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Introduction

Note on the content and background

This compilation of briefing papers has been written at a time when the financial and economic crisis is hitting European economies in unprecedented dimensions. The impact of the crisis on industries has been severe, naturally with some differences across industries and countries. However in general, the crisis has hit both the European and global economies in a symmetric fashion, sparing virtually no major industry or sector. It is affecting investment and consumption, sales and exports as well as ultimately also employment, in a detrimental way.

The difficulty arising for this stock-taking exercise is that the crisis impacts are a highly dynamic and ongoing process at the time of writing (February/March 2009). Therefore, this compilation can only partially and anecdotally capture the total effects of the aggressive downturn on European industries. Nonetheless it is a useful exercise as it takes stock of the events in some selected industries, thereby hopefully contributing to the process of finding the adequate policy responses.

The request of the ITRE Committee included analyzing the situation in five industry sectors in the EU: automotives, construction, chemicals, pharmaceuticals and food. In the end, given the tight deadlines, it was only possible to include four contributions in this compilation, excluding the construction sector from the above.¹

The first paper is written by **IHS Global Insight**, giving a comprehensive picture on **the EU automotives** sector, including a distinction of the situations before and during the crisis.

In the second paper, **Henrik Meincke**, Chief Economist of the European Chemical Marketing and Strategy Association (ECMSA) takes stock of the crisis impacts on the **chemicals** sector, putting the chemicals sector into an economy-wide perspective.

In the third contribution, **Benjamin Belot and Anne-Charlotte Pupin from Alcimed** look at the **pharmaceuticals** sector, differentiating between industry segments that are more or less hit by the crisis.

In the fourth and final paper, **just-food analyst Ben Cooper** analyzes the **food** industry in a comprehensive analysis with a firm- and country-specific breakdown of the impacts.

All contributions are written in individual styles of the authors, reflecting their diverse backgrounds. All four papers also include a 1-page executive summary which summarizes the contents and the findings in a nutshell.

¹ It should be noted however that the European Construction Industry Federation (FIEC) was kind enough to provide the ITRE Committee with a separate briefing note addressing the crisis impacts on the European construction industry.

Impacts of the Financial and Economic Crisis on the Automotive Industry

IHS Global Insight

EXECUTIVE SUMMARY

- The European automotive industry is an important keystone of the European economy. From vehicle manufacturing down the automotive supply chain it represents an enormous 1/3rd of all manufacturing jobs in the EU27, Invests annually over €20bn in Research and Development and is the leading industrial contributor to net external EU trade. Its importance increases by including vehicle distribution and associated financing sector activity which directly or indirectly supports 13 million jobs. Vehicle taxes contribute €360bn to member state revenue.
- For more than a decade, sales in the EU have oscillated within a relatively narrow trading range (16.7m to 17.7m). Starting in the summer of 2008 sales decisively dropped out of the floor of this range and then crashed further in the final quarter of the year. By January 2009, vehicle sales were running 3.5m units lower than these trend rates. The shock of this combined with a synchronized crash in key automotive export markets means that the situation has already deteriorated beyond worse case pre crisis contingency planning of even the most cautious manufacturers
- Consensus forecasts for the industry predict a 20% slump in vehicle production in the EU27 between the start of 2008 and the end of 2009. This approximates to a loss of over €60bn to industry revenue. Capacity utilisation rates have already fallen to 65% in what is a high fixed cost industry.
- The Automotive industry is currently one of the hardest hit sectors of 'the real economy' in a recession triggered initially by the financial crisis. (Surveys show that over 50% of car dealers reported increased rejection of car financing proposals). Since it has one of the largest multipliers from upstream resource input thru supply chain down to distribution and financing there will be lagged second round effects that will prolong the wider EU economic recession and hamper the initial pace of its recovery.
- The crash in domestic vehicle sales and in key export markets has been so sharp, deep and synchronized globally that virtually every single vehicle manufacturer will see significant cash burn, estimated in aggregate at between €18bn and €30bn in 2009 in Europe alone. This requires access to willing and liquid capital markets. Given the tightness in the financial markets many vehicle manufacturers in the automotive industry with its low margins, high fixed costs (which include labor) and high capital expenditure commitments for new (low emissions) technologies will approach or breach technical bankruptcy. This has already led to a spate of demands for government backed loans to cover the expected losses while sales are so low and with little forward viability of a bottom to the crash in demand.
- Providing such exceptional funding to the vehicle manufacturers clearly helps shore up their position but the collapse in volume feeds equally down the supply chain and also to dealerships and a host of SME's. These will run into many hundreds if not thousands of enterprises which have similar shore-up needs but without the profile, visibility and logistical admin to get similar aid. With unit vehicle assembly volumes falling by a quarter to a third, a wave of bankruptcies is predicted across the supply chain during 2009.

- Given the most likely environment where the vehicle manufacturers themselves are supported from failing, the so called 'second best' policy response able to deal with this crisis may be to help provide incentives to boost demand levels so that vehicle manufacturers output does not fall so severely -lowering their need for 'gap' financing while at the same time increasing volume and utilization rates across the supplier network. In this manner, all the various levels of the supply chain from the Major tier 1 suppliers to the SME's will benefit, effectively reducing the extent of gap financing requirements and helping boost overall levels of economic activity and reducing demands on state welfare and social programs.

1. INTRODUCTION

The objective of this briefing paper is to describe the impact of the current downturn on the European automotive sector, based on anecdotal evidence and case studies, being as up-to-date and empirical as possible, providing as many facts & figures as possible, inter alia by answering the following questions:

- What is the effect of the current credit constraints on the sector?
- What is the effect (and projection) of the sharply declining demand and the following recession on the sector?
- If possible, in the above distinction between big companies and SME's?
- If possible, effect on supplier industries?
- If possible, distinction between short term demand effects and long term structural effects?
- If possible/relevant, suggestions on what would be the best policy response?

This briefing paper is not intended to be a holistic and all-encompassing market intelligence report. In an environment of economic downturn and financial crisis, the industry and its prospects are changing rapidly and therefore, this paper aims to present some of the crucial impacts of the current situation on the EU automotive industry. In doing so, it uses ad-hoc evidence which exemplifies and supports the arguments made. It does not aspire to present proven "hard data", but relies to a considerable extent on "sentiment indicators" and comparable indices. It is as empirical, data-based and policy-relevant in its arguments as the current market conditions allow.

2. INDUSTRY SITUATION AND TRENDS: PRE-FINANCIAL CRISIS

The European automotive industry is an important keystone of the European economy. From vehicle manufacturing down the automotive supply chain it represents an enormous 1/3rd of all manufacturing jobs in the EU27, invests annually over €20bn in Research and Development and is the leading industrial contributor to net external EU trade. Its importance increases by including vehicle distribution and associated financing sector activity which directly or indirectly supports 13 million jobs. Vehicle taxes contribute €360bn to member state revenue.

Structure: The vehicle manufacturing business is highly complex. It is not limited to the assembly of vehicles and production of engines. The same manufacturers engage in testing, sales/marketing and distribution, maintenance, recycling and disposal. Most also make components – although the degree of vertical integration varies. They also have separate finance arms. These finance companies can provide finance to their dealer network, leasing activities and to final customers (captive finance). In recent years these non-automotive parts of a vehicle manufacturer's business have tended to generate more profits than their core manufacturing assembly operations and in some years may have been the only source of profits, thereby supporting the loss making automotive arm.

Competition: The European Automotive industry benefits from the size of its domestic market which is the largest single market in the world today, and from the partial adoption of European automotive standards in many export markets. This makes it attractive for new entrants and at the same time deters even marginal players from exiting the market.

This results in a highly competitive environment with lower degrees of market concentration than in many other key global markets. For vehicle manufactures this, in turn, confines them to very tight or modest operating margins which UBS calculates were well below 3% as averaged over the last five years

The high fixed costs and low margins means that a period of falling vehicles sales can push companies into loss and require high reserves and access to finance. The current crisis is unprecedented in that the collapse in sales has been so severe and synchronised that all and not just a few marginal players will be put into this position and at a time when global capital markets are virtually closed

Vehicle Sales in the EU

New vehicle sales in the EU market consist largely out of replacement demand but with a significant element of discretion on the timing of vehicle replacement. New vehicle sales depend on a range of factors influencing 'affordability', consumer confidence, utility of change and the availability of finance. In New Member States, demand is geared more towards new motorisation rather than replacement. New light commercial vehicle sales are correlated with a broad spectrum of business investment and retail activity.

