



market monitor

Mechanical engineering and steel/metals in:
Germany, France, Brazil, Denmark, Hungary
Short abstracts on steel/metals performance in some main EU markets
June 2011

Mechanical engineering shifts into higher gear

It was the English poet John Donne who wrote “No man is an island” – meaning that no-one thrives in isolation – and that’s very true of the mechanical engineering industry. As this month’s Market Monitor reports show, this sector has rebounded because of its integral links to other industries, like automotive and renewable energy, that have returned to good health following the global downturn.

In fact, the overall improvement in the global economy has in turn led to more capital investment and demand for the products of the mechanical engineering sector, especially from leading emerging markets like China and Brazil.

Nowhere is this more evident than in Germany, where in the first quarter of this year new orders for machine tools rose by 130% year-on-year. While Germany’s machinery sector is booming, in neighbouring countries like France, Denmark and Hungary the mechanical engineering sector has also profit from increased demand from Germany itself. According to Eurofer the EU mechanical engineering sector’s output will grow 8.2% after 9.7% in 2010.

As always, there are some downsides to the story, and businesses in this sector have to contend with the rising price of vital commodities. That said, growing demand for Brazil’s commodities has proved a boost to its mechanical engineering sector, creating increased demand for extraction equipment.

The upswing in mechanical engineering has helped growth in the steel sector too, as our reports on steel and metals in Germany and France show. However, the problems outlined in April’s Market Monitor persist: namely overcapacity and huge stockpiles of steel in China and rising commodity prices. Nevertheless, forecasts for 2011 steel consumption have been revised upwards since then, with Eurofer expecting EU real steel consumption to increase more than 5% in 2011.

On the following pages, we indicate the general outlook for each sector featured using these ‘weather’ symbols:



Excellent



Good



Fair



Gloomy



Bleak

Overview: sector performance in some EU markets

The Netherlands: Steel and metals



The Dutch metal industry suffered from stagnation in the construction and automotive sector, with low demand for steel from shipbuilding and heavy industry in 2010. Exports, however, (up 4%) compensated for the drop in domestic sales. While demand for construction steel reached its lowest level in Q4 of 2010 and Q1 of 2011, demand for steel from other manufacturing sectors has now risen. In 2011 we expect general revenue growth of 4%, as Dutch suppliers with buyers in Germany take advantage of that country's continuing growth. However, in general demand for steel and metal will remain below its pre-crisis level.

Belgium: Machinery



The Belgian machines sector suffered severely from the decline in business investment during the economic downturn. However, the situation has improved, helped by the banks' more flexible attitude to financing new investments. While the impact on the world economy of the disaster in Japan remains to be seen, the Belgian machinery sector will continue to profit from increasing investments, especially in emerging markets.

Belgium: Steel/metals



2010 saw a recovery in both volume and sales, with prices and margins improving, thanks to the general economic upturn. However, rising commodity prices create uncertainty as to whether 2011 will meet last year's performance. The insolvency rate is low, but payment times can be lengthy. We expect the sector to continue its upward trend, but at a more modest pace.

UK: Steel and metals



In the UK, steel and metals proved reasonably resilient to the downturn, as businesses reacted swiftly to the sudden severe drop in demand by cutting costs and improving efficiencies. However, the introduction of quarterly pricing for iron ore and the subsequent increases in the price of raw materials mean that the steel and metal industries still have challenges to face – not least in the light of the only slight uptake in demand. An essential determinant of the future health of companies in these industries is the sectors that they supply, with construction showing much slower signs of recovery than others.

Poland: Machinery



Production in the Polish machinery industry decreased 1.4% in 2010 and 8.6% in Q1 of 2011 with margins on sales and liquidity deteriorating slightly. However, the business climate looks set to improve as a result of the planned increase in investment in mining, power and agriculture, and higher demand from Germany and Russia. Despite this, the rebound will be tempered by rising commodity and transport costs, and by higher VAT. Our underwriting approach is relaxed for the precision and agricultural machinery subsectors, but more cautious in the case of machinery for road works and the mining and steel industry.



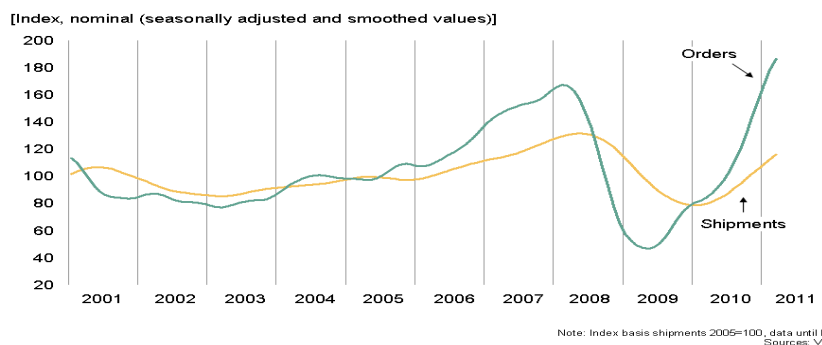
The unprecedented rebound continues

Like its economy as a whole, the German mechanical engineering sector has seen an unprecedented rebound following the recession of 2009, during which, according to the German Mechanical Engineering Federation (VDMA), the industry suffered a 24.6% decrease in production and 22.7% decline in turnover. Then, in 2010, the sector rebounded, with growth in production of 9.4% and growth in turnover of 7.7%, due in large part to strong foreign demand and the recovery of buyer industries such as automotive. The sector has profited in particular from the robust economic performance of large emerging markets, with a sharp rise in exports to China (35% year-on-year increase) and Brazil (29%). Overall, the sector's export ratio has now reached 75%, and constitutes 19% of total global machinery trade.

This boom has continued into 2011, with new orders increasing 32% and production rising 17.5% in Q1. The machine tool sector has recorded a remarkable 45% increase in sales with new orders rising 130% (see chart below) and average capacity utilisation of 90%.

