollar have increased pressures on operators.

Despite this, in the coming months air carriers' difficulties are likely to ease thank to lower fuel prices and a sustained boom in domestic air travel supported by rising incomes, urbanization and the likelihood of a gradual economic rebound toward the end of the year. There is real potential for further market growth in the long-term, underpinned by airport expansion: China aims to build 56 new airports in the next five year as part of the new stimulus package, which will increase the total number to more than 250.

In accordance with the 12th five years plan for China's aviation industry development, the industry plans to reach an annual FTK of 99 billion by 2015. Although ambitious, this gives some indication of the market potential. The growth pace in air freight will pick up to 7-8% in 2013.

A cautious underwriting approach

Despite signs of a rebound in certain subsectors, we have to maintain a cautious underwriting approach to transport in China. To properly manage the risks that our customers may face, we therefore approve credit limits only when buyers can demonstrate sufficient liquidity and low indebtedness based on their 2011 balance sheets and 2012 interim figures. We are particularly cautious with regard to the shipping subsector in view of its current serious problems and the fact that not much improvement can be expected in the foreseeable future.

Chinese transport sector

STRENGTHS	WEAKNESSES
Major players are strong state-owned enterprises with high chance of government support	Facing the serious issue of overcapacity, especially in shipping sector
The uplift in total fixed assets investment in railway development and the roll-out of a series of infrastructure projects will improve conditions	Increased fuel and labour costs eat into margins
A tax reform will help alleviate tax burden	Weak external and domestic demand

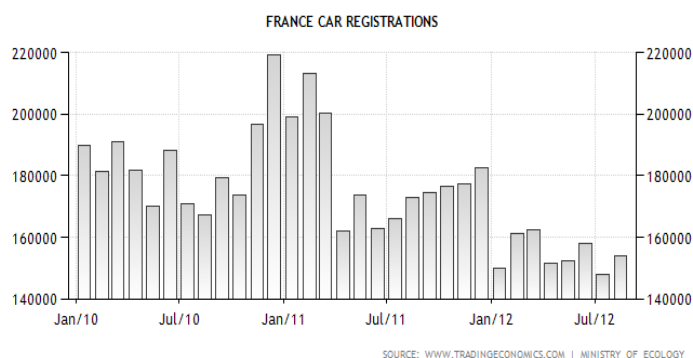
France



Automotive: a steep fall in production and sales

After recovering up to March last year, thanks to the government's 'Prime à la casse' scrappage scheme, the French car market has been steadily worsening. In 2011, sales decreased 2.1%, compared to a 1.7% decrease across Europe. This continued into 2012, with a 13.4% year-on-year decrease in the period from January to August.

Last year, domestic production increased 3%, with 2.3 million cars produced but, compared to pre-credit crisis levels, the figures are worrying: 2011 production was 27.6% lower than in 2006 and 36.7% lower than in 2001. As with sales, the decrease in production is worse in France than the European average. Stocks are piling up in the car distribution network and that will lead to a further reduction in production.



Because of their market positioning in the small and medium size car and low cost segments, French automotive producers generally have low margins, and this year their solvency and liquidity are shakier because of poor sales, increase stocks and high monthly cash consumption.

We are seeing structural changes in the market, with the small car segment now representing more than 50% of sales in France – a marked change since 2000. However, this size car is more often produced in emerging markets rather than in Western Europe: for instance, the new Renault Clio will be manufactured mainly (60%) in Turkey. And with the closure of the Aulnay plant, where Peugeot produces its small cars such as the C3, this trend will accelerate. Renault produces only 23% of its vehicles in France, compared to more than 60% in 2000, while PSA Peugeot Citroën production in France stands at just 40% - and this will decrease within the next 3 years with the closure of Aulnay plant.

The decline in domestic production has serious repercussions for French automotive suppliers, most of whom are traditionally linked to French car manufacturers like Renault and Peugeot. While sales in this subsector increased 5% to EUR 18.5 billion in 2011, driven mainly by exports, they have yet to regain their 2008 level of EUR 20 billion. Orders have decreased sharply since May this year. While those suppliers with substantial export business can maintain their activity, even they are concerned by falling global orders.

Pressure on automotive supplier increases

Suppliers' margins are constantly under pressure from powerful car manufacturers demanding greater productivity but at the same time lower prices – prices are estimated to have fallen 4.5% between 2005 and 2011. We calculate that average earnings before interest, taxes, depreciation and amortization (EBITDA) of this subsector were at best 1%

in 2011, after three negative years. While producers' equity is still quite strong, with a historically balanced financial structure, suppliers' equity has weakened because of their cumulative losses over the last five years. This industry is very capital-intensive, requiring both substantial levels of finance, for new investment and restructuring, and high working capital. However, these external financing requirements often weaken the financial structure of many suppliers, while the nervousness of banks and investors towards this sector simply add to its cash problems.

