

EUROPE CREDIT STRATEGY

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ABOUT

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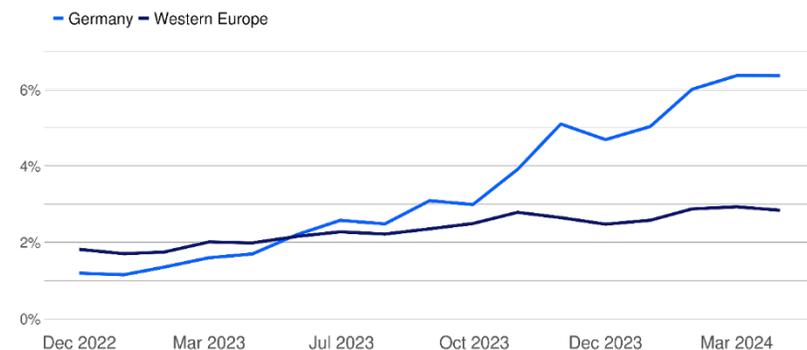
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From Boom to Gloom: Navigating the Impending Downturn in the German Construction and Real Estate Sector

A decrease in demand for new buildings is threatening the performance of the Construction and Real Estate (CRE) sector in several European countries. Germany, one of the largest and robust economies in the EU with an active property market, is currently experiencing a downturn in its real estate sector.

Credit risk has jumped sharply in the past twelve months. Figure 1 shows the average one-year probability of default (PD) for public companies in the CRE sector in Germany and Western Europe.¹ For German CRE companies, the average PD jumped from 1.7% in April 2023 to 6.37% in April 2024. This contrasts sharply with the increase observed for CRE companies in Western Europe with the average PD rising from 1.99% to 2.84% over the same period.

FIGURE 1 Average one-year PD for public companies in the CRE sector, Germany and Western Europe



Data source: Moody's EDF-X platform.

¹ Western Europe includes Åland Islands, Andorra, Austria, Belgium Switzerland, Cyprus, Germany, Denmark, Spain, Finland, Falkland Islands, France, Faroe Islands, United Kingdom, Guernsey, Gibraltar, Greece, Greenland, Isle of Man, Ireland, Iceland, Italy, Jersey, Liechtenstein, Luxembourg, Monaco, Malta, Norfolk Island, Netherlands, Norway, Portugal, Svalbard and Jan Mayen, San Marino, Sweden, and Holy See.

The deterioration in credit quality for German construction reflects a worsening in economic fundamentals in the sector. In August 2023, the number of new building permits granted reached a ten-year low. This downturn can be attributed to declining residential property prices and stagnant growth in construction employment. Residential construction project cancellations in Germany rose to 22.2% in October, and new building permits saw a decrease of 9.4% in November compared to the previous month. The ongoing deterioration in the sector can largely be traced back to escalating project failure rates, driven by a surge in interest rates (with the European Central Bank's interest rate peaking at 4.5% in September 2023) and soaring construction costs due to geopolitical and supply chain challenges. In May 2024, construction workers went on a nationwide strike, the first one in 22 years.

GERMAN CONSTRUCTION SECTOR SHOWS HIGH CONCENTRATION OF RISKY COMPANIES

The increase in the average probability of default for German CRE companies belies the potential credit risk of the sector. When industries experience sector-wide stress, it becomes more difficult, but even more essential, to be able to differentiate the companies in the sector that are most at risk. Moody's EDF-X Early Warning System (EWS) was designed to do just that. The EWS currently shows that the German construction sector shows a high concentration of exceptionally risk firms.