Exhibit 1

| EU Light Vehicle Sales by Country Market (2000-2008) | | | | | | | |
|--|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|
| Sales Country | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 |
| AUSTRIA | 301,920 | 325,685 | 340,324 | 336,736 | 339,076 | 330,693 | 326,596 |
| BELGIUM | 558,161 | 553,062 | 590,530 | 589,283 | 635,788 | 640,501 | 652,423 |
| BULGARIA | 13,772 | 16,548 | 24,790 | 33,434 | 43,295 | 53,334 | 61,191 |
| CYPRUS | 7,942 | 7,797 | 18,220 | 18,202 | 18,639 | 22,878 | 22,241 |
| CZECH REPUBLIC | 162,151 | 168,183 | 160,162 | 163,788 | 169,488 | 189,751 | 203,647 |
| DENMARK | 142,604 | 126,524 | 166,044 | 202,883 | 219,765 | 219,107 | 178,496 |
| ESTONIA | 16,559 | 18,178 | 18,857 | 22,527 | 29,146 | 35,574 | 27,742 |
| FINLAND | 132,291 | 162,216 | 160,693 | 164,244 | 162,922 | 144,005 | 156,438 |
| FRANCE | 2,549,929 | 2,390,304 | 2,421,347 | 2,487,270 | 2,440,581 | 2,526,611 | 2,510,175 |
| GERMANY | 3,421,131 | 3,417,945 | 3,456,944 | 3,518,568 | 3,665,783 | 3,370,630 | 3,314,478 |
| GREECE | 289,487 | 275,725 | 311,719 | 293,186 | 291,441 | 304,346 | 290,033 |
| HUNGARY | 199,542 | 228,410 | 231,087 | 221,267 | 201,734 | 193,122 | 174,365 |
| IRELAND | 190,698 | 175,728 | 184,230 | 208,021 | 217,859 | 228,920 | 178,451 |
| ITALY | 2,565,845 | 2,450,983 | 2,487,042 | 2,454,859 | 2,568,271 | 2,740,529 | 2,384,392 |
| LATVIA | 9,023 | 10,015 | 12,830 | 18,719 | 28,227 | 36,413 | 22,007 |
| LITHUANIA | 9,621 | 9,209 | 11,824 | 13,791 | 18,302 | 26,031 | 25,965 |
| MALTA | 9,763 | 7,135 | 6,056 | 6,983 | 7,762 | 5,334 | 4,548 |
| NETHERLANDS | 591,824 | 566,401 | 570,929 | 531,394 | 548,773 | 584,445 | 585,067 |
| POLAND | 329,141 | 384,417 | 355,318 | 271,740 | 280,353 | 349,674 | 381,255 |
| PORTUGAL | 305,425 | 258,894 | 269,288 | 273,233 | 259,272 | 270,363 | 268,856 |
| ROMANIA | 109,041 | 132,201 | 176,128 | 251,407 | 289,286 | 352,232 | 312,088 |
| SLOVAKIA | 65,756 | 67,651 | 67,616 | 71,296 | 78,560 | 83,364 | 96,490 |
| SLOVENIA | 57,903 | 67,190 | 69,199 | 66,877 | 65,681 | 73,937 | 77,976 |
| SPAIN | 1,600,787 | 1,679,608 | 1,852,589 | 1,917,332 | 1,909,752 | 1,891,645 | 1,328,003 |
| SWEDEN | 282,622 | 289,464 | 294,938 | 309,296 | 322,594 | 351,517 | 293,406 |
| UNITED KINGDOM | 2,834,104 | 2,887,075 | 2,902,193 | 2,768,612 | 2,677,085 | 2,748,901 | 2,430,080 |
| GRAND TOTAL | 16,757,042 | 16,676,548 | 17,160,897 | 17,214,948 | 17,489,435 | 17,773,857 | 16,306,409 |

Source: *IHS Global Insight; light vehicles include passenger and light commercial vehicles*

For more than a decade, sales in the EU have oscillated within a relatively narrow trading range (16.7m to 17.7m). Starting in the summer of 2008 sales decisively dropped out of the floor of this range and then crashed further in the final quarter of the year.

Despite the unified EU market, the relative stability in sales in the union in recent years has been in part derived from unsynchronised 'minor' sales cycles in individual economies and vehicle markets. (For example weak sales in some countries such as Germany had been offset by good new vehicle sales in others such as Spain).

In the five years leading up to the start of the 2008 credit crisis, EU wide sales were growing at a very modest 1.1% (CAGR). Over 40% of the growth over this period was derived from strong demand for vehicles in the New Member States.

Vehicle Production in the EU

In unit terms alone, production in the EU accounts for 27% of worldwide vehicle manufacture and assembly. Production levels have been consistently higher than domestic sales because exports to world markets are higher than vehicle imports. In 2007 €71.1bn worth of vehicles were exported from the EU27 while the value of imports were only about half of that value, leading to €37bn trade surplus.

EU27 vehicle production has tended to follow overall domestic sales plus approximately 1m units of net exports. Since 2006 the net export component has been increasing for two main reasons:

1. The growth of exports to world markets, most notably Russia
2. Substitution of imports by Asian Manufacturers with local production from new automotive facilities opening in the EU notably in the New Member States.

Exhibit 2

| EU Light Vehicle Production by Country (2000-2008) | | | | | | | |
|---|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|
| Production Country | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 |
| AUSTRIA | 106,906 | 95,020 | 201,324 | 208,245 | 226,558 | 199,969 | 134,775 |
| BELGIUM | 686,000 | 555,972 | 590,235 | 600,390 | 613,418 | 559,691 | 545,585 |
| CZECH REPUBLIC | 442,469 | 437,554 | 444,121 | 600,238 | 850,009 | 929,759 | 932,733 |
| FINLAND | 20,198 | 12,998 | 10,051 | 21,233 | 32,393 | 23,026 | 15,935 |
| FRANCE | 3,645,515 | 3,573,491 | 3,615,410 | 3,497,398 | 3,111,400 | 2,946,170 | 2,582,744 |
| GERMANY | 5,335,266 | 5,364,530 | 5,399,801 | 5,582,580 | 5,634,629 | 6,010,065 | 5,827,789 |
| HUNGARY | 139,080 | 125,406 | 117,045 | 148,213 | 187,559 | 288,996 | 338,435 |
| ITALY | 1,391,946 | 1,289,038 | 1,108,001 | 1,002,559 | 1,173,292 | 1,244,725 | 990,148 |
| LITHUANIA | - | 573 | 544 | 914 | 959 | 1,102 | 1,160 |
| NETHERLANDS | 182,368 | 163,270 | 187,600 | 115,121 | 87,332 | 61,912 | 60,653 |
| POLAND | 310,603 | 377,011 | 590,169 | 616,459 | 718,230 | 789,710 | 929,989 |
| PORTUGAL | 248,029 | 237,228 | 224,392 | 219,455 | 222,603 | 170,644 | 167,965 |
| ROMANIA | 78,992 | 95,014 | 121,943 | 194,616 | 213,073 | 241,547 | 245,020 |
| SLOVAKIA | 225,442 | 241,309 | 181,498 | 177,511 | 270,518 | 527,712 | 542,372 |
| SLOVENIA | 125,661 | 118,200 | 131,761 | 177,945 | 153,126 | 200,143 | 198,094 |
| SPAIN | 2,774,027 | 2,938,391 | 2,920,826 | 2,650,636 | 2,677,894 | 2,862,413 | 2,496,850 |
| SWEDEN | 307,851 | 355,146 | 333,272 | 331,967 | 332,817 | 350,514 | 256,406 |
| UNITED KINGDOM | 1,803,398 | 1,830,694 | 1,838,912 | 1,783,693 | 1,630,427 | 1,730,462 | 1,622,176 |
| GRAND TOTAL | 17,823,751 | 17,810,845 | 18,016,905 | 17,929,173 | 18,136,237 | 19,138,560 | 17,888,829 |

Source: IHS Global Insight; light vehicles include passenger and light commercial vehicles

All of the net growth in production in the union has come from vehicle assembly in the New Member States, notably Poland, Czech Republic and Slovakia. As a result of these developments, EU wide vehicle output reached a record level of 19.1m units in 2007. Despite the record production rate, installed assembly capacity in the region had also been increasing with the opening of new plants. This from an entire industry perspective kept utilisation rates from improving much above 80%.

The slump in domestic EU vehicle sales, since the summer of 2008, precipitated by the financial crisis combined with the earlier sharp drop in exports to the United States as vehicle sales there collapsed. This caused production at EU assembly plants to fall by 1.2m units during 2008 almost all of that confined to the last quarter of the year. Far worse is projected in 2009 as the financial crisis unfolds into a European and global recession. A steep fall in every major export market (including the until recently booming market in Russia) and a severe slump in EU 27 vehicle sales is now anticipated for 2009.

