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PANORAMA

STILL TOUGH TIMES FOR SOUTH AFRICA?

December 2016

COFACE ECONOMIC PUBLICATIONS

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South Africa's growth performance has been in decline since the global financial crisis. Since peaking in 2011, the growth rate (hit by lower commodity prices and power supply problems) has continued to slow. Although heavy droughts weighed on agriculture in 2015, service activities (such as finance and retail) were dynamic.

Is this situation likely to continue? After shrinking by 0.1% in the first quarter of 2016 compared to a year earlier, gross domestic product only expanded by 0.6% in the second quarter. Growth was mainly dragged down by agriculture and mining. Over the upcoming period, South Africa's links with China, volatility in the global financial markets, domestic politics and skittish investor-confidence

are all factors that could continue to burden the country's economic performance.

How will the country face these challenges? South Africa does have a number of strong points on its side, notably being the African continent's second-largest economy. It also benefits from a highly diversified economy and is considered one of the leading countries in terms of manufacturing output, despite competitiveness issues caused by high production costs. The country still has challenging times to navigate, as global growth will only experience a slight pick-up, while a significant rebound in commodity prices is not expected. Moreover, shocks could be amplified if the country loses its investment grade

rating. Although two of the three major ratings agencies retained South Africa's sovereign rating at investment grade level in late November (Moody's two steps above junk, at Baa2 and Fitch Ratings one step above, at BBB-), the situation remains risky, with continued economic challenges on the horizon. Coface forecasts that growth will show a weak recovery of 0.8% in 2017, after stagnating at zero growth in 2016.

This panorama will also focus on the automotive and agrofood sectors. Although risk levels are of some concern for these sectors, the automotive industry is continuing to attract major investments from large international players. The agrofood sector could still offer some export opportunities, particularly to the European market.

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STILL TOUGH TIMES FOR SOUTH AFRICA?



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“Political uncertainties, heavy drought and weak investment sentiment will weigh on the economic performance during 2017”

1 NO SIGN OF SOLID RECOVERY IN SOUTH AFRICA

Concerns about South Africa's economic performance have been intensifying, as the country has struggled to improve growth rates during the post-financial crisis era. After peaking in 2011, when GDP growth reached 3.3%, it slowed down to 1.3% in 2015 compared to a year earlier. Lower commodity prices and power supply problems hit the country's economic performance – as did heavy droughts that caused a drop of nearly 6% for the agricultural sector in 2015.

2016 did not get off to a good start. The economy contracted by 0.1% in the first quarter (compared to a year earlier) and was followed by a small recovery of 0.6% in the second quarter. An analysis of the seasonally adjusted quarterly data shows that growth has mainly been supported by the recovery in the agricultural and mining sectors, as well as dynamism observed in the service industries. Despite these positive developments, Coface expects GDP growth to edge up by just 0.8% in 2017, after stalling in 2016 due to the impact of serious droughts on agriculture, uncertainties over policy making, weak investor-sentiment and high inflation.

As regards the breakdown of national output, private consumption, which accounts for approximately 60% of GDP, will remain sluggish. Stagnation on the labour market, rising inflation (due to the weaker rand) and consequently lower purchasing power have dragged down consumer spending this year. This trend is expected to continue. The unemployment rate stood at 26.6% in the second quarter of 2016, equating to more than 5.6 million people out of work. Annual consumer inflation stood at 6% in July, a tick above the central bank's target range of 3-6% - a target which is only expected to be achieved during Q3 2017.

The government is struggling to reduce expenditure and spending is expected to rise, in terms of share of GDP. A budget deficit of 16.7 billion rand (\$1.2 billion) was recorded in August 2016, versus a deficit of 8.02 million for the same period a year earlier. For 2016, fiscal deficit stands at 3.4% of GDP – higher than the government's target of 3.2%. A key area for spending concerns state-