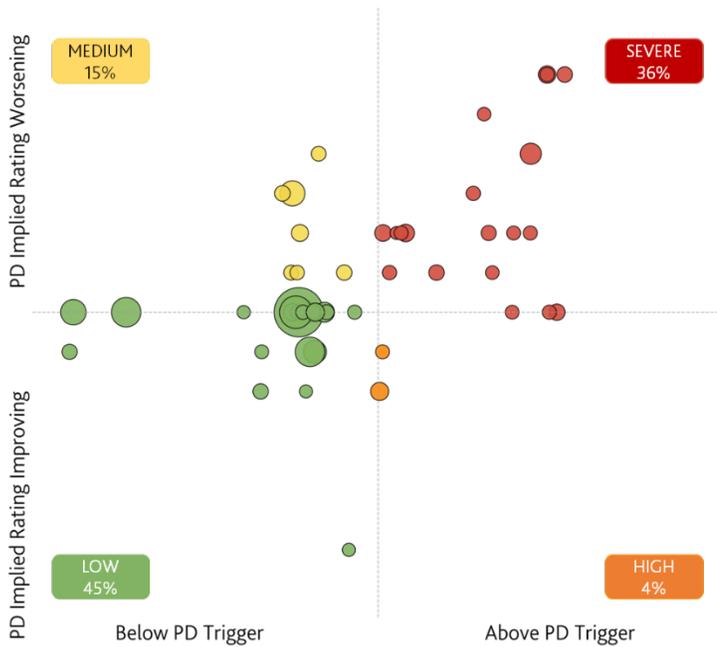
Moody's EDF-X EWS uses two key measures to identify companies as low, medium, high, or severe risk over the next 12 months. The two measures are (1) whether a company's forward-looking PD measure is above an appropriate sector early warning trigger level; and (2) the change in the PD-implied rating. Moody's research has shown that public companies with high early warning signals are 25 times more likely to default over the next year than firms with low early warning signals.

The EWS signals show that 36% of publicly traded German companies were classified as severe risk in April 2024 compared to its peers, vs. 18% in the previous year. Figure 2 presents the April 2024 snapshot of Moody's EWS, with each circle representing a company and their relative size (measured by asset value). The largest firms have been relatively more resilient to the increase in credit risk, as indicated by their placement in the bottom left quadrant (Low Risk EWS category). This adverse situation might impact an already highly exposed banking system. Not only do German banks hold the largest exposure to commercial and real estate loans in the European Union, they are also witnessing a rise in non-performing loans.² The planned government measures will alleviate the sector contraction, but they are not expected to avoid the decline already anticipated for 2024.³

² Sidders, J., Confort, N. and Callanan, N. (2024, February 27). Germany's Slow-Motion Property Crash Is a Looming Risk for Banks, *Bloomberg*.

³ https://www.moodys.com/research/Construction-Germany-Construction-downturn-will-hurt-materials-producers-but-help-Sector-In-Depth--PBC_1389566#Summary

FIGURE 2 EDF-X Early warning signals for public German companies in the CRE sector, April 2024



Data source: Moody's EDF-X platform.

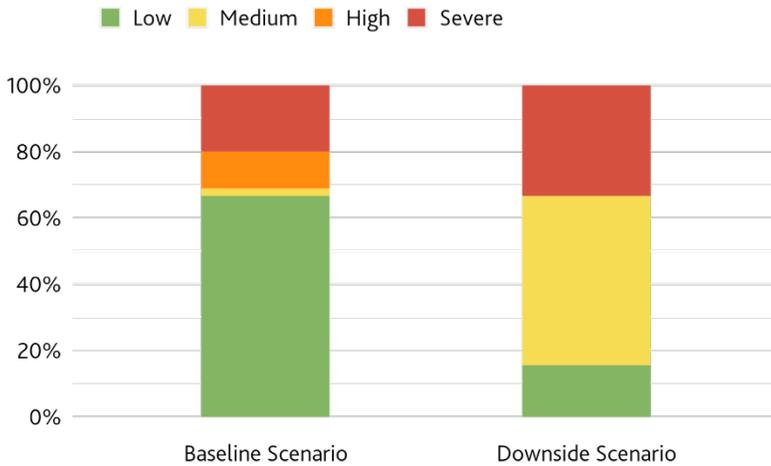
While Moody's EDF-X Early Warning System (EWS) provides actionable forward-looking signals, it's also crucial to consider the impact of a shifting macroeconomic environment and the potential realization of different future scenarios. To address this need, Moody's EWS methodology has been expanded to account for alternative macroeconomic scenarios to perform *what-if* analysis that can ultimately be used for stress testing. In the analysis that follows, we examine how the EDF-X early warning signals change for German construction companies under Moody's baseline economic scenario and a downside scenario.