3. INITIAL CREDIT CRISIS IMPACT

As previously noted light vehicle sales in the EU have been confined within a relatively narrow trading range (16.7m to 17.7m) since the 1990's. Starting in the summer of 2008 sales decisively dropped out of the floor of this range and have since crashed further

The drop in sales during the summer of 2008 was larger than would have been implied on the basis of the then slowing European economy. There is no pan-European data series measuring credit availability for vehicle loans, however, widespread anecdotal evidence suggests that banks were quietly but rigorously tightening lending criteria significantly as concerns about their liquidity position were mounting. At the same time rising inflationary pressures on household budgets were increasing risks of defaults on bad loans.

Two stage collapse of New Vehicle Sales

An analysis of the West European passenger vehicle market shows that the selling rate of the market (this is typically described in terms of the annualised rate of sales after seasonal adjustment or SAAR) has largely moved sideways over the last decade and drifting slowly upwards over the last five years, indicating the sales stability of the market and the relatively low growth opportunities.

The sales rate stepped down abruptly in the summer of 2008. Within a space of just two months -between June and August - the selling rate fell at an annualised rate of 1.5m units or - 10% and did not recover.

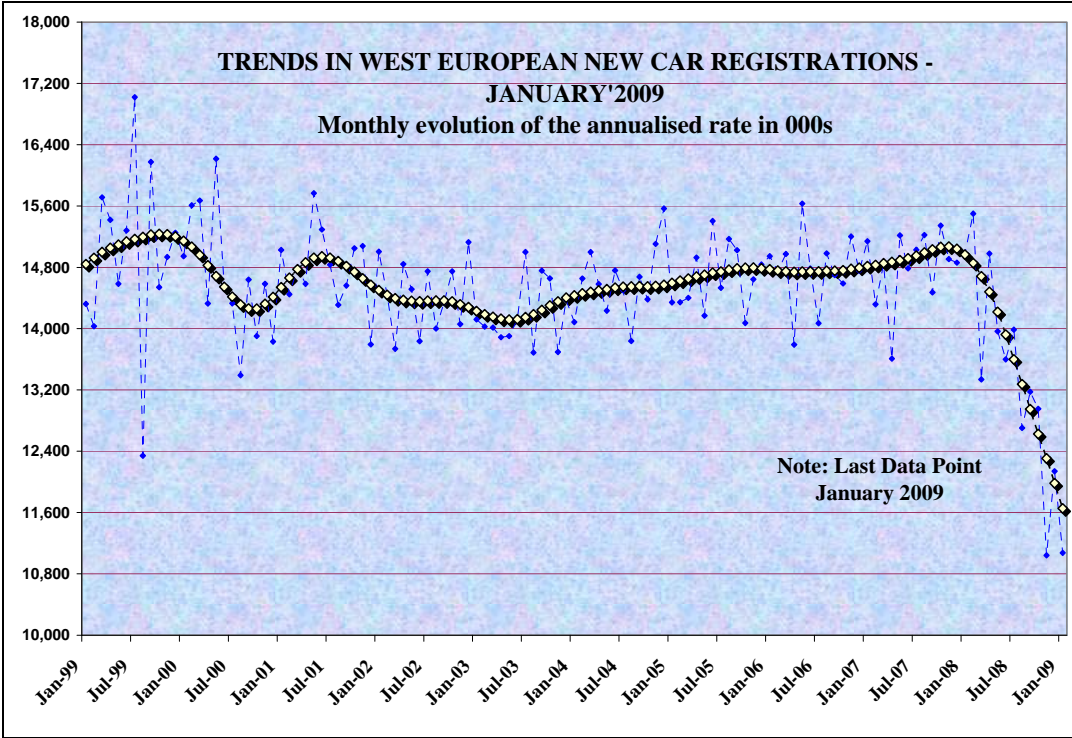
Oil prices had spiked to record levels at exactly the same time which increased uncertainty and pressure on household budgets. This makes it difficult to pinpoint the tightening of credit availability at that time as being the root cause of the initial sales shock but it certainly contributed greatly to a build up of pressure eventually causing a tipping point to be reached.

The banking tremors from late 2007 had also led to the withdrawal of mortgage products and spikes in inter-bank lending rates, this precipitated falling house prices which in turn led to secondary economic shocks for several economies and vehicle markets most notably Spain, the UK and Ireland.

A downshift in vehicle sales can be easily identified during last November. After the Lehman Brothers collapse in September rejections of applications for vehicle financing accelerated, banks and commercial finance companies started to pull out of financing and captive finance slowed as inter-bank lending froze.

Under normal conditions there is a lag of several weeks before ordering the vehicle and taking delivery. We note that this lag was clearly in evidence as vehicle registrations collapsed at an unprecedented rate in November which is a direct result of the withdrawal of finance by the end of September and a slump in consumer confidence after the intense bad news flow of banking sector problems.

Exhibit 3



In fact vehicle sales fell heavily across the world in November - every vehicle market in the world registered a slump in sales and orders. This level of razor sharp synchronisation has never been seen before in peace time.

Private sector corporate business plans were redrawn fast given the problems of general corporate funding in the financial markets and the race to preserve cash. This then caused a rapid reduction in investment spending which then immediately acted on orders for commercial vehicles which have similarly collapsed

The collapse in domestic EU vehicle sales, the sharp and synchronised downturn in global export markets and the slump in commercial vehicle sales (until recently both profitable and growing) is without precedent.

Recent months have witnessed acceleration in the rate of vehicle market declines. Virtually no market in the European Union appears immune in the current climate. Of the traditional European Big 5 markets, the Italian market fell 33% for January 2009, the U.K. was down 31%, while Spain continued to nose-dive, down 41.5%. Germany joined the gloom for January 2009 with vehicle sales down 14.2%, while France slipped back 7.9%; although both these markets have well received incentive schemes in place for 2009. Total West European new vehicle sales posted an estimated 895,000 units in January 2009, down by 26% on the same period for 2008. January 2009 vehicle sales equated to an annual rate of just 11 million. This compares to a running rate of 14.5-15 million units in early 2008, highlighting the dramatic and shocking nature of the collapse in new vehicle sales.

Most recent sales rates (to January 2009) suggest the EU market will see a peak to trough decline of more than 20% and at least 15% below the minimum trading range recorded at any time in the last decade. IHS Global Insight forecasts suggest that recovery back to this historic range will take at least three years.

Credit Crisis Effects – Vehicle Financing

Given the high purchase price of new vehicles relative to monthly income the availability of credit finance is an integral part of typical vehicle buying process. In general, the percentage of vehicles purchased using financial instruments tends to rise with the stage of development and maturity of the economy and vehicle market.

The wholesale freeze in the financial sector has rippled out to the automotive industry with devastating effect. As governments and industry bodies plead with the banking sector to free up lending, following the very high-profile public bail-out of the financial system, there is much anecdotal evidence to say that this is simply not happening, as banks retrench and restore their own balance sheets before moving back into any kind of wholesale lending. The effect is devastating on the automotive industry and the subsequent wide-ranging job losses and impact on the "real" economy will spiral downwards, leading to a deep and painful recession. The full force of a European recession is expected to hit in 2009.

Financing is a Very Significant Enabler for Most European Vehicle Transactions

- Around 60% to 80 % of new private vehicles are bought using some form of credit requiring financing (varies by market).
 - Private Loans 35%
 - Vehicle Loans 50%
 - PCP, Lease with Purchase option 15%
- UNRAE estimates indicate that about 80% of all transactions in Italy in 2007 were made using finance of some kind.
- Non-private demand makes up around 40% of the vehicle market.

Ongoing Economic & Financial Crisis Means Financing & Leasing Costs Rising

- Lenders are pulling back on easier credit, bigger deposits, stricter credit checks
- Effectively the provision of credit is being rationed.
- Italian Ifas Group data shows 80% of requests for customer loans are now being rejected (rejection rate was less than 50% in late 2007).
- According to the German Automotive Dealers Association (ZDK) commercial banks are increasingly raising the cost of and tightening the conditions of credit for vehicle dealers or even request prompt payment of existing loans.
- For Spain, Aniacam figures for the sales channel breakdown show that while private sales fell by 29%, business sales fell by 57% and rentals fell by 58%. Some 20% of new purchasers wanting to buy their vehicle using credit are currently being rejected.