owned-enterprises, which form part of the government's strategy to diversify the economy. These institutions are often characterised by underperformance, low return on public investment and continued dependence on government support in the form of subsidies or explicit guarantees (equivalent to 6% of GDP in 2010¹). In the current environment of low growth, the reduction of these subsidies and guarantees would pose a challenge for the government. Consolidated budget expenditure spending is therefore expected to edge up to 33.3% of GDP during the 2017-2018 fiscal year, up from 33.1% for 2016-2017. The government plans to reduce the budget deficit from 3.4% this year, to 3.1% for the 2017-2018 fiscal year, with a balanced fiscal consolidation mainly based on increased budget revenues. To achieve this, the government is proposing the introduction of tax policy measures that would increase tax revenues by 1.8% of GDP over the medium term². The second pillar of the budget policy is based on reducing the expenditure ceiling. Nevertheless, with weak economic growth and very limited improvement in budget revenues, there is a high risk that the government will miss its targets.

Despite these fiscal adjustments, the country's debt remains sizeable. The government projects that net national debt will stabilise at 46.2% of GDP for the 2017-2018 fiscal year and 47.9% for 2019-2020.

As government spending is financed by borrowing, government debt and borrowing costs have risen. This has created a crowding out effect on other social spending, such as education and healthcare. The government estimates that debt-service costs will rise from a revised 147.7 billion rand (\$10.5 billion) for the 2016-2017 fiscal year, to reach 163.6 billion rand next year and 180.8 billion rand for 2018-2019. Tepid growth performance, higher borrowing and the weaker currency could be obstacles to stabilising

¹ South Africa Policy Brief, July 2015, OECD

² Medium Term Budget Policy Statement, Oct. 2016, South Africa National Treasury

the country's debt. Although around 90% of this debt is denominated in local currency, non-residents hold approximately 35% of the government's rand-denominated debt. This could lead to increased financing costs if there is a deterioration in foreign investor-sentiment - or in the scenario of higher global interest rates and currency fluctuations³.

Another key challenge for South Africa's economy is the low level of capital investments.

Investment spending is equivalent to approximately 20% of GDP for 2016 - below that of some of its peer emerging countries, (44% in China, nearly 35% in Indonesia, 32% in India, 26% in Czech Republic and 23% in Mexico, according to IMF data). The capital investments needed to widen the economy's manufacturing base and maintain economic stability will remain subdued over the coming years, due to global financial uncertainties, tepid investor-sentiment and the lack of domestic savings. As at the end of March 2016, South Africa's official savings rate was only 15% of GDP, while household debt as a percentage of disposable income stood at 76.6%⁴. High unemployment, sizeable spending on private education, willingness to consume and rising inflation, are among the factors contributing to the low level of savings. As these issues are unlikely to be resolved in the immediate future, the achievement of higher investment rates or improved economic performance will remain difficult. The government estimates that the current account deficit (the difference between investments and savings) will stand at 3.9% of GDP in 2016, edging down to 3.8% of GDP by 2018.

Net exports, which contribute to around -1.5% of GDP, represent another challenge for growth performance.

Between January and August 2016, the cumulative trade balance surplus stood at 7.4 billion rand, compared to a deficit of 35.1 billion rand in 2015. Exports rose by 9% during the first nine months of 2016 compared to a year earlier. Nevertheless, this rise in exports does not necessarily imply a sustained improvement in the country's trade dynamics. The narrowing trade deficit is partially due to the weak rand and the increasing competitiveness of non-commodity exports. Although the rand has recovered more than 10% of its value against the dollar so far in 2016 (bolstered by the higher yield appetit of global investors), as it previously fell by 25% in 2015, it remains weak.

The slight recovery in commodity prices, during the first quarter of 2016, has helped the country to record higher value from its exports. According to the IMF, metal prices increased by 1.4% in August, to reach their highest level since July 2015. Slower growth in imports is mainly attributable to weaker domestic demand. Although the mining sector (including mineral products, precious metals and base metals) accounts for nearly half of total exports, they are still expected to remain low compared with pre-2014 levels, as commodity prices are not expected to rebound strongly.

Investors are also concerned by the country's rising political tensions - notably the increasingly contested legitimacy of President Zuma.