On average, payments in the French automotive industry take 60 days (end of month). Generally, timely payment is important in this sector and therefore we do not expect any increase in delays. While the sector is under strain, supplier payments are usually given priority in order to maintain deliveries and to avoid any damaging breakdown in the supply chain. Although we do not expect any change in payment behaviour generally, we do expect insolvencies to increase in the coming months, as lower production and production relocation will lead to overcapacity - especially for suppliers. Currently, capacity usage for 2012 is estimated to be 70%, as a result of which a major restructuring of suppliers seems inevitable.

Several suppliers will benefit from cash support - either directly from car manufacturers or indirectly from the French state (from public funds such as FMEA). However, there is a real danger that not all suppliers will be able to benefit from this support, especially those that rank second or third in the subcontracting chain. With shrinking order books and a lack of bank support, these companies may become insolvent - especially those engaged in foundry work, small stamping and suppliers producing items with low technology requirements. Therefore our underwriting stance towards the French automotive sector is cautious. We scrutinise businesses' customer structure and export share, the level of EBITDA - which poses a risk if less than 5% - financial costs and the level of short-term debt compared to sales.

In 2012, domestic production will reach roughly 2 million vehicles - and numbers will decrease in 2013. Similarly, car sales in France will fall by around 12% in 2012 and will slump further in 2013. Clearly, this will have an impact on suppliers: after six months of sales decrease in 2012, it is very likely that this trend will continue next year.

The sector (especially the suppliers' subsector) needs to be restructured. However, the key question is 'how?' Will there be a sharp rise in insolvencies and closures, or will there be 'clean closures', i.e. with no insolvencies and financed by shareholders, car manufacturers or the French state?

French automotive sector

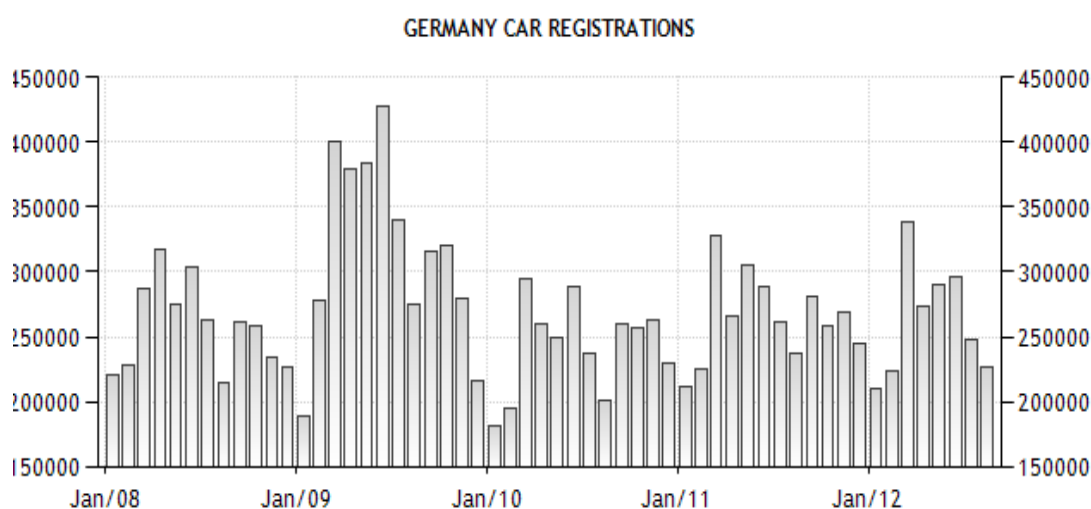
STRENGTHS	WEAKNESSES
Leader companies in some segments: FAURECIA, VALEO, Plastic Omium	Overcapacities and margins under pressure
Technical knowledge	Lack of financing/ lack of attractiveness for private funds
French State support with public funds (FMEA)	As main market the European market is a mature (not a growth area)

Germany

Automotive: production growth has slowed



According to the German Automotive Association VDA, German original equipment manufacturers (OEMs) had an excellent year in 2011: recording a further 6.6% growth in exports after a 23.7% year-on-year export increase in 2010. Worldwide, the production of cars by German manufacturers rose 11.5% last year, while production of their commercial vehicles rose by a very healthy 26.2%. However, in the course of 2012 this boom has lost momentum, mainly because of a drop in demand from Europe: between January and August 2012 both export and domestic production levelled off while new car registrations in Germany decreased 1.8% between January and September 2012. Competition is intensifying as struggling OEMs in Southern Europe try to boost their sales with incentives – in particular by cutting prices.