German Machine Tool Industry
Three-digit order growth in first quarter 2011

VDW



Source: VDW, VDMA

Overall, profit margins in the mechanical engineering sector are improving or stable and the healthy order backlog is likely to lead to increased profitability in 2011. While commodities such as steel, copper, aluminium and energy are of importance to some engineering subsectors, which are therefore affected by rising prices, many businesses are able to pass on the price increases and thus avoid pressure on margins.

General equity strength ranges from average to good, depending on the shareholder profile: within the machinery sector many companies have private equity backing. However, some smaller businesses still suffer from lower equity ratios. Solvability and liquidity also range from average to good, as most companies secured or adapted their financial structure during the economic downturn to safeguard their liquidity.

Nevertheless, we have seen some problems in the print machinery sector, which is dominated by three large players and has been the subject of many rumours about possible mergers. While, within this sector, the sheet-fed business has recovered, web-fed business is still some way away from a comprehensive rebound, as are some important buyer sectors, such as advertising print.



On average, payments in the machinery and metals industries take 50 days, and we have seen a decrease in payment delays in the last couple of months. With generally better liquidity, business payment times have reduced by around five days on average and we expect further improvement in payment behaviour during the rest of the year. Compared to other German industries, the machinery sector's average default/insolvency rate is good, and the situation will remain stable throughout 2011.

Investment and world class technology guarantee further growth

In 2011 the VDMA expects mechanical engineering production to grow by 14% year-on-year, following the successful first quarter, as domestic demand remains robust thanks to the rising - and necessary - business investment in German growth industries and continuing strong foreign demand. Despite its heavy dependence on global economic developments and on major sectors such as automotive (which has proved as a structural weakness in the 2009 downturn), we believe that German mechanical engineering is well prepared to face the challenges that lie ahead. In the increasingly important areas like energy efficiency and climate, German mechanical engineering technology is among the world leaders. Therefore our underwriting policy remains relaxed, with our main focus on each company's income from orders, capacity utilization and financial structure.

German mechanical engineering sector

Strengths	Weaknesses
• Innovation/High R&D • World export leader • Strong order backlogs	• High dependency on the global economy • Long payment periods (on average 50 days) • High Investments for innovations



Strong recovery despite ongoing problems in the steel trading subsector

In 2010 the German steel industry recovered strongly from its slump of the previous year. Turnover increased by 24%, and production of raw steel was around 34% higher than in 2009. According to the World Steel Association, German crude steel production increased 2.6% year-on-year between January and April 2011 and further growth is expected in the second quarter. Orders improved significantly in 2010 in all major customer segments and this trend has continued into early 2011.

Despite the upswing, there are still problems in the steel trading subsector, which supplies the automotive industry. This subsector has traditionally been very competitive, and positioned as it is between steel producers and car industry buyers there is considerable pressure on margins. During the economic crisis many steel traders saw their businesses deteriorate, although some, especially vital specialist traders, were aided financially by their automotive sector buyers. While the overall business situation has improved since then, this subsector is again having troubles – this time in passing on the increased commodity prices that they have to pay to steel producers. As a result, this subsector remains riskier than others – especially for non-specialised businesses.

Overall, profit margins in the steel sector improved markedly in 2010, apart from those of producers of construction-related steel products. And, as mentioned above, profit margins are still problematic for many steel traders serving the automotive industry. The general equity strength of steel producing companies/groups is good and average to good for steel trading companies. For most, solvability and liquidity improved in 2010, partly because of a marked reduction in working capital needs.

German steel: production and export ratio



*) WZ-Nr. 24.10 + 24.20: Erzeugung von Roheisen, Stahl u. Ferrolegierungen + Herstellung von Stahlrohren u. Rohrstücken aus Stahl
Quelle: Stat. Bundesamt u. eigene Berechnungen

Source: German Steel Federation



Turnover in the metals industry increased significantly in 2010, thanks to higher prices (mainly copper and aluminium) and an increase in orders - a development that has continued into early 2011. Orders from automotive and mechanical engineering in particular have increased, leading to an improvement in profit margins. The general equity strength of copper and aluminium producers is strong, while only average for trading companies. As in the steel sector, the general solvency and liquidity situation improved in 2010, helped partly by a reduction in working capital needs.

We have seen no change in payment behaviour in the last couple of months, with payments in the steel and metals industry taking, on average, between 30 and 45 days. There has been a fall in the number of non-payments notified to us in the last six months and we expect a further reduction in payment delays throughout the rest of 2011. On average (compared to other German industries) the steel/metals sector's default/insolvency rate is good and will remain unchanged in the short term. However, as explained above, those steel/metals trading companies supplying the automotive sector are considered to be a higher risk.

Strong domestic investment drives further growth

In April, the German Steel Federation revised upward its forecast from that of late 2010: it now expects crude steel production to grow 4% year-on-year in 2011 and order inflow to continue. Capacity utilisation is high, at 90%: 10% higher than the world average.

Most of those operating in the steel and metal sectors expect the upward trend to continue, with increasing production and turnover volumes, although not at the same pace as in 2010. This expectation is contingent on investments remaining a major pillar of the German economic rebound, and on continued high demand from the automotive and machinery/mechanical engineering industries.

The sector will also benefit from the pipe and wind energy industries, which has huge pending production volumes that were postponed during the economic crisis. Demand from German construction industry is expected to remain stable.

Despite this positive outlook, downside risks remain, as the sharp increases in prices for iron ore, coke, scrap and energy have a major impact on the steel/metals industry, and further price increases, especially for iron ore and coke, are expected. Competition with Chinese companies remains fierce, especially as those businesses face overcapacity in their domestic market and are therefore focusing on overseas sales. We expect the ongoing consolidation process in the weaker steel and metal trading subsectors to continue.