The President's decision, in December 2015, to replace Nhlanhla Nene as finance minister by an almost unknown parliamentarian (David Van Rooyen) before finally announcing the appointment of Pravin Gordhan (who had previously held the post from 2009 to 2014), surprised both investors and the South African business community. The population's dissatisfaction is also being fuelled by the country's weak economic performance, high unemployment and income inequality. Some political analysts believe that the ruling African National Congress (ANC) party could face even more infighting over the coming quarters, due to the sharp fall in popular support observed during the local elections of August 3. Although the ANC was able to obtain more than half of the votes, at 53.9%, this was the worst result achieved since the party took power.

The combination of these factors means that the risk of a sovereign downgrade is still on the table for South Africa. Moody's currently rates South Africa two notches above subinvestment grade, with a negative outlook, while Fitch and S&P have noted it at just a step above sub-investment level. Ratings agencies have already warned the country of possible downgrades, citing lower growth perspectives and increased political tensions.

Although two of the three major credit rating agencies (Moody's and Fitch) kept South Africa's sovereign rating unchanged at investment grade level in late November, the situation remains risky due to the continued economic challenges. Both agencies still have a negative outlook - which indicates that they may cut the country's rating over the coming months. Lower commodity prices (led by the slowdown in China) and normalisation of U.S. monetary policy are contributing to the economic slowdown and deteriorating the outlook for South Africa. The country's increasing debt, high current account deficit and heightened political tensions are accentuating the vulnerabilities that ratings agencies take into consideration when evaluating the sovereign credit rating. This situation could further fragilise growth dynamics, by provoking progressive outflows of the capital needed to finance domestic investments and reduce currency vulnerability.

The stability of the banking sector could also be called into question, even though South Africa's banking sector is one of the best regulated and well capitalised in the region. The slowdown in the economy is already creating some headwinds for banks, due to the slowdown in loan growth. Between the end of January and the end of August 2016, growth in loans to corporates dropped from 18.3% to 7.9%, while the default ratio of these loans only declined from 1.6% to 1%. Growth in retail loans was flat, at around 3.1%, during the same period⁵. Nevertheless, banks are well capitalised, with a total capital adequacy ratio of 15.5% as of September 2016 (compared to 14.23% in September 2015 and well above the Basel criteria of 8%). This indicates that banks appear to possess the adequate capital they would need to deal with

3 South Africa Ratings Affirmed; Outlook Remains Negative On Weak Growth, June 2016, S&P Global Ratings

4 National Savings Month kicks off on positive note, July 2015, SASI

5 Financial Stability Report, Second Edition, 2016, SARB

a downgrade to sub-investment grade. South Africa is still one of the most diversified economies in the region and this could be a support in the return to sustained growth, as this diversification drives productivity and added-value production.

Large manufacturing base with structural challenges

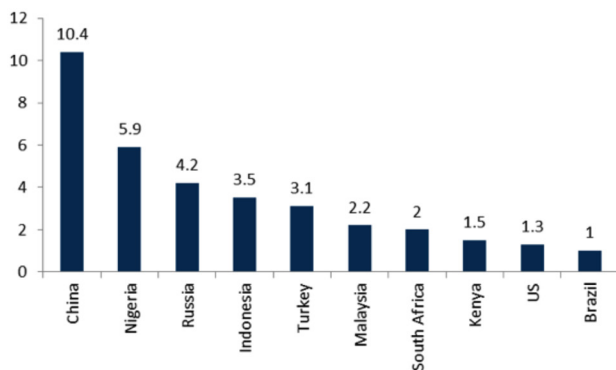
Although South Africa's economy is in a period of slow growth, it is still one of the region's leading countries in terms of industry. Manufacturing in South Africa is dominated by sectors such as the automotive industry, chemicals, mining, ICT & electronics and textiles & clothing. Although industry accounted for 28.7% of GDP in 2015, its weight has been declining since the 1990's, when the ratio was around 40%.

South Africa benefits from several advantages which help its economy to maintain its diversity. Firstly, it is close to Sub-Saharan Africa, a region which has one of the most dynamic growth performances in the world⁶. South Africa is therefore an attraction to investors targeting expansion into the rest of the continent. The country also provides access to the most important ports.