SOURCE: WWW.TRADINGECONOMICS.COM | FEDERAL MOTOR TRANSPORT AUTHORITY, GERMANY

In the first half of 2012, German automotive suppliers were still achieving profits, although below expectations. Increased raw material costs are adding to their burden, while conversely the aftermarket in spare parts is generally developing well as the average age of cars increases.

Overall, profit margins are currently decreasing, while the equity strength of many automotive businesses has improved since the 2008 credit crisis. In general, their solvency and liquidity situation is still positive.

Tyre wholesalers and retailers experienced a difficult year in 2011 because of the late – and short – winter, with most cars already equipped with winter tyres. The resultant extreme overstocking has had a negative impact on liquidity, while price competition and the growth of internet sales have both eaten into margins. This year, much will depend on the weather in early winter.

We have not seen any increase in notifications of non-payment in the German automotive sector over the last six months, although we expect this to change in the coming months as the European car market continues to worsen. Insolvencies are also likely to increase, although the extent of business failures will depend on the depth of the recession in the European car market, which is as yet hard to predict.

A cautious - but relaxed - underwriting stance

For the German automotive sector, the second half of 2012 will be tough - and the outlook for 2013 is still very uncertain, not just because of problems in Europe but also signs of reduced demand in Asia: especially China. However, despite increasing signs of a slowdown in the German automotive sector we do not yet view this as a real crisis.

For the time being, our underwriting stance remains cautiously relaxed. We continue to keep direct contact with buyers, as we have done over recent years, so that we can obtain their most recent financial information. Our focus is on businesses equity, profitability, working capital, cash flow, net debts and on liabilities to banks. We also monitor customer spread, the importance of a particular supplier to an OEM, and market feedback. Larger suppliers, tyre and aftermarket companies are monitored at least quarterly.

We pay particular attention to the tyres subsector for the reasons explained earlier. As their business has a seasonal structure, long payment terms are typical in this segment and consequently their balance sheets differ from those of manufacturers. Equity in the tyres subsector is very often quite low, margins are poor, fixed assets mainly privately owned, and stocks high. However, we have noted that the most recent insolvencies in this segment were the result of fraud rather than financial difficulty.

Generally, we do not approve credit on buyers that have been operating for less than one year, unless the newly founded company is part of a known group or is the successor of an existing buyer.

German automotive sector

STRENGTHS	WEAKNESSES
Technology leader	OEMs demand worldwide supply so constant & high investments necessary
Excellent reputation	Fierce competition

Germany

Transport: a sector under real pressure



The transport sector has been Germany's 'problem child' for a long time, as overcapacity and strong competition put margins under pressure. Consolidation is ongoing and only highly specialized logistics companies with value added services are performing satisfactorily and making enough net profit.

High fuel costs are a major concern for the whole transport sector and, while some well known blue chip companies are financially strong and profitable, smaller transport firms and forwarders lack sufficient market power (for instance, to pass on rising costs), are anxious to retain their current client base, and are the first to fall in an economic crisis.

The airline industry has felt the full force of a number of external blows: the long, cold winter of 2010/2011, the volcanic eruption in Iceland, increasing fuel costs and airport fees, fierce competition, and the political turmoil in North Africa and the Middle East. As a result, the outlook for airlines remains subdued.

The future direction of the transport sector as a whole will be determined largely by that of the overall economy, which for the time being is fairly sluggish. Against that uncertain background, our underwriting stance is necessarily cautious.

With the problems in the sector already referred to - higher fuel costs, ongoing consolidation, smaller players either being absorbed or falling by the wayside - it is not surprising that those larger companies with the wherewithal to do so are diversifying into other, more profitable, business activities. Further pressure is also being felt in the industry from the impact of toll charges and the imposition of EU lower emission restrictions (EURO 5 and EURO 6) that necessitate investment in new vehicles - and yet higher financing costs.

When underwriting the German transport sector, besides financial data we also take into account the age and size of the subject company. The customer portfolio is also an important factor, especially in the freight forwarding subsector where, to be healthy, businesses have either to have a good spread of risk or focus only on the best buyers. Losses experienced by companies in this industry differ markedly, depending on the quality of their credit management processes.

German transport sector

STRENGTHS	WEAKNESSES
Some stronger large companies	Fierce competition
	Higher fuel costs

United States



Automotive: a strong rebound, but more competition ahead

The US automotive sector had a very difficult year in 2009, as GM, Ford and Chrysler continued to see their market share erode and foreign original equipment manufacturers (OEMs) such as Honda and Toyota recorded falling profits. However, the sector has rebounded since then and, according to the International Organisation of Motor Vehicle Manufacturers (OICA), US car production increased 11.5% in 2011: to 8,653,560 units, of which 2,966,133 were cars and 5,687,427 commercial vehicles. The capital markets' appetite for auto and auto supplier investment grew as a result of this rebound in production and sales.