The Moody's baseline scenario for Germany projects a marginal fall in output with an average negative year-on-year growth rate of -0.37% until the last quarter of 2024, when growth is expected to turn positive.⁴ This scenario is based on the assumptions of no escalations in global geopolitical tensions and no changes in monetary and fiscal policies until mid-2024, when the ECB is expected to start cutting rates. Under this scenario, there is a significant improvement in the risk of public German companies in the CRE sector. Figure 3 shows the scenario-conditioned early warning signals distribution for these companies in December 2024. Compared to April 2024, the percentage of companies classified as severe risk has decreased significantly from 36% to 20%, while the percentage of companies classified as low risk has increased from 45% to 64%.

In a downside scenario, the credit risk environment for construction and real estate companies deteriorates significantly. In this Moody's scenario, sentiment in Europe turns down sharply amidst increasing concerns around global growth. Geopolitical tensions rise due to fears of escalations in the war in Ukraine and the Israel-Hamas conflict, as well as an increase in tensions between China and the U.S. The resulting increase in risk aversion leads to a sell-off in global financial markets, setting the scene for a moderate but prolonged recession where the ECB hesitates to cut rates. In this scenario, by December 2024 most public firms in the CRE sector are classified either as medium or severe risk, with firms under severe risk constituting 36% of the sector.

⁴ Moody's alternative economic scenarios are available through www.economy.com to subscribers of the service.

FIGURE 3 Scenario conditioned early warning signals distribution for public German companies in the CRE sector, December 2024



Data source: Moody's EDF-X platform.

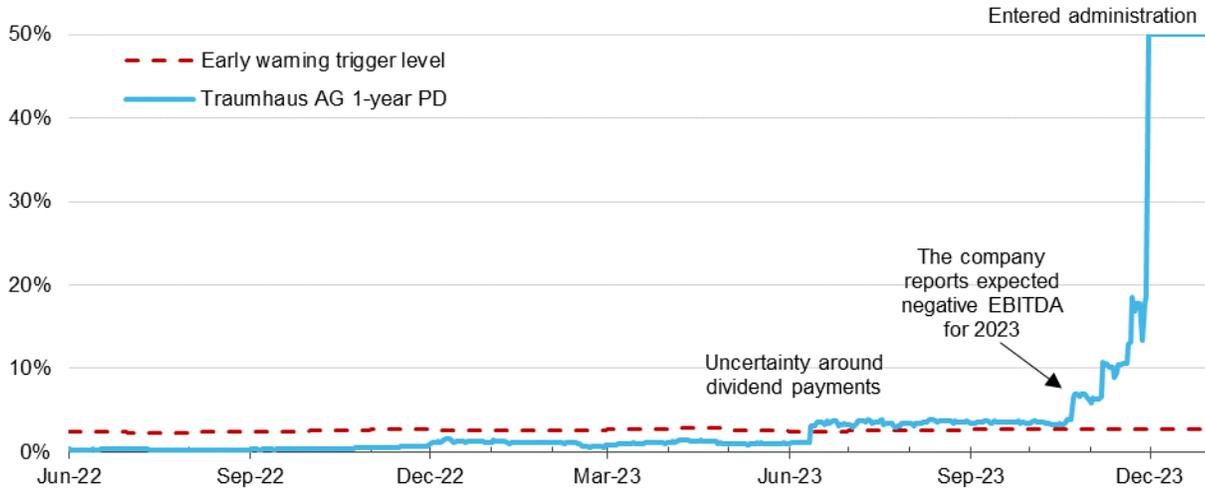
A “VICTIM” OF THE SECTOR DOWNTURN: TRAUMHAUS AG

A clear example of how the sector downturn is affecting specific companies is Traumhaus AG, a public German company with total assets around \$160 mil (as of date Orbis, 2022). Founded in 1993, the company operates within the full chain of real estate project development, from land acquisition to production, marketing, and management of properties. The company recently filed for self-administration proceedings. The financial downturn and situation surrounding the company have been extensively covered in the news media.