Another of the country's advantages is its integration into regional and continental trade and its effective open trade policy. As 75% of South Africa's manufacturing companies export to other African nations⁷, this provides important sources of revenues and dynamism for the corporate sector.

The importance of the mining sector has also allowed South Africa to develop a highly qualified human capital with engineering skills. Productivity in the overall economy remains higher than for some of South Africa's peers, although its pace of growth is sometimes slower. Between 2000 and 2012, real productivity per employee rose by 2% a year, compared to 3.1% in Turkey, 4.2% in Russia, 3.5% in Indonesia and 5.9% in Nigeria⁴.

Chart 1: Compound Average Growth Rate (CAGR) of real productivity between 2000-2012 (%)



Source: MCKinsey Global Institute

These advantages have helped to increase the production levels and exports of some of the country's high added value products. Between 2009 and 2015, the compound annual growth rate of chemical exports stood at 5.4%, machinery and equipment at 4.2%, fuels at 51% and plastics at 5.9%⁸.

The strength of the manufacturing sector is not enough to enable South Africa to attain sustainable growth momentum. In the wake of the global financial crisis, economic conditions around the globe have remained weak, compounded by uncertainties in international financial markets and geopolitical developments. The sluggish recovery of the European economy and the rebalancing of China into a more domestic demand-driven model, have also had significant negative impacts for commodity exporters such as South Africa. Lower commodity prices have hit domestic production and had a more generalised impact on South Africa's economy. In addition, the fall in Chinese demand has resulted in excess capacity in the steel sector, forcing producers to reduce prices and narrow their margins.

Weak conditions in domestic and global markets have weighed on the manufacturing sector. Simultaneously, rising production costs and infrastructure problems (mainly related to shortages in electricity supply, volatile fuel prices, toll costs, lack of qualified drivers and technicians) have hurt the country's competitiveness, as has the inflexibility of the labour market. In the World Economic Forum's 2015-1016 Global Competitiveness Report, South Africa was ranked 116th in terms of electricity supply and 107th in terms of labour market efficiency. Unit labour costs, per hour worked, rose by 5% in 2014 compared to a year earlier - only 7.8% below Russia, according to the OECD⁹. This is mainly due to the strong presence of labour unions. Wages are usually subject to highly complicated negotiations, while strikes are frequent, particularly in the mining and automotive sectors. This has a negative impact on exports and widens the current account deficit, disrupting output levels and hurting investor-confidence in the economy. Strict rules on job protection and wages are discouraging firms from hiring, which is contributing to high unemployment. According to a Department of Labour report quoted in the media¹⁰, the country recorded at least 88 labour strikes in 2014, which cost the economy around \$500 million. This difficult environment has led to a decline in fixed investments in the manufacturing sector, which in turn restrains future production capacities. The real annual change in fixed investments in the manufacturing sector showed a decline of 3% in 2014 and 0.2% in 2015.

8 World Bank World Integrated Trade Solutions

9 OECD (2016), Unit labour costs (indicator). doi:10.1787/37d9d925-en (Accessed on 11 October 2016)

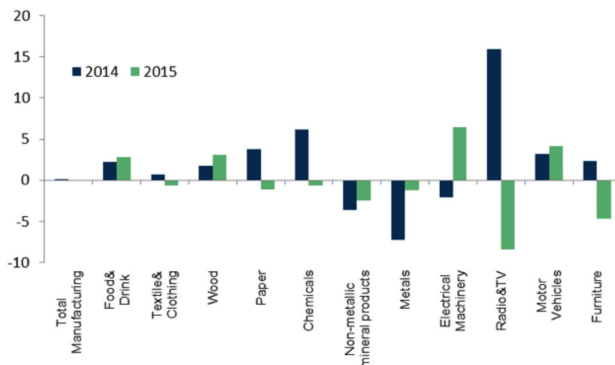
10 South Africa Labour Strikes Cost Economy \$500M Per Year As Nation Struggles With Slow Economic Growth, IBT, September 2015

6 South Africa's big five: Bold priorities for inclusive growth, 2015, McKinsey Global Institute

7 Africa gearing up, PwC

The manufacturing sector is also being negatively affected by volatility in exchange rates. According to South Africa's official statistics office, between January 2011 and January 2016, the rand depreciated by around 136% versus the dollar, while manufacturing production rose by a mere 3%¹¹. The sluggish recovery in Europe (which has accounted for 25% of South Africa's exports so far in 2016) and low domestic consumption have also weighed on the country's lacklustre manufacturing output.