According to the German Automotive Association (VDA), sales of light vehicles (passenger cars and light trucks) in the US increased between January and August this year by 14.7% year-on-year, to 9,678,700 units. GM and Ford in particular are continuing to see improving results.

Many companies in those auto-related businesses whose performance does not depend directly on vehicle production (i.e. used cars, aftermarket parts, tyre makers, and auto retailers) have also improved their performance since 2010.

Sales of larger vehicles have made a strong recovery but, because of increased fuel prices, consumers may opt for smaller vehicles as they did during the recession. Higher oil prices have led to an increase in larger vehicles and truck inventory, which is why OEMs are stepping up their incentives for buying larger vehicles. Detroit auto manufacturers are facing their stiffest challenge yet in the market for mid-sized family sedans, with GM and Ford up against fierce competition from Japanese, Korean and German rivals in this subsector. The US automakers have consistently fallen short in this sector for almost two decades - trailing behind Toyota and Honda since the mid-1990s - and it is now even more important that they regain some of that lost market share.

On average, payments in the US automotive industry take between 60 and 90 days. While payment delays have not necessarily increased, agreed payment terms have been extended, especially for the larger automotive retail stores: in many cases to as much as 360 days.

We will be keeping a close eye on developments in Europe over the next six months, as sales of cars there - including US cars - have been low this year and are expected to decrease further. However, we do not expect any significant increase in late payments in the near future in the US. We have received few credit insurance claims for the US auto sector in recent months and do not anticipate any increase in insolvencies in the next six months.

Segment totals, ranked by Aug unit sales

	Aug 2012	% Chg from Aug'11	YTD 2012	% Chg from YTD 2011
Cars	650,576	27.8	5,055,971	19.1
Midsize	317,556	25.6	2,521,441	22.2
Small	249,468	47.4	1,858,802	21.5
Luxury	82,621	2.6	669,343	12.2
Large	931	-85.6	6,385	-88.9
Light-duty trucks	634,626	12.7	4,655,073	10.4
Pickup	175,791	12.5	1,251,088	10.3
Cross-over	271,812	17.2	1,983,873	8.6
Minivan	78,769	22.5	573,574	18.8
Midsize SUV	60,195	6.7	462,065	12.3
Large SUV	17,744	-30.1	150,664	-3.7
Small SUV	18,099	3.7	133,641	18.2
Luxury SUV	12,216	6.2	100,168	7.4
Total SUV/Cross-over	380,066	10.9	2,830,411	8.8
Total SUV	108,254	-2.3	846,538	9.3
Total Cross-over	271,812	17.2	1,983,873	8.6

Source: National Automobile Dealers Association

Growth continues - but at a more moderate rate

We are expecting further production growth in the US automotive sector in 2013, albeit at a lower level (about 5%) than in 2012/2013. The US automotive sector is highly competitive in every subsector, with many powerful competitors, but the entry barriers are quite high. While our underwriting stance on US original equipment manufacturers and suppliers for the rest of 2012 and early 2013 will continue to be conservative, we are open for cover up to 90 days credit terms and without pre-credit risk cover.

US automotive sector

STRENGTHS	WEAKNESSES
Large incentives	Higher oil price
Most companies have completed a restructuring plan	Europe's economic performance
Development of green technologies	High inventory levels

United States



Transport: fuel costs are a major concern

Airlines

The US airline industry was badly hurt by the 2008/2009 recession as it is both capital-intensive and very sensitive to consumer spending. However, airlines' revenues improved since the end of 2010 and throughout 2011, albeit from a very weak starting point. A recovery in demand from business travellers and international passengers has been a major driver of those revenue gains.

Increased oil prices and the turmoil in the Middle East are major concerns for the airline industry. Jet fuel prices have increased since the end of 2011 causing many airlines to slash their profit forecasts for 2012. Any further significant rise in the fuel price will almost certainly turn weak profits into losses.

Major players in the US industry include American Airlines, United Airlines and Continental. They fall into two distinct categories: budget airlines, which operate a 'no-frills' service with competitive pricing, and legacy airlines, which operate a premium service. However, legacy airlines have discounted tickets for many of their domestic routes in a bid to compete with budget airlines such as Southwest and Jet Blue. Budget airlines may struggle to compete against their larger legacy rivals, who can offset losses against premium services and have used their large economies of scale to significantly cut costs through streamlining.