In general, our underwriting policy remains relaxed, but we are paying particular attention to operating results, liquidity and financing. However, we are more cautious about steel trading and steel processing companies (forging and pressing of metals/metal casting) supplying the automotive industry. Buyers from construction related subsectors, such as the manufacture of metal structures, carpentry and joinery of metals, are also monitored more closely.

German steel/metals sector

Strengths	Weaknesses
• Highly specialised steel producers • High entry barriers for steel producers • Largest steel/metal traders are financially sound	• High dependency on automotive and mechanical engineering • Ongoing consolidation process in steel/metals distribution industry • Strong international competition, especially from China



The recovery gains momentum

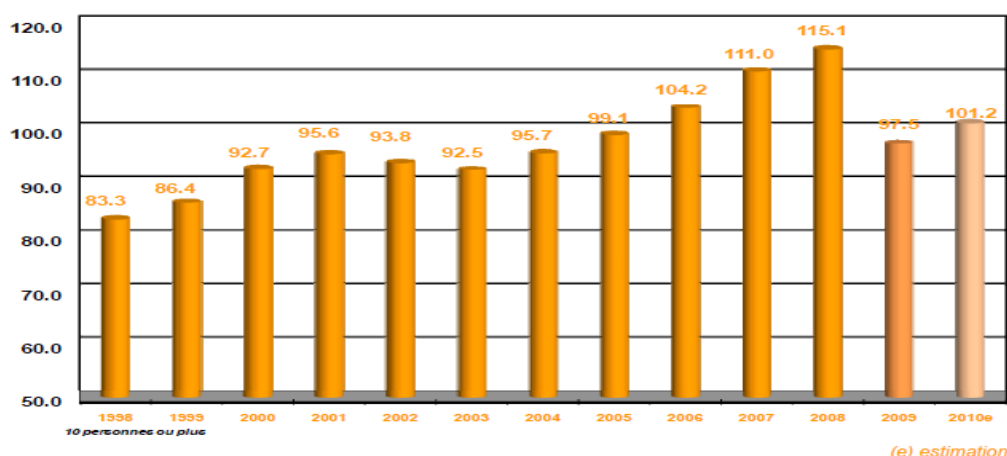
The French mechanical engineering industry suffered heavily in 2009, with orders and sales declining steeply throughout the year and into 2010. This decline can be largely attributed to French companies cutting back on investment because of the economic crisis: overall French industrial investments decreased by 25% in 2009.

According to the French Mechanical Engineering Federation FIM, the mechanical engineering sector recorded a decrease in turnover of 17% in 2009. Businesses in the lifting and handling equipment and construction equipment subsectors recorded declines of between 25% and 55%, while other specific equipment subsectors suffered a 25% decline. The situation was slightly better for the farm equipment sector, where turnover decreased by a still significant 12%.

2010 saw only a modest rebound, as French domestic investment shrank again (down 2%). However, French mechanical engineering turnover increased 4% last year, thanks mainly to demand from the automotive sector and also from aerospace, rail transport and the nuclear energy sectors. Sales in the machinery segment increased just 2.2%, mainly due to exports. In other subsectors, 2010 results were quite disparate: in lifting and handling equipment, turnover increased by between 15% and 30%; in construction equipment, between 5% and 30%, and farm equipment saw a dip of 7%.

Even though the rebound seems significant in some subsectors, the level of activity did not compensate for the 2009 losses. Moreover, in 2010, France was still suffering from production overcapacity and this acted as a deterrent to investment.

French mechanical engineering: total invoicing (in billion Euros)



Source: FIM



In 2011 orders in hand have increased and, according to FIM, production will grow by 5%. Several mechanical engineering segments should benefit from an upturn of investment in particular industries:

- Farm equipment: farmers' capacity for investment should increase as their revenues rise, thanks to commodity price increases (e.g. for cereals)
- After two very difficult years, lifting, handling and truck markets are turning around
- There are also indicators of increasing investment in the chemical and pharmaceutical sectors
- Recovery is apparent in construction equipment, thanks to the renewal of equipment by rental companies.

Overall, in 2011 the mechanical engineering industry will benefit from the continued recovery of investments in the aircraft, industrial, farming and construction sectors. Producers of specialised equipment are also profiting from emerging markets demand, especially from China.

At present, in general the profit margins of mechanical engineering businesses are quite tight as a result of the huge decrease in volumes in 2009. In addition, higher raw material costs - especially steel prices - saw margins squeezed in 2010 and the ongoing commodity price volatility continues to create some uncertainty. Nevertheless, some companies have quite comfortable margins, especially producers of high technology goods, where the level of technology rather than price is the key factor.

Improvement in payment behaviour

The mechanical engineering sector is capital intensive and thus its financing needs are high. Consequently, businesses in this sector can incur large debts that weaken their financial structure and overall solvency. In addition, with lengthy production cycles, liquidity may be under stress from high working capital requirements. However, in many cases companies benefit from payments in advance that alleviate their cash situation.

On average, payments in the mechanical engineering industry take between 60 and 110 days (although the longer payment terms may follow advanced payments). Payment behaviour has remained unchanged in the last six months and we have seen a decrease in the number of non-payments notified in that period. With a more optimistic business outlook, we expect payment delays to decrease further during the rest of the year. That goes for insolvencies in this sector too, which are on a par with other French industries. However, the lifting and handling subsector was hit harder than others by the downturn, and therefore companies in this subsector still have a higher risk profile.

Taking into account the 2011 recovery in most subsectors, our underwriting policy will be more relaxed. However, we are still cautious about companies in the lifting or handling subsector.



When underwriting mechanical engineering businesses, the first element we analyse is the customer portfolio profile, which should indicate the trend in orders and sales for 2011. Export share is also a key point to consider. We pay careful attention to the ability of each buyer to finance working capital requirements as these will increase along with a rise in orders and sales.