“Vehicle Manufacturers are Banks too”

- Vehicle manufacturer in-house finance companies also face squeeze on funds for new loans & leases due to ongoing financial crisis.
- Captive financing makes up 25%-30% of total sales.
- More importantly, for the vehicle manufacturers, in-house financing divisions are major contributors to revenue & profits (could average 15% of vehicle manufacturer earnings).
- The figures are probably much higher for premium vehicle manufacturers as they tend to have higher levels of in-house financing as leasing makes up higher proportion of their end user business.
- Worst-case scenario sees vehicle manufacturers unable to access funds for new vehicle loans which could jeopardise around 20-30% of new vehicle sales volume.

In one of the few large scale surveys undertaken since the Credit Crisis hit, Sewells Information & Research conducted a survey of 984 used vehicle dealerships in the UK in the final months of 2008. The survey found that 53% of franchised dealers and 75% of independent used vehicle dealers are having more vehicle finance applications turned down than twelve months earlier. In addition the survey found that dealers were having to contact a far wider range of finance companies and brokers which was an indication of how hard dealers are trying to place business.

Although not directly comparable samples the Sewells surveys suggest a tightening of credit availability at the point of sale for vehicle buyers during 2008. In June 37% of dealers reported a reduction in successful acceptance of applications for vehicle credit compared to a year earlier. By August this had risen to 42% and reached 53% by November.

4. THE RECESSIONARY PHASE – SECONDARY REAL ECONOMY IMPACT

The Financial Crisis has rapidly morphed into a full economic recession, via the mechanism of collapsing consumer and business confidence, falling consumption, sharply reduced investment spending and workforce layoffs.

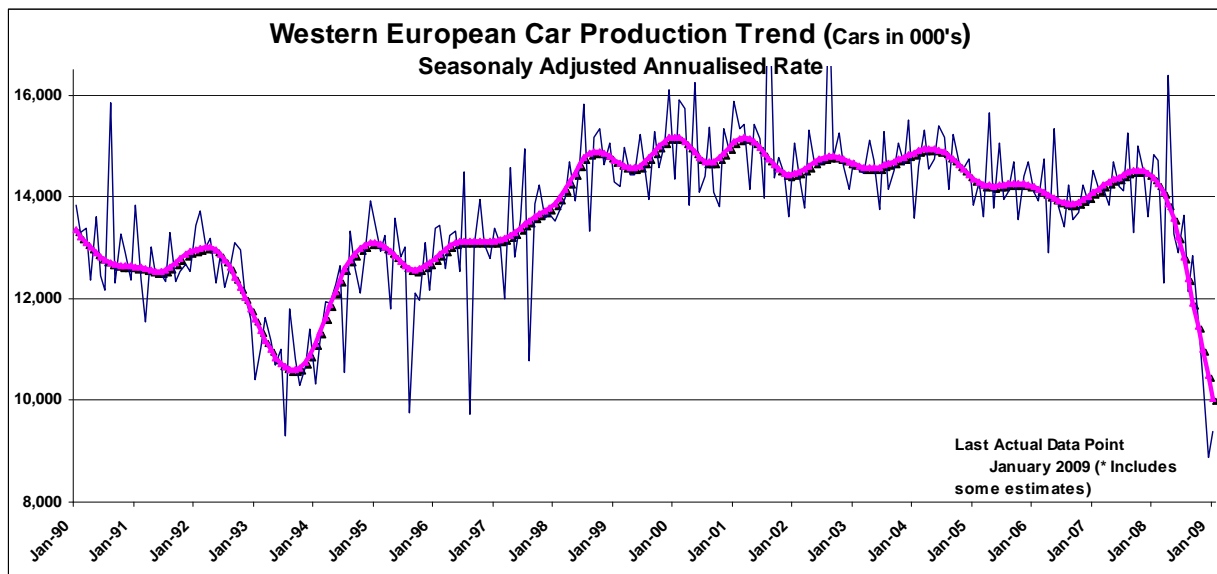
In this phase it is not possible to disentangle the exact contribution of each of these to the severe contraction in automotive sales. All point to falling sales in short to medium term. At this stage even a marked improvement in availability of vehicle financing now would not prevent the market falling heavily for the rest of the year.

Accounting for direct government measures to support vehicle sales that have been already announced by several member states, IHS Global Insight projects a minimum decline of 12% in EU27 sales during 2009. This would result in a 21% peak to trough decline in sales volumes representing a loss of 3.6m units. (Estimates of losses without direct support scheme would push the peak to trough volume drop above 25%)

Impact on Production

Vehicle production lagged the collapse in sales by a few months of 2008 as everyone was taken by surprise at the speed at which demand had contracted. By November drastic action was clearly needed and the majority of Europe's assembly plants were idled for 2 or 3 weeks during December.

Exhibit 4



Estimates for January suggest that production will be cut back by virtually 40%. Excessive inventory levels caused by the speed of market collapse have to be worked off and this will make the contraction output during early 2009 even more severe. Annualised production rates have fallen sharper and are already at lower levels than recorded back in the 1992/3 recession. (And are in fact at levels last seen in the mid 1980's).

After a 6% decline in 2008 forecasts for EU wide production in 2009 are for a further 14% drop during 2009, making a 20% slump over two years. (These forecasts already account for various market support measures that had been announced by the 27th of January).

In fact the annual figures mask a deeper and more immediate volume crisis for the industry. Q4 2008 production fell by 25%, all indications are that it will contract by a sharper 30% during the first quarter of this year and probably by more than 20% during Q2. This means that manufacturer's suppliers and dealers will have to survive through a sustained period of at least three consecutive quarters where on average one quarter of their business volumes will have disappeared.

Industry Response So Far

In order to preserve precious cash the vehicle manufacturers have already begun delaying new model launches previously planned for 2009 and some projects have been cancelled or indefinitely postponed. Capital expenditure plans have been reduced.

So far in this crisis no major assembly plants have been announced as permanent closures although we see this changing in coming months as part of company specific restructuring.

The most obvious, widespread and visible reaction from the vehicle manufacturers so far has been to move on to short time working, lay off temporary and contract workers and close down the assembly plants for extended periods.

The following table shows announcements of plant closures and numbers of equivalent plant days lost that were made by 10 February covering the period between October 2008 and March 2009.

| Temporary Shutdowns at Europe's major Vehicle Assembly Plants | | | |
|--|----------------|--------------------|------------------------|
| Announced Shutdowns in Plant Days or Day Equivalents During Q4 2008 and Q1 2009 | | | |
| Manufacturer | Country | Plant | Shutdown Period |
| Renault | Spain | Palencia | 15 days |
| | | Valladolid | 30 days |
| | | Avila | 30 days |
| | France | Mauberge | 7 days |
| | | Flins | 20 days |
| | | Sandouville | 23 days |
| | | Douai | 11 days |
| | Romania | Pitesti | 42 days |
| Slovenia | Novo Mesto | 9 days | |
| BMW | Germany | Dingolfing | 16 days |
| | | Munich | 8 days |
| | | Regensburg | 25 days |
| | | Leipzig | 12 days |
| | United Kingdom | Oxford | 41 days |
| | | Goodwood | 22 days |
| Daimler | Germany | Bremen | 34 days |
| | | Sindelfingen | 28 days |
| | | Dusseldorf | 26 days |
| | | Rasttat | 26 days |
| Fiat | Italy | Cassino | 52 days |
| | | Melfi | 45 days |
| | | Mirafiori | 54 days |
| | | Pomigliano | 59 days |
| | | Termini | 67 days |
| | Spain | Valladolid (Iveco) | 9 days |
| Ford | Belgium | Genk | 23 days |
| | Germany | Saarlouis | 6 days |
| | | Cologne | 5 days |
| | Spain | Valencia | 10 days |
| | United Kingdom | Southampton | 27 days |
| Sweden | Torslanda | 28 days | |

| Temporary Shutdowns at Europe's major Vehicle Assembly Plants | | | |
|--|----------------|----------------|------------------------|
| Announced Shutdowns in Plant Days or Day Equivalents During Q4 2008 and Q1 2009 | | | |
| Manufacturer | Country | Plant | Shutdown Period |
| GM | Germany | Bochum | 34 days |
| | | Eisenach | 42 days |
| | Spain | Zaragoza | 24 days |
| | United Kingdom | Ellesmere Port | 34 days |
| | Poland | Gliwice | 40 days |
| | Sweden | Trollhatan | 7 days |
| Honda | United Kingdom | Swindon | 52 days |
| Hyundai | Czech Republic | Nosovice | 13 days |
| Nissan | United Kingdom | Sunderland | 39 days |
| PSA | Spain | Vilaverde | 5 days |
| | | Vigo | 26 days |
| | France | Hordain | 33 days |
| | | Mulhouse | 23 days |
| | | Poissy | 57 days |
| | | Rennes | 37 days |
| | | Sochaux | 48 days |
| Toyota | France | Valenciennes | 34 days |
| | United Kingdom | Derby | 19 days |
| VW | Czech Republic | Kvasiny | 14 days |
| | | Mlada Boleslav | 20 days |
| | | Vrchlabi | 13 days |
| | Slovakia | Bratislava | 3 days |
| | Germany | Ingolstat | 14 days |
| | | Neckarsulm | 9 days |
| | | Wolfsburg | 19 days |
| | Spain | Martorell | 15 days |
| | | Pamplona | 11 days |
| | United Kingdom | Crewe | 40 days |
| | Hungary | Gyor | 20 days |
| | Poland | Poznan | 13 days |
| | Portugal | Autoeuropa | 26 days |

