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Euler Hermes foresees high risk that US housing crisis may spread to the UK, the Netherlands, Ireland and Spain
Slower albeit still positive growth for construction industry in the euro zone

In a report entitled “global construction industry: is the US crisis contagious?”, the economic and construction industry experts of credit insurer Euler Hermes SFAC review the global outlook for the sector. The report highlights that in a global economic slowdown, the Netherlands, UK and Ireland top the Euler Hermes real estate risk index, but without any real deflation of the bubble in 2007. In France, lower 2007 corporate earnings and higher cash requirements will lead to an increase in bankruptcies.

1. Sharp slowdown in growth for the sector, but no "bubble" effect expected

- Fall in US housing investments, but gentle reduction in prices in 2007

US housing investments fell by 5% in 2006 and by 14% in 2007. We have recorded six consecutive quarters of reductions in the construction industry. While new housing starts collapsed suddenly in the 2nd and 3rd quarters of 2006, housing prices have declined slowly— estimated at about 1% on average in 2007, after 9% in 2004, 13% in 2005 and 1.8% in 2006.

- The 2005 rise in long-term interest rates and the 2006 reversal in the interest rate curve tightens liquidity for US housing investments

The rise in short-term interest rates eventually spread to long-term interest rates in 2005 thereby boosting variable rate mortgages. As from 2006, the fall in prices and reversal in the interest rate curve in the US caught out those who were borrowing short term in order to lend long term; this generated bad debt risks for on private mortgages in securitisation funds and variable rate subprime mortgages became unprofitable once asset prices stopped rising.

- \$10 billion to \$50 billion unrealised losses in subprime mortgages

Since 2003, subprime mortgages have grown rapidly. In 2007, the rate of bad debts surged while the prime market was not affected. The rise in bad debts concerned variable subprime mortgages, representing 2/3 of the total and amounting to \$1,200 billion; the value of mortgages with rates that will change in the future will continue until March 2008.

“We assume that unrealised losses on the subprime market may amount to some \$10 billion to \$50 billion, accounting for 0.1% to 0.4% of the total US mortgage market”, explains Philippe Brossard, research director at Euler Hermes SFAC. “The real estate crisis has turned into a banking crisis. The spread of risk via securitisation trading has generated a leverage effect for the potential losses without an ability to localise them. The fact that spreads between the central banks’ benchmark interest rates and the inter-bank lending rates reached an exceptional 70 basis points in the euro zone reflects mistrust between the retail banks”.

Euler Hermes assumptions

Estimated final losses on subprime mortgages	Total volume (\$ bn)	Bad debt rate	Asset coverage	Final loss (\$bn)
High estimate: surge in bad debts and drop in real estate prices	1,700	10%	70%	51
Low estimate: bad debt rate comparable to 2001, higher asset coverage	1,700	3%	80%	10

- Large differences in housing prices in Europe

In Europe, prices vary by a factor of 3, ranging from €100,000 in Portugal to €304,000 in Ireland. In relation to purchasing power (i.e. GDP per capita), prices are very high in Spain and UK. However, these markets are not at all comparable in that new housing construction has been high in Spain whereas in UK, construction of new homes has remained low for many years. There is a large stock of homes in Spain carried by often highly geared promoters. In France, the price/GDP ratio is moderate. In Japan it is low and is not excessive in the US.

- Real estate prices more than doubled in 10 years in five European countries: Ireland (206%), UK (162%), Norway (120%), Spain (119%) and Sweden (116%)

Overall, Euler Hermes has seen prices surge in most countries. In the US, prices rose moderately given the growth in the US economy. In Germany and Japan, prices have fallen sharply almost every year without interruption.

- French, Belgian and Italian households have low debt levels

Italian households are less than 50% indebted, while Dutch households are nearly 90% indebted. In practice, the most indebted consumers take out mortgages of 30 years or more, as is often the case in Northern Europe. French people, who had 15 year mortgages five years ago, now take out 20 year mortgages.

- The Netherlands, UK and Ireland top Euler Hermes real estate risk index

Euler Hermes introduced a theoretical index tracking risk in each country's real estate market. When the index stands near 0, the real estate market in question has exactly the same level of risk as the other markets under review. The UK, Ireland and Spain appear clearly as high-risk countries. In the UK, we have not yet witnessed major signs of a price slowdown despite the interest rate hikes by the Bank of England. In Ireland, where construction has been booming for some time, prices have begun to fall at some 5% per year. Spanish prices for the time being are holding up despite clear signs of nervousness.

2. World economic growth slowdown and mixed outlook for housing industry

- The US slowdown will impact global growth

US growth will hardly reach 2% in 2007 and 2008 and US household consumption will fall. The euro zone will slow to 2% in 2008 dragged down by the strong euro. Lower demand from developed countries will hit the newly industrialized countries (NIC). Worldwide, we estimate that growth will decline from 4% in 2006 to 3.5% in 2007 and 3.3% in 2008.

- Commodity prices will remain high

Oil prices will be bolstered by geopolitical uncertainties. Having stabilized at about \$65 per barrel, they are still expensive. We forecast that commodity prices overall will edge down slightly in view of the dip in growth of global demand.

- Inflation should fall in the US and Europe

Given the stabilisation of oil prices coupled with a reduction in commodity prices, we expect inflation to fall in many countries from +1.6% in 2006 to +1.4% in 2007. Globally, inflation rates will converge at the level of the underlying rates (e.g. relatively stable oil price).

- Private investment in new housing will stabilize in 2008

US housing construction will continue to fall in 2008, but at a slower pace than in 2007. We expect construction in the euro zone will also dip in 2007-2008.

3. In France, corporate earnings continued to fall since 2006 due to SME cash needs. Defaults soared in 2007

- Break in earnings trends as from 2006

The study conducted by Euler Hermes was based on 69,226 balance sheets available in its database for the carcass and finishing market segments. It does not take into account self-employed trades who don't have to publish their accounts. The Euler Hermes database enabled us to review 69,286 balance sheets out of a total of 308,553 in the industry, i.e. 22%. Together these account for 63% of the total sales of the construction industry. *"Erosion of margins has hit both large companies and SMEs"*, comments Jean-Pierre Brasi, a Euler Hermes SFAC expert.

- Housing prices in France are stabilizing

“In 2007-2008, the changes made to tax legislation will have only a limited impact on the housing market. The tax deductions are equivalent to a rate reduction of 40 basis points and compensate for the rise in interest rates over the last 6 months...”, comments Nicolas de Buttet, a Euler Hermes SFAC expert.

- Erosion in margins will continue in 2007-2008 together with an increase in claims

Maintenance and corporate real estate will bolster the carcass segment in 2007-2008, but costs are rising faster than sales, and earnings will continue to suffer in 2007 and 2008. After a 5.6% margin in 2006 and 5% estimated in 2007, post-tax margins will decline to 4.7% in 2008, which is lower than 2003 (5%).

“For the 12 months ended in August 2007, bankruptcies were up 12% for the industry. Bankruptcies are running at 12,000 per year. The rise in claims began late 2006, they fell in the second quarter but have increased sharply since then”, concludes Laurent Bonheure, industry consultant with Euler Hermes SFAC.

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