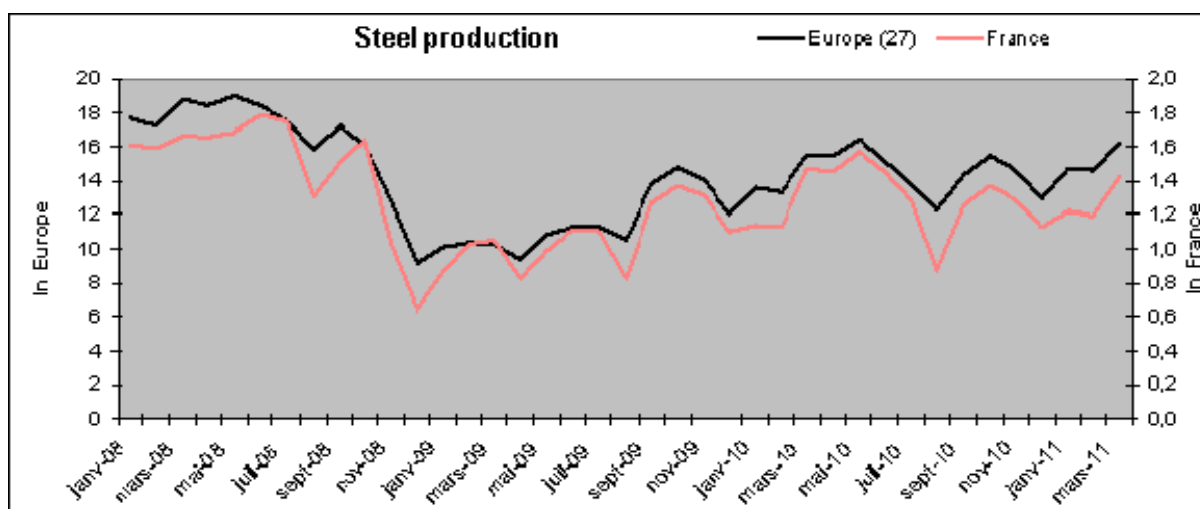
French mechanical engineering sector

Strengths	Weaknesses
• Technical knowledge • Good worldwide position (France is the 6th largest world player) • Leadership position on some key products • Diversity of outlets	• Low domestic demand • High financial needs • Competition from emerging markets • Dependency on export markets • Threat on competitiveness due to Euro/US\$ parity



Steel producers: good performance and financially strong

The fortunes of French steel producers have improved greatly since the end of 2009, especially for large global players who have benefited from the increase in steel prices and the improved economic environment in 2010. According to the World Steel Association French steel production increased 20% year-on-year in 2010, although this was still 14% down on 2008 levels. The improving trend mirrors that of overall European steel production and is mainly the result of an increase in demand from key buyers, especially in the automotive sector.



Millions of tons

Source: Eurofer

After a slight slowdown at the end of 2010, production in Q1 of 2011 increased again: by 3% on the previous quarter, according to the French Steel Association (Acier). Orders in hand are relatively good, with the expectation of renewed global demand, especially relating to trucks, aircraft, industrial and agricultural equipment, and residential construction. The higher capacity utilization forecast by main producers has confirmed this trend, with steel shipments expected to increase in 2011, albeit at a lower level than in 2010.

Profit margins are also heading in the right direction, thanks to the increase in steel prices. Indeed, an increase in average steel selling prices is expected to more than offset this year's cost increases. Against this favourable backdrop, steel producers, already benefiting from ample equity and a strong financial structure, will further consolidate their - already comfortable - financial position.



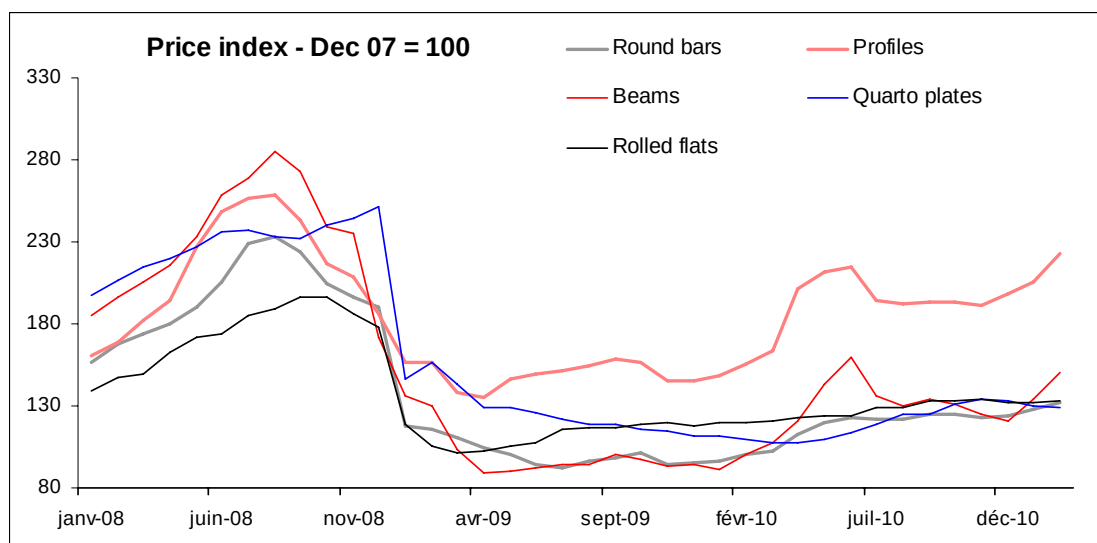
Wholesale of metals and metal ores has also profited from the rebound

Small and large wholesalers alike have benefited from the increase in steel prices and the economic recovery of 2010. They deal with two main categories of product:

- Flat products - dedicated to the automotive, construction, aircraft and industrial equipments sectors, and
- Long products - dedicated to the construction, boiling, piping, and rail industries.