We are still increasing our credit insurance coverage of the profitable discount carriers and the small regional carriers that are showing growth and healthy profitability. Now that business travel has picked up we have also cautiously broadened cover on larger carriers.

Railroads

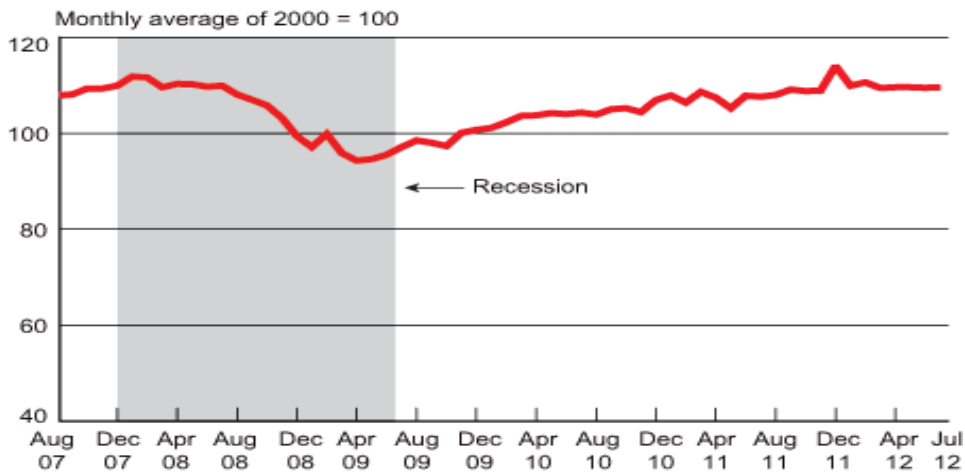
The US railroad industry includes about 360 railroads with combined annual revenue of around US\$ 55 billion. Major freight railroads include Union Pacific, Burlington Northern Santa Fe, CSX, Norfolk Southern, and Kansas City Southern. Amtrak is the sole nationwide passenger rail service. The industry is highly concentrated: during the past thirty years, the number of operating Class I freight companies has fallen by 90%, and seven companies now account for around 93% of all US freight revenue. It came as no surprise that US rail traffic deteriorated in 2009, but the long-term future of railroads remains moderately good, as growth was seen in 2011 and even more growth is expected in 2012 and 2013 - depending on future oil prices. As a result we view this sector favourably.

Trucking – road haulage

While other parts of the US economy stagger along the road to recovery, the trucking industry is still 'cruising' - performing better than the economy at large. Sales by privately-owned general freight and specialized freight trucking companies have increased more than 14% over the last 12 months. Industry experts say a number of factors are contributing to the current trucking environment - which is often seen as a leading indicator of economic activity - but in particular the pickup in manufacturing since 2009 has helped increase road haulage volumes. However, increased fuel prices are now the major concern in this industry.

The U.S. Department of Transportation's Freight Transportation Services Index, a broader measure of changes in freight shipments via trucks, rail, air and pipelines, rose by 1.9% year-on-year in July 2012 and has risen 12.9% since July 2009.

Five Years: Freight Transportation Services Index, August 2007 - July 2012



Source: US Bureau of Transportation Statistics

Hurt by sharp falls in volume in 2008 and 2009, trucking companies have been wary of adding drivers and capacity. And, having worked through a glut of trucking capacity, most carriers are now spending on replacement

equipment rather than on new trucks for growth. The evidence is that it is still tough for some carriers to get finance. Forecasts are for a roughly 3% increase in freight tonnage in 2012 and price increases of between 5% and 8%.

We had tighten up exposure in this sector in the past, and rightly so as we did see a number of bankruptcies. However, those businesses that made it through 2010 should continue seeing slight improvements in their results throughout the rest of this year, although - as elsewhere in the transport sector - a major concern is the cost of fuel. That said, our risk appetite for this segment is cautiously favourable.

General underwriting approach

We need to see a current financial statement if we are to consider any sizeable amount of cover on a private company. Our focus is on analysing sales, earnings, profitability, working capital, tangible net worth and leverage conditions. For subsidiaries that do not produce their own set of financial accounts, we will take into consideration the financial strength of their parent company when assessing credit approval. Businesses that we perceive to be problematic - for instance, those with heavy debt levels, working capital deficit and/or liquidity problems - are put on a quarterly 'watch list'.