Chart 2: Year-on-year change in volume of manufacturing production volume

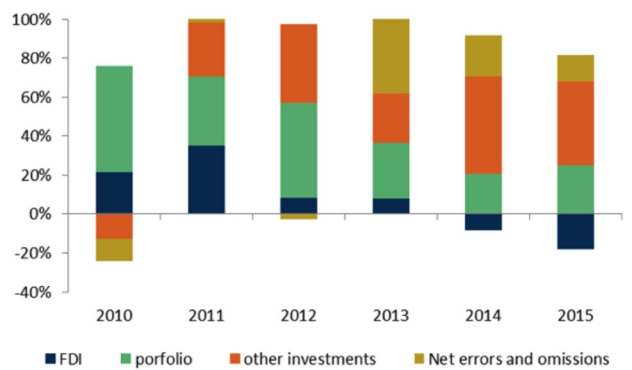


Source : Statistics South Africa

Greater uncertainty over the direction of government policy could also temper investor enthusiasm, limiting the economy's development potential. In October, the National Prosecuting Authority (NPA) announced that Finance Minister Pravin Gordhan and two other

former South African Revenue Service officials, Ivan Pillay and Oupa Magashule, will be prosecuted for fraud and were summonsed to appear in court on November 2¹². These developments have sharpened the volatility in exchange rates, as the rand lost around 4% versus the US dollar following the news announcement. This instability is also a factor in the financing of the current account deficit, mostly through short-term capital inflows. In 2015, portfolio investments and net errors and omissions accounted for 60.4% of external deficit financing, up from 50.2% in 2014. As short-term capital inflows are extremely sensitive to global risk aversion, this leaves the country vulnerable to the possibility of sudden shocks in global financial markets and narrows profit margins for industries.

Chart 3: Composition of net capital inflows to South Africa



Source: IMF Balance of Payment Statistics, Coface calculations

2 SECTOR RISK: HIGHER RISK PERSPECTIVES

This section focuses on the agrofood and automotive sectors. Agrofood makes an important contribution to South Africa's economy in terms of export revenues and employment. The automotive sector remains one of the key drivers for economic development due to its close links to many sectors, such as iron and steel, light metals and petrochemicals.

Sectorial Risk Assessment

Sector	Risk level	Sector	Risk level
Agrofood	Very high risk	Metals	Very high risk
Automotive	High risk	Paper-Wood	High risk
Chemicals	High risk	Pharmaceuticals	Medium risk
Construction	Very high risk	Retail	Medium risk
Energy	High risk	Textile-clothing	High risk
ICT	Medium risk	Transportation	High risk

● Moderate risk ● Medium risk ● High risk ● Very high risk

Agrofood: Unfavourable conditions

Agrofood is one of South Africa's largest manufacturing sectors, providing employment for around 30% of the working population¹³. The primary agricultural sector contributes to around 3% of GDP, but if the entire value chain is taken into account, its input is approximately 12%¹⁴. The agricultural sector accounts for around 10% of South Africa's total export earnings. The country has a well-developed commercial farming industry, with highly productive lands in deep rural areas. 12% of South Africa's land can be used for crop production and the country is self-sufficient for most major agricultural products. There is a wide range of output, thanks to the diversity of the country's climate and topography.

South Africa's agrofood sector is one of the most sophisticated in Sub-Saharan Africa. Agriculture has been flagged by the government as being a top priority in its New Growth Path, which aims to explore ways of addressing high input costs. This has contributed to bet-

11 South African manufacturing production and the rand (an update), September, 2016, Statistics South Africa

12 Politics is interfering with SA's economic reform, says US ambassador, Business Live, Oct. 12, 2016

13 South Africa agribusiness report, Q4 2016, BMI

14 South African Government

ter business conditions for the agrofood sector and its links, both upstream and downstream, with agriculture, wholesale and retail. The country's grocery retail sector is the largest, in terms of value, in Sub-Saharan Africa. In addition, large amounts have been invested into the Proudly South African campaign, which aims to encourage consumers to buy local goods and support sale volumes.