After a difficult 2009, with sales volumes decreasing roughly 25%, 2010 was slightly better, according to Acier. Sales were up 6%, driven primarily by a rise in flat product sales (11%) due to the recovery of the automotive sector. With a sluggish recovery in the French construction sector in 2010, long product sales increased just 3%.

In 2011, orders in hand are adequate but any further increase will be only moderate. Indeed, after the massive increase in demand from the automotive sector, we estimate that demand will not rise above 5% this year. The construction sector, representing around 33% of the wholesalers' outlets in France, is still slow - mostly in the non-residential segment. In term of profitability, the increase in prices (see chart below) improved wholesalers' profit in 2010 and this bodes well for 2011.



Source: Word Steel Organisation

The financial strength of wholesalers varies according to size, and structural financing needs are closely related to working capital requirements. A key issue in this sector is the management of those requirements, which increase relative to raw material prices. Major players usually have the advantage of a strong financial structure and adequate financing to cover rising working capital needs while, for smaller companies, short-term financing opportunities can be limited and liquidity strained.



Metal manufacturing: structural deficiencies

This subsector is experiencing more distress and pressure on margins: on one hand, because of commodity price increases and, on the other, with pressure for price cuts from their large customers. This sector's main activities are casting, stamping, forging and cutting, mostly for the automotive and aerospace sectors which represent around 50% of their customer base.

A common factor of these capital-intensive subsectors is their need for funding. This is required to finance not just the high level of investment needed to improve productivity and competitiveness and to retain key customers who have developed new plants in emerging markets, but also for R&D to satisfy the demands of customers producing technically advanced, added value products. Funding is also vital to restructure ageing plants in established markets struggling with overcapacity and to repay high long-term debt. However, sources of finance are limited, due to a lack of profitability and difficulties in obtaining new long-term backing from shareholders and/or banks.

Consequently, the profit margins of many companies in this sector are tight, with large debts weakening their financial structure and solvency. In addition, liquidity is under stress due to significant working capital requirements and high stock levels.

After a major dip in sales in 2009, of between 25% and 30%, metal manufacturing industries recovered with an average sales increase ranging from 5% to 15% in 2010, depending on the subsector. Nevertheless, activity is still some way below pre-crisis levels and orders in hand are quite low. At best, there will be only a slight increase in sales - below 5% - with sales to the automotive sector remaining to level off.

In view of the weaknesses in the metal manufacturing sector in France, it is no surprise that the economic crisis triggered some structural changes, such as a trend of consolidation, in subsectors such as stamping and casting. The main reason is production overcapacity: the result of a dependency on the automotive sector. Thus, consolidation has been necessary to achieve cost synergies and purchasing efficiency, and to strengthen financing capacity.

At the same time large automotive producers and the French government have created a financial fund (FMEA) to bring new money to some key metal manufacturers that suffered during the crisis.

More insolvencies in metal manufacturing

On average, payments in the French steel/metals industries take 60 days, and we expect payment delays to decrease in the coming months. Compared to other French industries, the steel/metal sector's average default/insolvency rate is very good for mining and quarrying, and for iron and steel production, average for wholesale metals and metal ores, but worse for metal manufacturing.



Several bankruptcies occurred in the metal structures and parts manufacturing subsector in Q1 of 2011. Small and medium-sized companies dependent on the construction sector (mainly non-residential property), and which suffered in 2009 and 2010, entered a price war to attract new business, with the result that, even if they won that business, the increase in raw material costs meant that they could not reach break-even, nor cover their working capital requirements.

Therefore, our underwriting approach to metal manufacturing companies is understandably very cautious. In particular, we scrutinise the sectors that represent the main outlets for the company, comparing their debts and short-term debt share to their cash flow and also their short-term debts to sales levels. We also monitor the capacity of companies to find new export channels and the potential outcomes of any mergers and consolidations in progress.

We are more relaxed when underwriting steel wholesalers, but still remain cautious in some instances, again focusing on the main buyer sectors of companies and their stock levels. Steel producers tend to have the strongest finances in the sector.

French steel producing subsector

Strengths	Weaknesses
• Global players • Strong financial structure	• Price volatility • Global competition • Dependency on construction and automotive performance

French steel/metals wholesalers subsector

Strengths	Weaknesses
• Benefit from steel price increase • Flexible cost structure	• Price volatility • Dependency on construction and automotive sectors • High needs for short-term financing

French metal manufacturing subsector

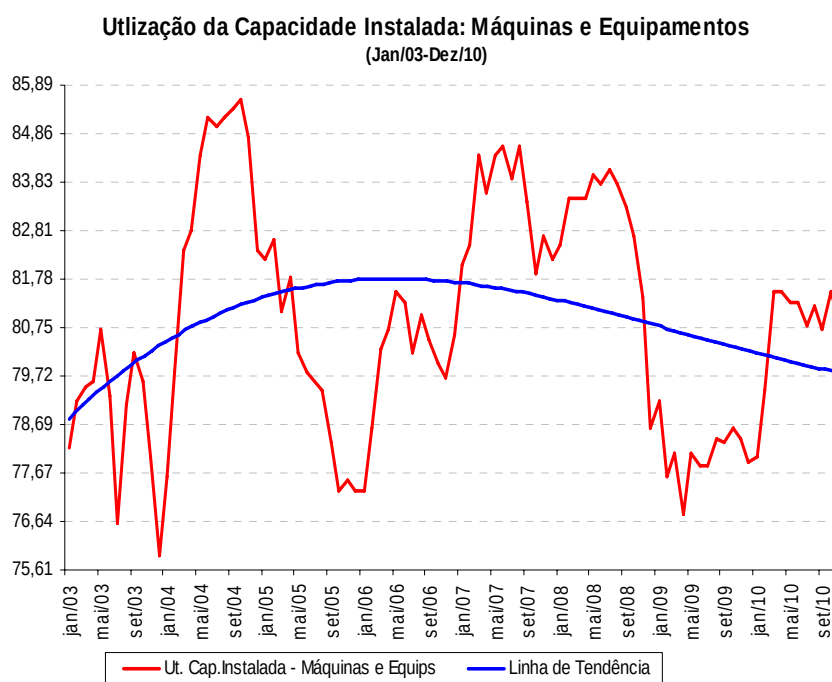
Strengths	Weaknesses
• Technical knowledge • Historical and strong partnership with big customers. • A key sector in term of employment (potential French state support)	• Production overcapacity in some segments • Lack of productivity • High restructuring and investment needs