Moody's EWS flagged Traumhaus AG as being under severe risk in June 2023, when the company's 1-year PD jumped to 3.1% (equivalent to a B1 implied rating), surpassing the early warning trigger level as shown in Figure 4. This severe risk warning was issued four months before the first of several steep declines in the company's stock price that would occur in 2023. The initial severe decline took place in October 2023, with the stock value falling by 38% over a week. A subsequent decline occurred in a single day in November, with the stock plunging from €2.20 to €0.28. This was also preceded by the EWS's one-year PD escalating to 18.7%. The PD eventually reached its peak at 50%, when the company entered administration.⁵

⁵ 50% is the maximum forward-looking probability of default for non-financial companies in Moody's EDF-X platform.

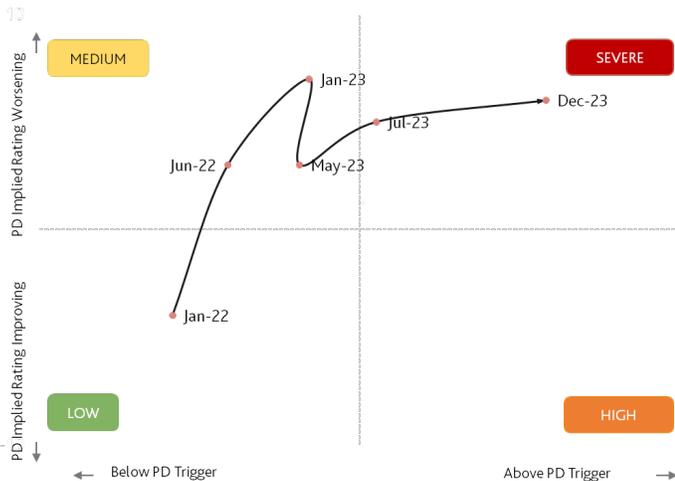
FIGURE 4 Traumhaus AG's one-year PD vs. its sector early warning trigger level



Data source: Moody's EDF-X platform.

The protracted path of Traumhaus AG into administration was traced by EWS, as shown in Figure 5. The company's low and stable early warning signal began to deteriorate in early 2022, and by June of the same year, the company was marked as medium risk. The firm's credit risk continued to deteriorate, gradually approaching severe risk by June 2023, six months prior to administration.

FIGURE 5 Traumhaus AG's early warning signal across time



Data source: Moody's EDF-X platform.

NAVIGATING DISTRESS WITH TIMELY RISK IDENTIFICATION

The credit risk deterioration within the German construction sector, as indicated by Moody's forward-looking probability of default, suggests that the industry is potentially on the verge of a significant downturn. This downturn, characterized by an uptick in project cancellations and a growing number of companies deemed severe in terms of credit risk, signals a potential crisis in the making. In a scenario where the German economy underperforms beyond expectations, the sector could face a more prolonged and severe crisis, with an increasing number of companies struggling to maintain their operations. Moody's scenario conditioned EWS estimates that the percentage of at-risk companies could rise to 40% under an adverse economic scenario.

A striking example of this crisis is the case of Traumhaus AG. Moody's Early Warning System (EWS) helped in identifying and anticipating significant increases in credit risks within specific country and sector markets. Identifying risky firms on time is crucial for credit risk management as it provides investors and lenders with greater opportunities to implement mitigation plans and reduce financial impacts.

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