US transport sector

STRENGTHS	WEAKNESSES
Most companies have completed a restructuring plan	Oil prices
Customer incentives	Europe's economic performance
	Large leverage

Spain

Automotive: Exports keep the Spanish industry afloat



In 2011, overall vehicle production in Spain fell slightly - by 0.6% - with 2.3 million units produced. 90% of this production is destined for the major European markets and, with weaker domestic and EU demand, exports to non-EU countries have increased. Overall, Spain exports vehicles to over 130 countries. This level of production keeps Spain as the world's ninth largest vehicle maker and Europe's second largest.

Over 1.8 million cars were produced last year - a year on year fall of 3.9% - making up 77% share of total vehicle production. The high level of productivity and competitiveness in Spanish factories (with eight models made there) has ensured that Spain remains among Europe's three largest car manufacturer in Europe. Production of off-road vehicles increased by 27.3% last year - to 48,204 units - almost all of which were exported.

Production of commercial vehicles in 2011 exceeded the previous year's figures: an increase of 11.3% on 2010's poor results with some segments, such as vans, showing strong growth. There was significant percentage growth in all other commercial vehicles, but again this was compared to the low volumes achieved in 2010. Spain continues to lead the European production rankings for these types of vehicles.

Throughout 2011, a total of 2,121,068 vehicles were exported: 2% higher than in the previous year. However, after slight domestic market growth in 2010, new registrations in Spain fell by 16.4% in 2011, reflecting the country's financial and economic situation, with its high unemployment and restrictions on credit to both households and businesses. The total number of vehicles registered in Spain was 931,412 - similar figures to those of the 1990s and far below the potential demand. The car market showed the steepest decline: down 17.7% to 808,059 units, and on a par with 1993 levels. Registration of commercial vehicles such as vans was also down - by 10% - as a result of the poor trading activity of the self-employed and SMEs. However, the registration of heavy vehicles (i.e. trucks) grew in virtually every segment - overall by 27.6% - but again from the previous year's extremely low level.

Suppliers

After a fall in production in 2009 (down 14.6% year on year) many suppliers in both Tier 1 and Tier 2 adapted their business structures to the new market reality. Those who couldn't left the market, especially during the second half of 2009 and the first half of 2010. But during late 2010 and throughout 2011 the situation for suppliers improved significantly, thanks to a growth in orders.

Despite this, over the past decade the relationship between most automotive manufacturers and their suppliers has focused on the struggle for lower prices. In recent times, many manufacturers have renegotiated prices with their suppliers two or three times a year, seeking cuts of up to 10%, and this trend seems destined to continue. Consequently, although orders are stable, suppliers are under constant cost pressure that has adversely affected their economic performance, both in terms of return on sales (EBIT: sales) and asset productivity (sales: net assets). This can cause particular problems for suppliers whose financial structure is weak. And, of course, the possibility that

many first-tier suppliers may fail is not in the interests of vehicle manufacturers. Fewer suppliers mean fewer options and less competition, and when suppliers are economically weak there is less room for investment in innovation. As Tier 1 and 2 suppliers are becoming the industry's leading innovators, manufacturers are taking special care to ensure that their supplier base remains diverse and financially robust.

It is worth highlighting the significant change in the relationship of manufacturers and their suppliers. During the past five years, the supply of automotive components from low-cost countries in Asia, Eastern Europe and Latin America has increased enormously. In particular, China has become a key source of auto parts for European, Japanese and American manufacturers. Therefore, most manufacturers have established buying offices in China. At the same time, many leading European, Japanese and American car parts suppliers have established joint ventures in China and in other low-cost countries in Eastern Europe and Latin America.

The situation this year and the outlook for the industry

In 2012 Spain will produce fewer than 2 million vehicles. Total vehicle production in the first half of the year was down 18.34% on 2011, to a total of 1,096,082 units. The passenger vehicles segment recorded a decline of 18% while commercial vehicles were down almost 25%. ANFAC (The National Association of Car and Truck Makers) also expects a steep exports decline: down of 21.3%.

Recession in those European markets where Spain sells its vehicles has a direct impact on production volumes. Hence the Spanish industry is diversifying its production and looking for new export destinations. From January to June, vehicle exports fell by 21.28%: with a total of 940,186 units shipped to abroad.

In Spain, businesses and rental companies show falls in purchases of close to 30%. The continued decline in consumer confidence and high unemployment foreshadow a gloomy outlook for the rest of this year, with sales of cars not expected to exceed 700,000 units (compared to 808,059 units in 2011).

The stagnation – if not a decrease – in demand from the European countries that are the usual destinations for Spanish-made vehicles, and the weaknesses in the domestic market characterized by high unemployment, rising taxes, difficult access to financing and lower consumer confidence, have strongly influenced the evolution of the automotive sector in Spain.