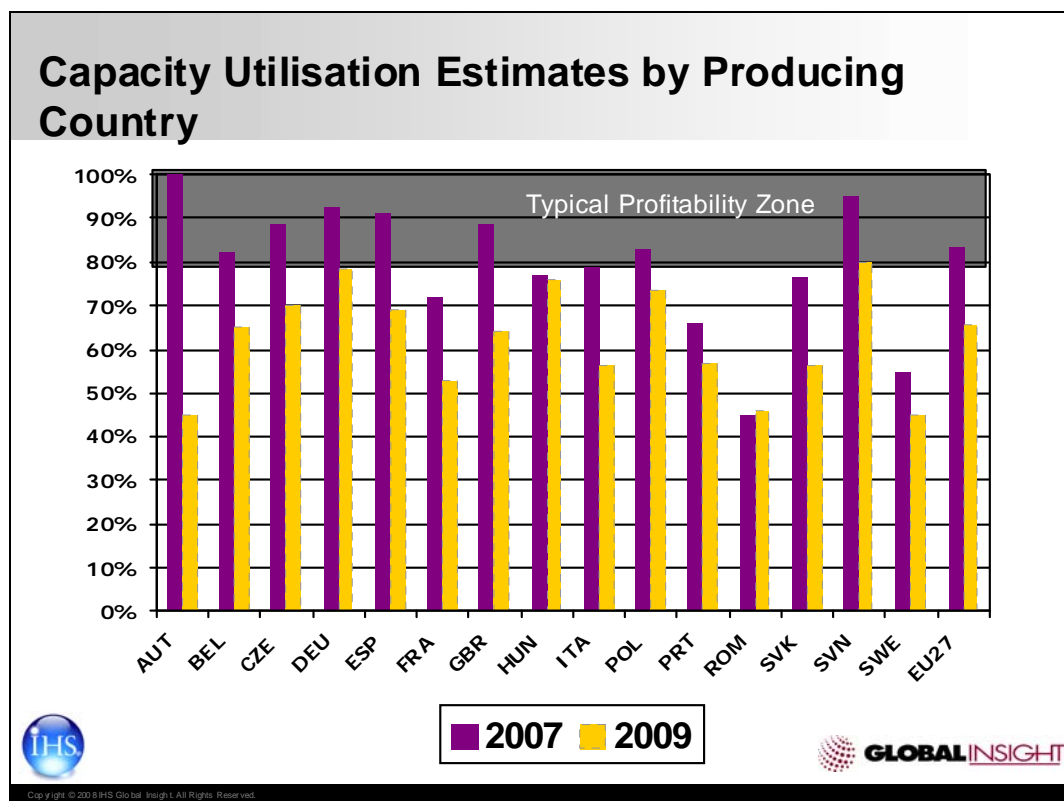
Source: IHS Global Insight Plant Monitoring, Company Announcements

Manufacturing Efficiency is Crippled as Capacity Utilization Collapses and Cost Burden Increases

Given the collapse in domestic sales, global export markets, and the need to make additional inventory cuts production in 2008 will contract sharply. Capacity Utilization rates that had only recently reached the 80% range are likely to have fallen to 70% in 2008 and are projected to fall to no more than 65% during 2009. These levels are unsustainably low for any form of profitability and a similar drop in utilization rates (although from different levels) can be assumed across the component supply sector.

While no major assembly plants have yet been closed permanently as a direct result of the crisis, if volumes were to stall at currently projected levels for 2009, as many as ten major European vehicle assembly plants would have to be closed in order to restore utilization rates to pre crisis levels.

Exhibit 5



Dangers to the Supply Chain

The automotive supplier industry is being severely impacted by this crisis. Hundreds of automotive suppliers, manufacturing a variety of components that make up new vehicles, could potentially fail this year leading to industry wide disruptions and of course job losses. Already many smaller suppliers are struggling financially, and the recent spate of production cuts and vehicle manufacturer factory shut-downs will likely drive them over the edge during the coming months. Overall the vehicle manufacturers in Europe have acknowledged the current supply sector concerns and are working with various distressed suppliers to manage risk and facilitate restructuring.

To illustrate the scale and importance of the issue, one has to understand that up to three quarters of the value of a typical vehicle is being contributed by the automotive supply chain, while a typical mass-volume European vehicle manufacturer will have dealings with around 800 suppliers and procures about €30bn per year with those suppliers. It should also be remembered that much of the innovation in the supply chain actually resides at the lower tier levels (Tier 2-3), which are often small and medium sized enterprises (SME) who only have limited own capital. And with the manner in which the automotive industry operates, it typically takes up to 45 days on average from the time a supplier company ships its components to the vehicle manufacturer assembly factory, until the invoice for these components gets paid. So normally the supplier companies take out loans to bridge this gap, but in the current climate many banks have stopped lending money, causing a liquidity wave-effect throughout the supplier community.

Up until early February, perhaps surprisingly, any form of orchestrated lobbying by suppliers at an EU-level appeared to be missing, so instead national governments were reviewing the situation on a piecemeal basis. And the eventual expected EU 'bail-out' loans will have to originate from the European Investment Bank (EIB), which has admitted that it is not set-up to deal with the current influx of requests.

Consequently, behind the scenes, many of the vehicle manufacturers are starting to get nervous about how the current economic crisis could impact the supply industry. From a vehicle manufacturer's point of view, all necessary steps need to be considered in order to safeguard stability in the supply sector, which means that many vehicle manufacturers have to start looking after their best suppliers. Selected vehicle manufacturers are currently negotiating plans with suppliers, and in some cases even removing tooling to other more financially secure suppliers. However changeover of supplier during mid product-cycle is hard, costly, and takes time.

Exhibit 6

| Automaker aid | |
|--|--|
| What some automakers have done to help the suppliers they want to keep | |
| BMW | Porsche |
| <ul style="list-style-type: none"> ▪ Encourage stronger suppliers to take over weaker ones ▪ Pay in advance for parts ▪ Speed up payments ▪ Temporarily pay higher price for parts | <ul style="list-style-type: none"> ▪ Help finance production tooling |
| Ford | PSA |
| <ul style="list-style-type: none"> ▪ Give loans ▪ Speed up payments | <ul style="list-style-type: none"> ▪ Speed up payments ▪ Pay in advance for parts ▪ Buy raw materials for them ▪ Help them find financing ▪ Advise on possible alliances, mergers |
| Daimler | Renault |
| <ul style="list-style-type: none"> ▪ Temporarily pay higher price for parts ▪ Provide advice on how to cut cost ▪ Provide advice on how to improve efficiency | <ul style="list-style-type: none"> ▪ Speed up payments |
| | VW group |
| | <ul style="list-style-type: none"> ▪ Form special team in purchase department to prevent suppliers collapsing |

Source: *Automotive News Europe*

Nevertheless, some high-level bankruptcies (like Edscha and Wagon Automotive) have already been witnessed in 2009 and others have only been narrowly averted. Overall, a significant number of bankruptcies in the supplier sector are expected in the near term future, and when a supplier shuts down, other related companies also tend to be impacted.

The major issue regarding the supplier industry lies in the failures of smaller companies down the supply chain (Tier 2-3 suppliers). Typically these specialist suppliers focus on commodities like raw materials, wiring, and others which all are needed for the larger Tier 1-2 suppliers to create the modules/systems that are required in final vehicle assembly. So the further down the supply chain any issues occur, the broader the impact upon the whole supply sector. For example, a polymer supplier would supply several automotive interior system suppliers, so any failure at this level would disrupt the entire automotive manufacturing chain as none of these interior system suppliers would be able to supply the vehicle manufacturers.