Growth driven by domestic demand

In 2010 the Brazilian economy recorded GDP growth of 7.5%. The unemployment rate decreased from 8.1% in 2009 to 6.8% in 2010, which, together with rising average incomes and better availability of bank finance, has led to higher domestic consumption. The mechanical engineering sector has benefited greatly from the investment in capital goods made by other industries to meet growing domestic demand (industrial production increased 10.7% year-on-year in 2010), as a result of which orders are increasing and companies in this sector are profitable and financially strong. The growing demand for Brazilian commodities such as cellulose and iron ore has also proved a boost to mechanical engineering, creating demand for technologically advanced extraction machinery. According to the research firm Lafis, sector turnover increased by 10.3% to R\$ 70.7 billion in 2010.

Capital Goods: Capacity Utilization Rate (Jan. 2003 – Dec. 2010)



Source: Lafis

Payment behaviour in the Brazilian mechanical engineering sector is good, and we expect this positive trend to continue for the foreseeable future. The same is true of the sector's default/insolvency rate.

According to Lafis, mechanical engineering's turnover will grow 6.7% in 2011 and 7.1% in 2012, to R\$ 75.4 billion and R\$ 80.8 billion respectively. This forecast takes into account expectations of a continued global rebound, robust domestic growth rates and higher investment in infrastructure in preparation for the World Cup in 2014 and Olympic Games in 2016. Domestically, the expectations for 2011 are that economic expansion will continue, driven by further growth in average income and improvements in the level of employment. However, it is important to note that macro-prudential policies (to safeguard against banking activity that may create financial instability), together



with the new cycle of monetary tightening promoted by the government, will cool output in 2011 to a still robust 4.4% growth rate.

Our underwriting approach remains relaxed, in view of the good prospects for the sector. Order levels and liquidity will not be a concern in the coming months. Important factors to take into account when analyzing a company in this sector are the evolution of the company's sales and profitability, financial strength and access to credit to support the large investments needed.

Some downside risks remain

The sector is very sensitive to the central bank's interest rate and current monetary policy orientation designed to contain inflation. Rising interest rates may affect companies' financing costs and the credit lines used to buy machinery and equipment. The central bank's benchmark interest rate (Selic) rose from 10.75% in 2010 to 12% in April 2011.

Exchange rate fluctuations have a major impact on this sector, as high volatility in the Brazilian currency makes it difficult to plan for future investments. An appreciation of the Real may favour machine imports, especially of high tech goods and equipment, while at the same time decrease foreign demand for consequently more expensive Brazilian machinery: both scenarios potentially damaging the performance of the domestic mechanical engineering sector. The Real has appreciated against the US\$ in the last couple of months due to Brazil's strong economic performance and the US's monetary policy of quantitative easing. A projected slight Real devaluation may therefore favour the sector.

If the recovery of the world economy stalls, causing stagnation of global demand, the national industry would be forced to take smaller steps, and this may prevent investments and future projects.

Brazilian mechanical engineering sector

Strengths	Weaknesses
• Strong market position in Latin America • Investments in the innovation of technological trends for bio fuels: leading position in the production of machines and equipment for this segment • High-end specialized standard production in combination with specific production processes. The sector fosters the productive process of all other industrial segments	• Exchange rate volatility • Competitiveness remains underdeveloped with a lack of incentives to boost the sector's further advance (R&D) • Strong competition from developed countries (high tech products) and China (price levels) • The capital goods sector performance is very sensitive to credit conditions due to the long financing periods



Robust growth from strong domestic demand

The Brazilian steel industry continues to perform well, thanks to robust demand from its main buyer industries. In Q1 of 2011, crude steel production increased 6.2% year-on-year, to 8.4 million tons. Exports reached US\$ 51.23 billion - up 30.6% on the same period in 2010 - reflecting the more consistent recovery in the global economy. Some countries, including the United States and China, have increased demand to meet the needs of their infrastructure and construction projects, while Japan at present has to import steel to compensate for the disruption of its domestic production. Imports reached US\$ 48.06 billion in Q1, compared to US\$ 38.35 billion in the same period last year, with the appreciation of the Real contributing significantly to this increase. Although some steps have been taken to restrict imports, the exchange rate and world steel surplus keep steel imports rising. However, despite this growth in imports, Brazil's trade surplus has increased.

Brazilian production of flat steel bars fell 0.7% year-on-year in Q1, to 3.76 million tons. However, March saw a 2.7% rise, triggered by increased demand for white goods and automobiles. Domestic sales of flat steel increased 2.4% in Q1, to 2.9 million tons, while exports of flat steel bars increased 14.2%. Production of long steel bars also rose 6.1%, to 2.6 million tons, with domestic sales up 10.5%: an indication of the positive trend in the Brazilian construction sector, which is Brazil's biggest consumer of long steel products.

Thanks to current high demand, domestic steel producers are now able to pass on raw materials price increases – something that was not possible last year – and this has led to improved profit margins. In general, steel companies have a good profile of equity strength. With the positive trend and continuing high demand in the steel trade sector, most companies have healthy order books and liquidity.

Payment behaviour in the steel sector is good and we expect this to continue for the foreseeable future. Throughout all subsectors the insolvency ratio is lower than in other industries. There is little prospect of major default in the industry thanks to the high level of domestic demand and the major infrastructure projects that are underway (World Cup and Olympic Games). Therefore order levels and liquidity are not a concern at present.