On average, payments in the Spanish automotive sector take 72 days. We have seen no change in payment behaviour – or indeed in the level of notification of non-payments – in this sector in the last six months and do not expect any change in the foreseeable future. However, we do expect the number of insolvencies to rise, as those small second-tier suppliers whose main client is a first-tier supplier, and have neither sufficient financial strength to withstand a significant drop in sales nor the freedom to diversify, will be forced out of the market. The industry must adapt its manufacturing capacity to the reality of the economic situation and the drop in sales. That will mean redundancies and lower margins throughout the supply chain and the possibility of closures for both manufacturers and suppliers.

In 2013, we expect a similar story, with a slight drop in production and new registrations. However, the medium-term outlook for the sector will depend greatly on the evolution of the European economy to which it is so exposed.

A cautious underwriting policy

Because consumer demand is currently stagnant, our underwriting approach is cautious. We require the very latest financial data if we are to consider large requests for cover, and must be particularly vigilant in the case of repair shops and spare parts suppliers.

Spanish automotive sector

STRENGTHS	WEAKNESSES
Exports 90% of production	High exposure to European economic developments
Technological capacity	Risk of relocation (non Spain-based groups)
Ability to adjust workload	High exposure to political decisions of the parent company

Spain

Transport: A shrinking market and an overmanned sector



According to UNO (the Business Organisation of Logistics and Transport), during 2011 and the first quarter of 2012 the transport industry in Spain consisted of around 24,000 companies, representing 4.59% Spain's companies: with 19,150 dedicated to road transport.

The sector employs more than 850,000 people - 4.32% of Spain's workforce - although by the second quarter of 2012, more than 26,000 jobs in this industry had been lost. Although those losses, as a percentage, are less than the overall percentage of jobs lost in the Spanish economy, the majority - 23,000 - have been in road transport firms. Nevertheless, throughout 2011, this sector accounted for 5.5% of Spanish GDP. The number of companies in the sector fell by 1.6% in 2011, compared to growth of 10% in previous years.

The transport sector is seeing a major drop in its turnover because of falling demand caused by the economic crisis: demand fell by 20% in the second quarter of 2012 with a drop in road transport of more than 30% in that period. Aviation has also suffered sharp falls, of around 20%, while the maritime subsector has seen a decline of 10% of its fleet.

The rise in fuel prices in recent years has seriously hit the whole logistics industry, with margins that were already low reduced even more. The problem is compounded by the fall in demand, difficulties in obtaining bank finance, and late payments from public bodies. All this may well put many firms out of business.

Compared to the transport sector in other European countries, the Spanish sector is overmanned. For instance, in Germany, while turnover in the transport sector is 60% higher than in Spain, 23.5% fewer people are employed in the German industry. It is a similar story in France, where the logistics market is only 2.5% higher than Spain while 11.5% fewer people are employed. The trend is repeated in the UK and in Italy and exposes a real structural problem in the Spanish transport sector.

We expect the number of credit insurance claims to increase slightly in the coming months because of increased fuel prices and short-term financing problems faced by firms in the sector.

The outlook for the rest of 2012 and 2013

There was no investment in the sector in the first quarter of this year because of poor business and consumer confidence, and the Spanish government's austerity measures.

Three factors will influence the development of the sector for the rest of 2012:

- Growing investor caution
- Investors redirecting their focus towards assets that give greater assurance of a return during the current economic downturn.
- The opportunity for the buy-out of firms in financial difficulties by private equity buyers, (investment funds or pension funds).

The survival of the sector is dependent on improvements in the level of service: through outsourcing, consolidation, the reduction in costs, more flexibility and the reduction of fixed assets. There is little sign that there will be a revival in demand in the foreseeable future, and where there is such a revival it will be in the air and maritime subsectors. The only positive sign at present is that, while the transport of goods and animals looks set to remain troublesome in throughout 2013, there may be slight improvement in 'people' transport.

Our underwriting stance – quite restrictive

In the light of our appraisal of this sector, we are naturally cautious and vigilant to signs of increasing risk. When underwriting buyer risk we look at profit margins, the level of debt, outstanding receivables and the extent of late payments. We are more cautious in our appraisal of subsectors dealing with the transport of goods and animals than those engaged in transport of people.

Spanish transport sector

STRENGTHS	WEAKNESSES
Increase in exports and outsourcing.	Sector closely linked to the fluctuation of the price of oil, and as a result of the fuels.
Some slight forecasts of improvement in demand, mainly in air and maritime transport.	Bad perception of the situation on the market.
Margins of improvement in service.	Difficulties in accessing finance.

Czech Republic

Automotive: a sector vulnerable to Eurozone demand decrease



According to the Czech Automotive Association, total car production increased 11.5% year-on-year in 2011: to 1,220,779 units. Domestic car sales increased 4% while exports rose 11.9%.