Tough times

What suppliers have done to cope with big cuts in auto production

Bosch

- Extend holiday plant shutdown
- Reduce length of workday at plants in Rommelsbach and Bamberg

Continental

- Halt investments that are not urgent
- Extend holiday shutdown by 1-4 weeks
- Reduce length of workday and workweek

Delphi Europe

- Extend holiday plant shutdowns
- Temporarily layoff full-time workers

Faurecia

- Shut most of its 37 plants in France for most of December

Haldex

- Cut 700 jobs

IAC Europe

- Close door panel plant in Poland

Schaeffler Group

- Cut temporary workers
- Halt production on certain days

Valeo

- Shut most of its sites in France for

Source: *Automotive News Europe*
Source: Companies

German supplier Brose, a leading developer and supplier of automotive mechatronic systems with a procurement budget of €1.8bn, already has had to provide life-support for several of its Tier-2 suppliers according to its Deputy CEO Mr Klaus Deller. Given that they expect more of these support cases, Brose is creating a special risk management team to monitor the financial health of most of its Tier-2 suppliers.

Overall the supply sector clearly is facing troubles ahead and at the recent European supplier association (CLEPA) technology day the overriding impression was that the number of automotive suppliers is very likely to be reduced significantly given the current decline in vehicle production. And given that the pace at which the current market developments are occurring is unprecedented, it makes it very hard for suppliers to effectively cut costs and being able to cope with these vehicle manufacturer production cuts. On top of that, most suppliers are finding it increasingly hard to secure capital from banks at affordable rates. So even if the European automotive sector eventually arises from this current crisis, there is the risk that the vehicle manufacturers might actually be unable to manufacture the demanded vehicles due to a shortage of components and suppliers.

5. CURRENT GOVERNMENT RESPONSE


Recent months have seen mixed responses from the National Governments of Europe on how to deal with the crisis (see below Exhibit).

For example, the German government has put in place a generous scrapping incentive for vehicle buyers trading in older vehicles for new, low-emission passenger vehicles, while the French government are offering around €6bn of loan guarantees to protect its domestic industry in addition to an already existing scrapping incentive plan.

Other Member States are formulating their own financial aid and incentive packages to help their individual industries. Clearly, this will lead to distortions in the Europe-wide passenger vehicle market, especially for those member states with the largest automotive industries and therefore with the most to lose from a protracted and painful demand slowdown.

Exhibit 7

| Governments to the Rescue: Incentive Schemes | |
|--|---|
| Country | Summary Details |
| Germany | 1 or 2 year exemption from annual road tax for cars registered until July '09 New Scrapping incentive scheme worth €2,500 for 2009 (could be extended) |
| France | New "Super-bonus" scrapping incentive scheme worth extra €1,000 off new car Also provision of lines of credit to PAS/Renault |
| Italy | Re-launch of €1,500 scrapping incentive scheme |
| U.K. | Cut of VAT on cars to 15% from 17.5% until December 31 st 2009 Rumour of scrapping scheme |
| Spain | Re-launch of Plan Vive, possible extension to captive finance companies |
| Poland | Rumour of new scrapping scheme with VAT (22%) deduction for new car buyers in exchange for scrapping their old car (exact details undertain) |
| Austria | New scrapping scheme |
| Belgium | Belgium government close to agreeing a scrapping incentive scheme |
| Ireland | Rumour of scrapping scheme |
| Czech Republic | Rumour of scrapping scheme linked to VAT reduction |



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| CASE STUDY – IMPLEMENTED MEASURES (FRANCE) |
|---|
| <ul style="list-style-type: none"> • Scrapping measure is more generous than in 2008: €1,000 (vs. €300) for cars over 10 years (vs. 15) if purchase of a car under 161g/km of CO₂ (vs. 131g/km of CO₂). Plus, measure is extended to light commercial vehicles (without CO₂ constraint on the purchased model). Measure applied since Dec. 08 |
| <ul style="list-style-type: none"> • Main manufacturers have already complemented the scrapping measure to vehicles between 8 and 10 years. |
| <ul style="list-style-type: none"> • Bonus incentives for fuel efficient vehicles remain unchanged for 2009 (despite cost) |
| <ul style="list-style-type: none"> • €360bn plan for banking sector (not focused on automotive but goal to ease credit access) |
| <ul style="list-style-type: none"> • Government industry support by the offer of around €6bn of loan guarantees to protect the domestic industry |
| <ul style="list-style-type: none"> • €1bn already available for the financing arms of PSA and Renault (50/50) |
| <ul style="list-style-type: none"> • Investment fund to help the suppliers: €300 million brought by the State and PSA/Renault |
| <ul style="list-style-type: none"> • Public €400 million investment (during 4 years) to help French vehicle manufacturers develop very fuel efficient vehicles (seems focused on electric solution) |
| CASE STUDY – UPCOMING MEASURES (ITALY) |
| <ul style="list-style-type: none"> • All-new Italian scrapping incentive programme to run until December 31, 2009 |
| <ul style="list-style-type: none"> • Bonus of €1,500 to purchase a new vehicle will be provided if the vehicle to be scrapped is Euro 0, 1, or 2 and registered until December 31, 1999 and the new vehicle emits no more than 140g/km of CO₂ (130g/km of CO₂ if diesel) |
| <ul style="list-style-type: none"> • A bonus of €2,500 will be provided to purchase a new light commercial vehicle if the light commercial vehicle to be scrapped is Euro 0, 1, or 2 and registered until December 31, 1999 |
| <ul style="list-style-type: none"> • Further bonuses of €1,500-€4,000 to buy "greener" vehicles come on top of the scrapping incentives (i.e. they can be added) |
| CASE STUDY – MEASURES UNDER DISCUSSION (POLAND) |
| <ul style="list-style-type: none"> • The Polish government is working on a new proposal, which includes VAT (22%) deduction for new vehicle buyers in exchange for scrapping their old vehicle. This would apply to all vehicles and both private and company buyers. |
| <ul style="list-style-type: none"> • If the Polish Government decides that this would be too costly for the country's budget, there is a possibility that cash incentives (several thousand zloty [€1=4.5 zloty]) will be introduced instead and this would apply to vehicles, whose CO₂ emission does not exceed 155g/km CO₂. |
| <ul style="list-style-type: none"> • Details of this proposal and introduction timing should be known by the end of March '09. The legislation is designed to encourage the churn rate of older vehicles, helping to renew the Polish vehicle parc, which is on average around 14 years old. Clearly the measure would provide a short-term boost to new vehicle sales. |

6. LONGER TERM STRUCTURAL IMPACTS

There are several implications for the industry as a result of the current crisis that will stretch well past the point of a cyclical economic upturn, these may include:

- 1) With consensus economic forecasts pointing to a harsh recession across much of the EU longer term GDP per capita expectations have been reduced over a longer term horizon say a five to six year period. This means that levels of vehicle demand would be lower than previous projections.
- 2) Rising Government debt from various bailouts, fiscal policies and automatic cyclical increases in welfare payments as recession takes hold may lead to higher long term tax burden – again reducing affordability of vehicles in the longer term
- 3) Doubts about the ability of manufactures to maintain required R&D expenditure to fulfil emissions reduction targets.
- 4) Consumer sensitivity to higher prices of vehicles (for example by adding emissions lowering technologies) will probably have increased as they de-leverage and rebalance long term savings
- 5) The rundown of vehicle manufacturer reserve assets combined with big increases in debt loads of the vehicle manufacturers by the end of this crisis will push up interest and repayment costs, further squeezing thin margins. Vehicle price increases in real terms, lower investment spending, additional downward pressure on manufacturing costs and probably a combination of all of these will be needed.
- 6) Increases in financial regulation and a return to higher risk premiums in financial lending as a result of more cautious use of derivative products (longer term compared to the five in the run up to the credit crisis) implies a tightening of access to vehicle credit will be long term and not just a short term reaction. Structural trend levels of new vehicle demand may have to be adjusted downwards at least in the medium term horizon (The used vehicle market would probably benefit from this trend).
- 7) Lower trend levels of European sales (combined with points 3 and 4) will reduce the rate at which the EU Parc (the stock of existing vehicles on the road) will be replaced with new low CO₂ vehicles now being launched, possibly endangering EU commitments to greenhouse gas reduction.
- 8) Severity of the current downturn will probably lead to significant near term supplier bankruptcies or fire sales. This will tend to increase concentration in the component supply industry as smaller suppliers and SME's find less support. The trend away from even vertical integration may be reversed as the funded vehicle manufacturers have to take control of key assets to ensure their supply chain is stable. Overseas component manufacturers may also leap into the void, closing out opportunities for European-based suppliers and SME's to make a comeback, leading to longer term further erosion of the European manufacturing base.
- 9) A phase of industrial consolidation is typical during or immediately following sharp market downturns. However the track record of the majority of automotive M&A deals seen in the last 15 years has been very poor (with a few exceptions) which along with political and social considerations may prevent significant industry wide restructuring and capacity reduction.
- 10) The flow of inward DFI to the EU automotive manufacturing base from Asia manufacturers is likely to dry up for some time until global capacity utilisation recovers to pre-crisis levels.