Currency appreciation remains a downside risk

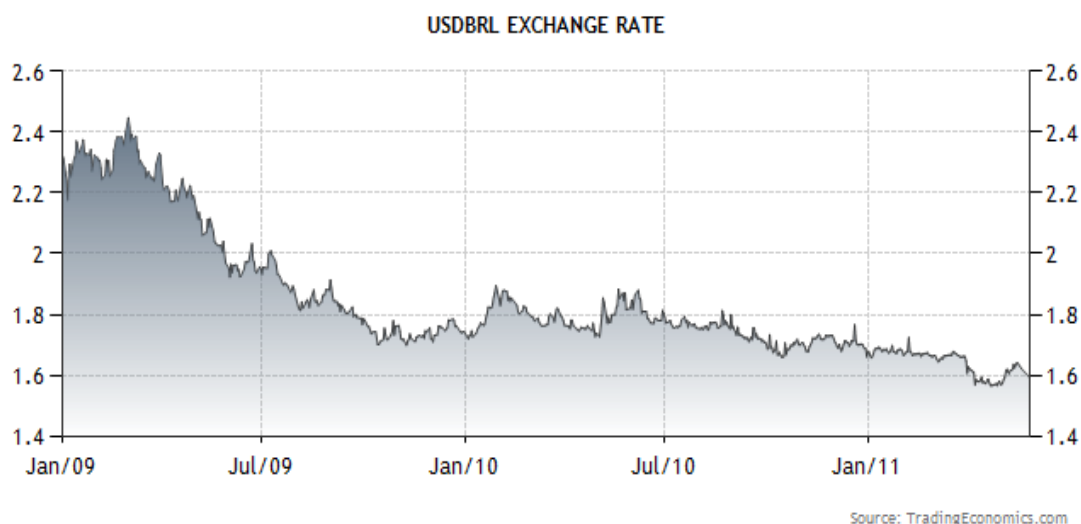
2011 economic growth forecasts for Brazil remain positive, although, at 4.4%, the pace of growth will be lower than in 2010. However, as mentioned, domestic consumption and major infrastructure projects promise a positive outlook for the steel sector. Production of crude steel is projected to increase by 13.1% year-on-year, to around 37.2 million tons, mainly as a result of the investment in those infrastructure projects and the upward trend in the automobile industry. It is estimated that Brazil's total steel sales will be around R\$ 71.8 billion: a 12.6% increase.



Sales of flat steel products are forecast to increase by 5.8%, to around R\$ 38.4 billion, thanks again to the demand for steel products for the automobile industry and white goods (household appliances). Long steel sales volumes are estimated to grow 34.1%, to R\$ 31.0 billion, due to the good prospects in the construction sector. Crude steel exports will increase 16.4% in 2011.

However, despite the optimistic outlook there are some downside risks:

Despite its good performance, the Brazilian steel industry is beginning to suffer from the Real appreciation against the US\$, with some Brazilian steel consumers turning to cheaper imports - mainly from China, India and Russia. If this continues, some Brazilian steelmakers will see a rise in their inventory levels which they will then have to sell at below cost price, with an impact on their income and profit margins.



The Brazilian Real exchange rate (USDBRL) depreciated 12.24% during the last 12 months. The Brazilian Real spot exchange rate specifies how much one currency, the USD, is currently worth in terms of the other, the BRL.

Source: TradingEconomics.com

Increases in interest rates by the central bank could cool down demand from some industries such as automotive or construction. The requirement for environmental certification means that steelmaking processes must be adapted, adding to their costs.

Because of the healthy state of the steel sector, our current underwriting approach is positive. However, we are monitoring the industry closely, to evaluate the effects of the forecast economic slowdown and the reduction in credit financing. When analysing a company's stability and credit worthiness, our focus is on the evolution of sales and margins/profits, and to ensure that increasing raw material prices won't have an impact on the company's profitability, stock levels and financial strength.



Brazilian steel/metals sector

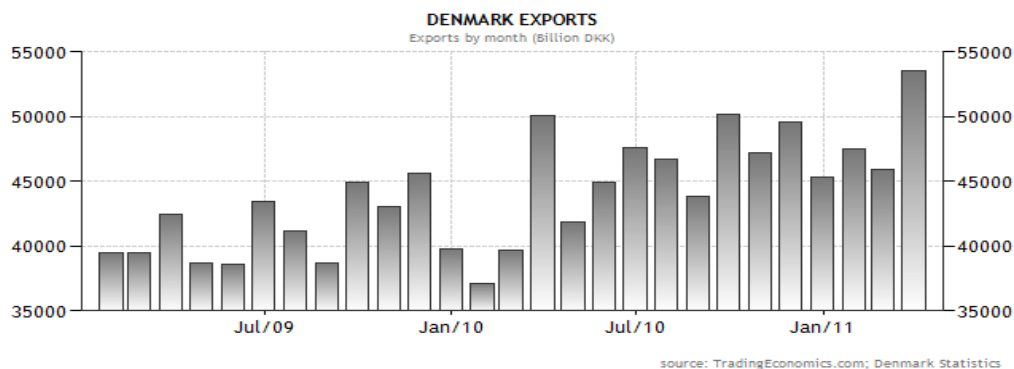
Strengths	Weaknesses
• Largest steel producer in Latin America and the 9th largest in the world ranking • The production chain, with mining companies incorporated into the steel mills to diversify production and guard against the prices fluctuations of iron ore • Large iron ore reserves • Production of goods with higher added value by the national steel industry	• Too dependent on the domestic market • Increasing domestic competition from substitute materials such as aluminium



Recovery after the crisis, but high risks remain

During the economic crisis, overall turnover in the Danish metals and machines industries declined substantially, by 31% at the end of 2010 compared to its peak in mid 2008, as demand in the domestic market - and from international customers in the agricultural, food processing and automotive sectors - deteriorated. Employment has shrunk by approximately 20% since 2008, according to the Dansk Industri/Metal og Maskinindustrien.