In the first half of 2012 production increased 5% year-on-year: to 662,529 units. However, there was a marked slowdown in the second quarter after growth of 14% in Q1.

Skoda Auto's output increased 6%, to 376,524 cars, while Hyundai's production rose by a massive 36%, to 163,530 cars. Conversely, Toyota Peugeot Citroen Automobile (TPCA)'s production decreased 20%, to 122,474 cars, due

The sector is very export oriented, but export growth rates are slowing this year: to 6.1% year-on-year in the period from January to August, as demand from the Eurozone decreases. However, for the time being at least, this decrease is partly offset by higher demand from the US and the BRIC nations.

Profit margins, general equity strength and solvency and liquidity in the Czech automotive sector are good. We expect growth for the whole of 2012, but the outlook for 2013 is uncertain and will depend on the direction of demand from EU markets, while demand from Asia and the US is to remain satisfactory. As the sector is very cyclical, our expectation is for negative impact from the economic consequences of the Eurozone debt crisis. Clearly, this will mainly affect those automotive businesses with a higher reliance on demand from EU markets.

On average, payments in the Czech automotive industry take between 30 and 90 days and, because of mounting difficulties of this export-driven sector, we expect payment delays to increase in the coming months. Compared to other Czech industries, the automotive sector's default/insolvency rate is good and, despite the expected decrease in activity, we do not expect a sharp increase in defaults as we saw in 2008/2009.

For the time being, our underwriting stance remains quite open across all subsectors. Our main criteria are equity strength and debt position against earnings before interest, taxes, depreciation and amortization performance (EBITDA).

United Kingdom

Automotive: growth driven by sales to emerging markets



In the UK, 2012 will see significant new models entering production at Nissan, Honda and Toyota. It is expected that, after a 5% increase in 2011, total production will strengthen further to around 1.4 million new cars. Car output was up 22.2% in July and 15.1% for the year-to-date, reflecting the investment made in UK car production and the appeal of some of the models manufactured. However there are already indications that the Eurozone crisis has hit car sales, when Vauxhall announced that it would shut down its plants in Ellesmere and Luton for a week at the end of September.

New car sales grew 3.3% year-on-year - to 1,260,997 units - during the period from January to August this year. September typically accounts for 17% of the annual total and is second only to March for sales volumes. The Society for Motor Manufacturers & Traders (SMMT) forecast the sale of 1.97 million units in 2012. There is significant investment in new models and production capacity at a number of plants, notably at Jaguar Land Rover (JLR) and BMW. Despite the threats from global macroeconomic uncertainty, there is potential for the UK auto industry to increase in size - the industry has repeatedly shown its resilience in the past. On average, payments in the automotive industry take between 45 and 90 days. We are not aware of any recent change in payment habits and do not expect changes in the coming months. Compared to other UK industries, the automotive sector's default/ insolvency rate is very good, with a stable outlook.

Over the past 18 months, virtually all those involved in the British automotive industry have announced expansion of some form: a combined total of about £4.5 billion in new investment. Structurally, the UK's automotive industry has found itself well placed to ride both the emerging market boom, and the move upmarket to more aspirational, premium models. Britain sells a greater proportion of cars to high-growth non-EU countries than any other European nation, and overcapacity is not a problem for premium brands. In fact, strong sales growth around the world has left them needing more, not less, production capacity. However, lower growth is forecast for global auto sales in 2013, due to lower demand in Europe and weakening sales in China. Moody's have projected growth in global light-vehicle sales of 2.9% for 2013: lower than its January forecast of a 4.5% increase. With lower expected demand, it is likely that more auto makers will disclose restructuring plans to deal with overcapacity in Europe. Demand in Western European will decline 3%, because of the weaker markets in Southern Europe. In China, Moody's estimate light-vehicle demand growth of 8.5%: down from its January forecast for a 10% increase. Mid-market players - such as Ford of Europe and Opel/Vauxhall - are having a difficult time: suffering falling sales, profits and market share as they are squeezed from below by the South Korean manufacturers and from above by the premium brands.

Our risk underwriting stance is positive towards all parts of the UK automotive sector. Second tier component suppliers are enjoying JLR's success and we are increasing our exposure on them as a consequence. Our positive approach reflects car manufacturers' more efficient business models and subsequently improved profitability and cash flow. However we do not underestimate the fragility of the economic situation, especially in the UK and Europe. Overcapacity also remains an issue in Europe and will continue to put pressure on margins. Growth will continue to be driven by sales into markets such as India, Russia, China and Brazil and the rebound in demand seen in the USA.

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