Impacts of the financial and economic crisis in the EU chemicals sector

Henrik Meincke

**Chief Economist
European Chemical Marketing
and Strategy Association (ECMSA)**

EXECUTIVE SUMMARY

With a workforce of 1.2 million and sales of nearly €540 billion (2007), the chemical industry is one of the biggest industrial sectors in the European Union. The industry provides the technical basis for other economic activities, both in traditional sectors such as agriculture, construction, textiles, clothing and footwear, and in technologically advanced industries ranging from automobiles and modern healthcare to electronics.

The current financial and economic crisis has severe consequences for the European chemical sector. In the fourth quarter of 2008, demand for chemical products collapsed. The sluggish demand, high inventory levels and overcapacities forced many companies especially in the basic chemical segments to reduce production levels and to shut down plants. European chemical production declined by more than 13%. The sectors most affected were petrochemicals, inorganic basic chemicals and polymers. However, specialties and consumer-related chemicals also showed a considerable output drop.

At the beginning of 2009 the situation remains tough and difficult to predict. Due to the weak demand, the inventory run-down within the value chain will last longer. Most companies plan on a day to day basis. In January and February the assessment of the actual business situation deteriorated further. It can be expected, that the situation will improve in the upcoming months with the end of the inventory cycle. This is not a sign of an overall recovery, but some kind of normalization within the downward trend. Nevertheless, in 2009 European chemical production is expected to be 6% lower than previous year.

With its innovative products and system solutions, the European chemical industry helps companies in all industries to become innovative. This is an important contribution combating the current economic crisis. Europe needs its strong industrial sector to pull the economy out of the recession.

Politics can help the economy to overcome the crisis. Many countries already responded to the crisis with national recovery plans. They stabilise the banking system, invest in infrastructure and education, stimulate consumption and encourage energy-efficiency. While these measures are useful today, they have also a positive long term impact. However, protectionism must be avoided.

The long term prospects for the chemical industry are favourable: The actual challenges for humanity require new solutions, many of which can only be implemented through new materials and new technologies provided by the chemicals industry. European chemical companies are innovative and well prepared to meet these challenges.

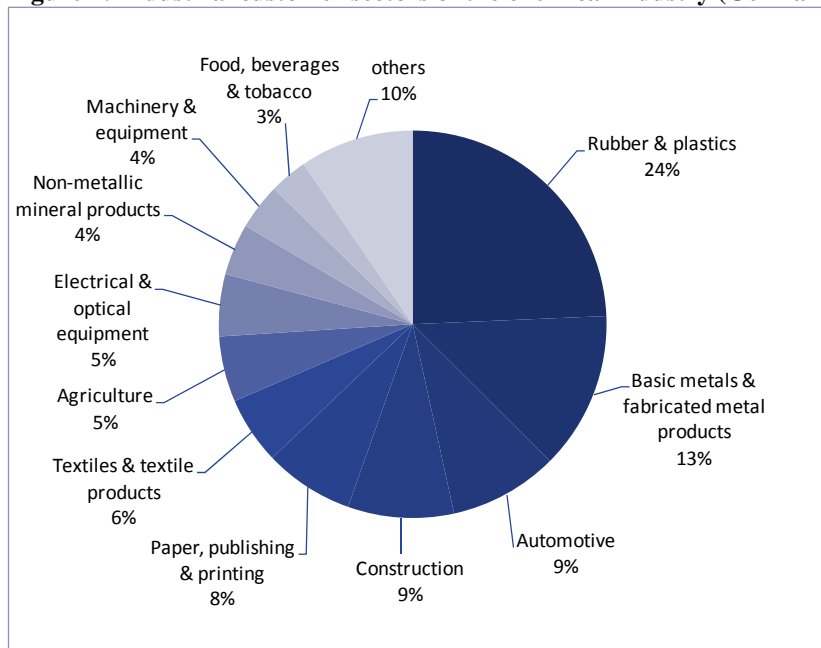
1. THE EUROPEAN CHEMICALS SECTOR²

The chemicals industry is present everywhere in our daily lives. Modern society and its life style are unthinkable without its products. More than any other manufacturing sector, this industry provides the technical basis for other economic activities, both in traditional sectors such as agriculture, construction, textiles, clothing and footwear, and in technologically advanced industries ranging from automobiles and modern healthcare to electronics.

With a workforce of 1.2 million and sales of nearly €540 billion (2007), the chemical industry is one of the biggest industrial sectors in the European Union. In a global perspective, the EU has always been an important player in the global chemicals market and so far it has been in a position to positively benefit from trade opportunities. Europe has a substantial trade surplus in chemicals (€35 billion in 2007). It has a surplus with each main trading region (NAFTA, Asia, Japan, Latin America, Africa, Rest of Europe and Oceania), and has broadly retained its market share (~30%) in global chemicals sales over the last decade. Germany is the largest chemicals producer in the European Union. Nearly 25% of sales fall to the share of German chemical companies.

The chemical industry is well integrated in the value chain of the European industry. More than 80% of chemical production is sold to industrial sectors. However, the biggest customer for chemical products is the chemical industry itself. Usually more than one chemical company is involved before a chemical product is sold to the downstream industries. As a result, the development of one chemical segment is not independent from the situation in other chemical segments.

Figure 1: Industrial customer sectors of the chemical industry (Germany), in percent³



Source: Destatis, VCI

The general performance of the European chemical industry is good especially in comparison to other traditionally established chemical producing countries such as the US and Japan. However, production of chemicals is no longer limited to industrialised countries.

² Unless otherwise stated, all figures relate to chemical industry excluding pharmaceuticals (NACE 24-244).

³ Based on Input-Output-Table (2004)

It takes place in every region of the world, with an increasing presence of the emerging economies in Asia. Markets for chemical products are steadily growing worldwide especially in China, India and Russia. Generally, high growth rates are found in countries with a strong domestic demand mainly caused by industrialisation, urbanisation and preferential access to raw materials. In the industrialized countries growth of chemical demand is lower and closely aligned with general GDP-growth.

Recognising the industry’s strategic importance, China and India have made successful efforts to build up large and increasingly sophisticated production facilities. Notably due to their feedstock advantages, countries in the Middle East attract very high investments in petrochemicals. Consequently, the European chemicals industry’s competitive position is challenged. The trade position of certain important sub-sectors, in particular the raw material and energy intensive parts of the chemicals industry, namely basic organics such as petrochemicals and fermentation products with basic inorganics such as fertilizers, show first signs of deterioration.

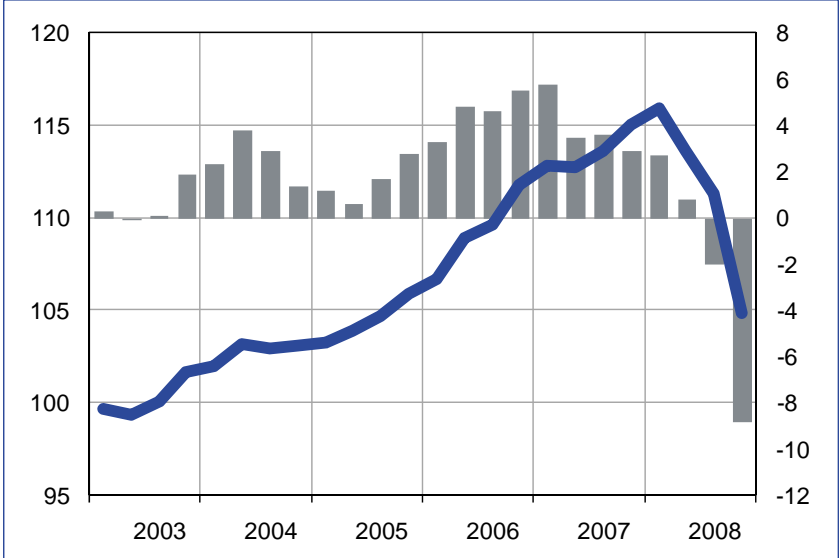
More than 45 % of the production of the global chemicals industry is traded and trade is growing faster than production. Many supply chains have become inter-continental and the relevant markets for many products are global. International trade is vital for growth and employment of the European chemicals industry. The industry has placed itself at the centre of global trade and thus depends vitally on open markets. As global growth is concentrated in the emerging economies, favourable access to these markets is of high importance.