The country's well-established food market, which ensures a certain level of demand, remains an advantage for the agrofood sector. Rising per capita income, the evolution of consumption habits towards healthier products and the growing population are supporting the demand for agrofood products. This environment also brings great opportunities for companies to further expand in the market. In addition, the fact that South Africa has benefitted from duty-free access to the EU since 2009 provides an important advantage in terms of exports. This means that the gradual recovery in Europe will continue to support exports. Exports of vegetables from South Africa to Europe rose by 15.7% in 2015 compared to the previous year.

Despite these advantages, there are challenges to be addressed and Coface rates this sector at very high risk level. First and foremost, the deteriorating macroeconomic outlook and uncertainties surrounding economic policies are fragilising consumer sentiment and business confidence. The country's unreliable power supply, high unemployment and relatively subdued commodity prices are also weighing on growth performance. Furthermore, the weakness of the rand may well continue to undermine household purchasing power, pushing consumers to restrain their spending - including on higher-end food products. This could drag down the growth of food sales and narrow profit margins. Overall, the market value of the agrofood sector is expected to decline by 16% year-on-year in 2016, to \$17.5 billion, following on from the contraction of 8% in 2015 compared to the previous year.

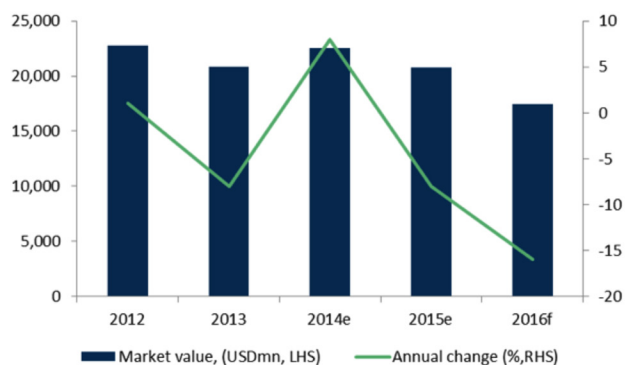
Conditions in the agrofood sector may continue on a negative trend. The ongoing drought could weigh heavily on agricultural production, increasing input costs and other operational costs, such as insurance. Underinvestment in some zones has created irrigation problems and an inability to adjust to weather conditions. This has also resulted in product losses and reduced margins for producers.

Another reason for higher costs is the weakening of the local currency against the dollar. The rand fell by almost 35% against the greenback in 2015, leading to higher import costs. At the same time, imports of machinery and electronics declined by 16% compared to a year earlier, thus restricting production capacities.

Moreover, the poor state of the country's rural infrastructure makes it difficult to reach non-urban consumers. This is preventing companies from earning additional revenues by getting rid of tough competition conditions of the urban zones. The lack of infrastructure also means higher costs for farmers when transporting their products - whether for domestic consumption or export. The lack of coordination between rural development

projects, along with excessive bureaucracy, also result in lower production and less generation of employment. The number of farmers in the country is declining and there is a migratory trend from rural areas to urban zones. This could represent a threat to agricultural production and to the further development of agricultural skills and expertise.

Chart 4: Market value of agrofood sector in South Africa



Source: BMI

Automotive: Government support crucial as macro outlook deteriorates

Automotive exports are a major force in South Africa's manufacturing sector and the overall economy. In 2015, exports of vehicles and transport equipment accounted for nearly 13% of total exports. Many of the large global car manufacturers have production facilities in the country for manufacturing components and assembling vehicles for local and international markets. In 2015, total vehicle production stood at 570,000 units and sales at 620,000 units (a decline of 4.1% from a year earlier¹⁵).