While domestic demand has not yet recovered from the crisis, the rebound of exports has gained momentum since the second half of 2010, due mainly to increased demand from Germany and Sweden. The Danish metal and machine industries are highly export-oriented, with 60% of turnover generated in foreign markets, and emerging market destinations such as China and India growing in importance.



In recent years the risk profile in this sector has been high, especially for those companies dependent on just a few end-customers in troubled industries, or for businesses with uneven turnover who are nevertheless burdened with capital intensive production. Manufacturers and sellers of agricultural machinery and parts are particularly high risk, as investment by agro/farmland customers is still low due to lack of finance or high indebtedness. In contrast, suppliers to, or manufacturers of, wind turbines and related products (accounting for approximately 20% of the whole industry's turnover) have weathered the crisis relatively well, mainly because they have benefitted from a healthy order book, although orders taken in 2010 were down on previous years. One segment that has suffered from weak order books in the last two years, but which can now be more optimistic, is that of manufacturers of specialized and tailor-made processing equipment/solutions for the global food industry.

The turnover for wholesalers of metals, including metal scrap, has improved, with increased demand from foundries and ultimately from large industrial customers including the automotive industry. The recovery of raw material prices has benefitted wholesalers but domestically oriented companies were still unable to generate profits in 2010. The productivity of steel yards, foundries, scrap processing etc. is under pressure from high energy costs, increased prices for raw materials and substantial competition from Asia, especially China.



On average, payments in the machinery and metals industries take 90 days. While payment delays increased in 2010, this has normalised in the last six months. Although large manufacturers, with a global reach, managed a very strong turnaround in 2010, low capacity utilisation and weaker orders, especially from Danish customers, means that there is still a substantial insolvency risk for small and medium-sized manufacturers focused on the domestic market. We expect metals and machinery insolvencies to level off year-on-year in 2011, and for all Danish industries we expect a 10% decrease this year after increases of 13% in 2010 and as much as 54% in 2009.

Growth opportunities for the energy efficiency subsector

The general outlook for metals and machinery has improved. After years of cost reductions, reduced activities and 'red' figures, the 2010 accounts reveal increasing or stable top-lines and a general improvement in profitability. As a result, we have relaxed our underwriting stance after its tightening in 2008-2010. A recent survey of members of the Danish metal and machine industry (Jern og Maskinindustrien, May 2011) revealed that 60% of those members expect a positive turnover development in 2011, while 20% expect turnover to level off year-on-year, and 20% forecast deterioration of revenues.

The main issues for 2011 will be the low capacity utilisation and weak domestic order inflow (e.g. from the construction and agriculture sectors) and a dependency on a rebound of Denmark's main export markets. Companies in the climate/energy efficiency subsector have by far the best growth opportunities. For instance, suppliers to the wind turbine industry may still have very good growth potential if they can follow the wind turbine manufacturers that they supply into global growth markets and cope with the increasing pressure on price and terms of delivery.

Danish steel/metals and machinery sector

Strengths	Weaknesses
• Very strong global foothold for the largest groups • Very strong support system in place for further internationalisation of the industry • Strong knowledge sharing e.g. via clusters	• Smaller companies: highly dependent on a few key customers • Many businesses are too small to cope with globalisation. Consolidation may be needed • Very high cost levels in Denmark (salaries, energy costs, etc.)



Most of the significant companies operating in this sector have a healthy financial profile, with strong average equity, solvency and liquidity. Profit margins are above the overall industry norm (1.55% in 2009). On average, payments in the machinery and equipment industry take 60 days. In the last six months we have also received fewer notifications of non-payment and seen a slight decrease in insolvencies. Compared to other Hungarian industries, the machinery sector's average default/insolvency rate is good. The percentage of companies in the sector going into liquidation was 2.2% in 2010, but has risen somewhat in the early months of 2011. One reason for this is insufficient regulation, as the Hungarian corporate bankruptcy law doesn't contain sufficient sanctions against a debtor company liquidating without paying all its debts.

The industry will continue to profit from strong German demand

Overall the good performance of the machinery sector is expected to continue in the near future, as economic growth gains momentum in 2011 (the IMF forecasts 2.8% growth). This will continue to be driven by foreign demand but domestic consumption and investments may also increase slightly. The ongoing resurgence of the German mechanical engineering sector in 2011 will no doubt stimulate demand for Hungarian machinery products.

However, there are challenges. Companies have to adopt new technologies and meet the ever-changing market requirements. According to some experts, the state doesn't support this sector sufficiently, although the New Széchenyi Plan – the government's strategy of support for small and medium sized companies, designed to stimulate the economy – may help.

On education, a shift has started to the German-style dual vocational training system. As a consequence, companies in the mechanical engineering sector and other key industries, such as automotive, will have access to skilled Hungarian workers without bearing the expense of training them for the job.

Our underwriting approach is relaxed because mechanical engineering is considered a less risky sector with a below average liquidation rate. The financial and business structure of a company is one significant factor that we consider; often a company can be assessed not only on a stand-alone basis but also as a group member.

Hungarian mechanical engineering sector

Strengths	Weaknesses
• Good geographical location /developed infrastructure • Lower operational expenditures (e.g. labour costs) compared to most EU members • Machinery is considered as a less risky sector with a below average liquidation rate • Less exposed to fraud as it doesn't involve anonymous or easily moveable goods	• Strong dependence on foreign demand • Volatility of Hungarian currency (forint) can be a risk factor • Insufficient level of vocational training • Due to the low added value of production in Hungary; production can be shifted to Asian countries with lower cost levels (e.g. India or China) • Due to continuous investments the gearing can be relatively high; narrowing bank facilities can affect liquidation problems



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