The automotive sector benefits from some important advantages. The first of these is that South Africa enjoys a strategic geographical position which allows producers to reach the rest of the continent. Moreover, the government supports the automotive sector through several programmes, such as its Vision 2020 strategy which aims to double local vehicle production by 2020. Automotive exporters are currently benefitting from the Automotive Production and Development Programme (APDP), which came into effect in 2013. The APDP also has the objective of encouraging local component production and includes duty-free credits¹⁶. In addition, it provides an investment allowance, which means that investors can receive a percentage of a project's value over a three-year period.

These supports have attracted multinational car producers into the South African automotive market. This year, German motor manufacturer Daimler announced that it intends to make South Africa a regional hub, as part of its strategy for the development of its global truck and

¹⁵ South Africa Autos report, Q4 2016, BMI

¹⁶ Automotive industry, CREAMER MEDIA'S TELECOMMUNICATIONS REPORT, 2015

bus divisions. The Volkswagen Group has announced it will invest more than 4.5 billion rand in South Africa by 2017, to produce new models. Other companies such as the BMW Group, Toyota Motor SA and the Ford Motor Company of SA have also declared their intentions to invest further and expand their production in the country.

South Africa offers car manufacturers the potential to increase their exports of vehicles and components through-out Africa. The main export markets are Algeria, Kenya, Nigeria, Angola and Mozambique. Vehicle exports from South Africa to Algeria and Nigeria declined in 2014, due to changes in regulations in these countries. Nigeria has launched its own Automotive Industrial Policy Development Plan, in order to boost local production and to limit imports. Import tariffs for vehicles start at 35%, while cheap complete (or semi-complete) kits for domestic assembly can be imported either without tariffs, or at 5% or 10%¹⁷. In Algeria, the government has curtailed its support for the purchase of commercial vehicles. These developments have dragged down South Africa's exports to these destinations. Exports to Europe, however, should see slight increases in 2016 and 2017, due to the modest recovery in the European economy.

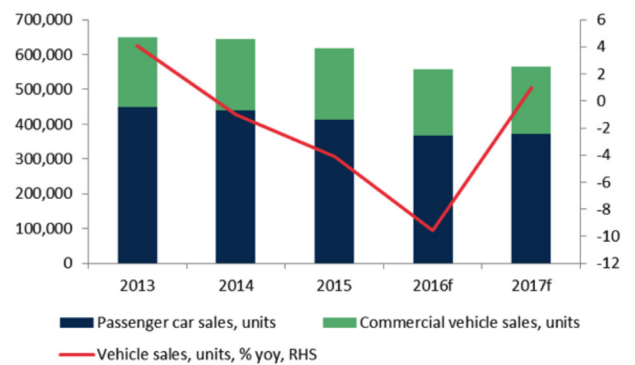
Despite these strengths, there are some factors weighing on the profitability of South Africa's automotive sector and Coface therefore rates this sector at high risk level. The deteriorating economic outlook is dragging down domestic sales. Aggregate new vehicle sales recorded a substantial decline of 14.3% in September 2016 compared to the previous year. Meanwhile, the slowdown in the economy could hit the sale of commercial vehicles particularly hard. High inflation (due to the weakness of the rand) and interest rates, which are reducing the consumer purchasing power, will continue to weigh on total vehicle sales. These are forecast to fall by a further 9.6% in 2016, before edging up by 1% in 2017¹³. Further interest rate

hikes from the US Federal Reserve and rising food prices (due to the heavy drought) will continue to add inflationary pressures and dampen consumer intentions to buy new cars. Higher interest rates would also make it more difficult to purchase new cars.

The fact that the debt to household income level remains high is a further barrier to an increase in car sales. Moreover, the unstable labour market and the constant threat of strikes are also hampering sales. Traditional labour and union forces are hampering production volumes. In 2014, U.S. auto producer GM had to suspend production at its main South African assembly plant in Port Elizabeth, due to its component suppliers being hit by a strike. In addition, problems with the country's electricity supply could impact auto production and also limit the uptake of electric vehicles.

The weakening of the rand could also put pressure on production costs – costs that car makers may progressively reflect in their final prices.

Chart 5: South Africa total vehicle sales



Source: BMI

¹⁷ Oxford Business Group, Increased support for local production in Nigeria

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