2. THE CRISIS AND ITS IMPACT ON THE EUROPEAN CHEMICAL INDUSTRY

The global economy is in recession. The world economic activity and the global business climate have worsened considerably and pessimistic expectations prevail. GDP forecasts have continuously been revised downward for all major regions. The downturn already reached the chemical industry in the first half of 2008, when European chemicals production flattened.

The end of the global investment boom was reinforced by the US subprime crisis and has developed to a serious threat to the banking system worldwide. The crash of industrial production in November and December 2008 was mainly triggered and intensified by the financial crisis.

Figure 2: Manufacturing industry output, EU27, index 2000=100, growth year-on-year in percent



Source: Eurostat, VCI

2.1 A world out of balance

The current economic downturn should not have come as a very big surprise. Since 2007 the world economy already has shown significant economic imbalances and clear signals for an upcoming downturn. However, the collapse of the financial system and the dynamic of the global drop in industrial production and GDP, which was observed in Q4 2008, surprised all experts. Today, the world is facing the greatest international financial and economic crisis for many decades.

In contradiction to prior troughs, when crises occurred in one region with global spill-over effects, the current crisis is hitting all economies worldwide at the same time - regardless of their specific growth path. In principle there have been four different growth models:

- Some economies like Spain or the US can be characterised by high GDP growth rates due to a build-up in (private sector) debt, and on the back of a surge in housing markets and the construction sector. The corollary was a growing current account deficit. Critical factors common to this group are the rise in private debt and an increasing dependence on foreign financing.
- The second model is demonstrated by Germany, which strongly gained from foreign demand. Germany did not experience a housing boom, household debt declined and the current account surplus increased.
- The third model is represented by Emerging Asia, e.g. China: These countries opened their markets and stimulated an enormous investment boom with industrial policies. The economy benefited equally from foreign and domestic demand. These countries accumulated strong surplus in their current accounts.
- Those countries with access to raw materials, e.g. Middle East represent the last group: High prices for raw materials – especially for crude oil – brought enormous revenues to these countries. These ‘petrodollars’ were partially spent for consumption. But these countries invested also a large share in building up new capacities in downstream industries.

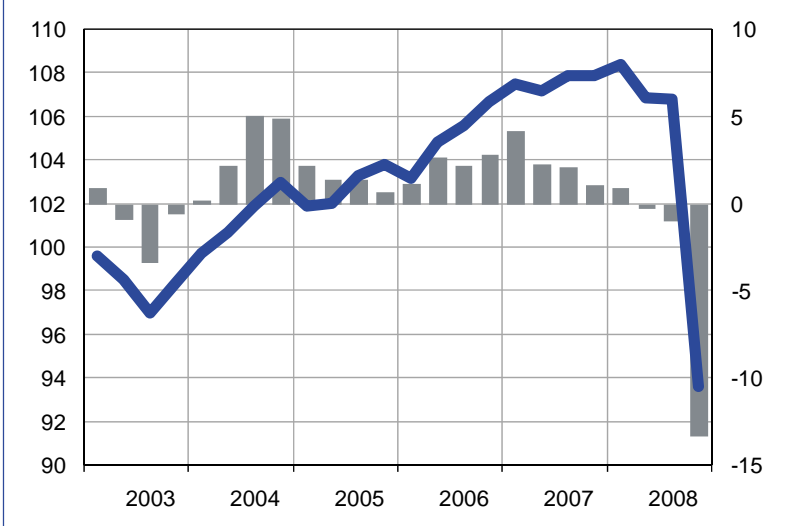
When the current crisis rose due to problems in the financial sector, decreasing raw material prices and a burst of housing bubbles, a slowdown for the United States, Spain, the U.K., the Middle East and Russia was expected. But there was still the hope that Asia and countries like Germany would be less sensitive to a global downswing. However, the economic downswing and the financial crisis reached the global economy simultaneously. No one escaped from this crisis. Overcapacities in construction, automotive and chemical industry (basic chemicals) amplified the downward trend.

2.2 The hard landing of EU chemicals sector in facts & figures

The chemical industry world was still fine until Q4 2008. After it had grown considerably in the past four years, output has flattened on a high level. From January to September 2008 European chemical production was 0.1% below previous year's level. But, this stagnation was widely expected. Most analysts forecasted a weakening of chemicals exports and domestic demand due to the global downswing. However, there was no clear signal that chemical output and demand would drop sharply in the face of the financial crisis and the economic downturn. Since November the European chemical industry output has collapsed. In Q4 2008 European chemicals industry output dropped by 13.3% (yoy).

The production level was more than 6% lower than back in 2000. When major chemical companies made dramatic cuts in production – with volume declines of up to 30 percent – instituted job cuts, and released warnings of profit reduction, the economic crisis officially hit the chemical industry.

Figure 3: Chemical industry output, EU 27, production index 2000=100, growth yoy in percent



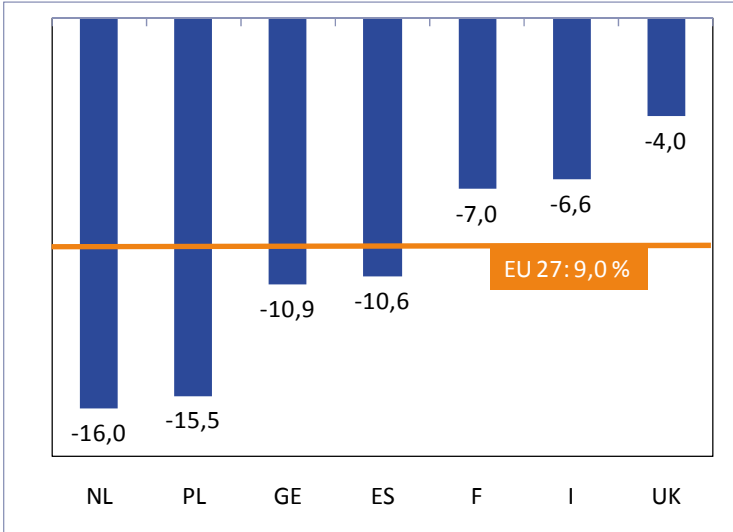
Source: Eurostat, ChemData, VCI

The sharp drop was not a European phenomenon only. Chemical production fell all across the globe. In Q4 2008 chemical output declined in the US by 9% and in Emerging Asia by 2.5%⁴.

2.2.1 Chemicals production declined everywhere in Europe

In Q4 2008, the chemical industry output dropped dramatically in all European countries. Unfortunately, Eurostat only publishes production data for overall chemicals (including pharmaceuticals). The pharmaceutical industry was not affected by the demand decline. Therefore, the following overall chemistry figures show lower production cuts. However, the decline in Q4 2008 is severe (-9%).

Figures 4: Output growth in the chemical industry 4th quarter 2008, yoy in percent



Source: Eurostat, VCI

⁴ VCI based on ACC figures for chemical industry including pharmaceuticals

Countries with a large share of basic chemicals - like the Netherlands, Germany, Spain or Poland - show the strongest decline of chemical production while France, for example, was less affected. This can partially be explained by the large share of pharmaceuticals and consumer-related chemicals in the French chemical sector. The U.K. is also specialised on pharmaceuticals and, therefore, it seems to be relatively stable.

2.2.2 Basic chemicals production dropped sharply

The sectors most affected by the economic crisis are petrochemicals, inorganic basic chemicals and polymers. These segments are highly dependent on business cycles. Furthermore, they supply large shares of their products to industry sectors which suffered most from the current crisis e.g. automotive and construction. Additionally, basic chemicals are very capital intensive, have very volatile feedstock prices and are threatened by overcapacities in Middle East.

Table 1: output growth in the chemical industry by segment, EU27, yoy, in percent

| Segment | 2008 | Q4/2008 |
|---|---------------|----------------|
| Petrochemicals | - 3.2% | - 17.4% |
| Inorganic basic chemicals | - 3.7% | - 15.8% |
| Polymers | - 4.2% | - 18.4% |
| Specialities | - 3.5% | - 11.1% |
| Consumer chemicals | - 0.2% | - 2.4% |
| Overall chemicals (excl. pharma) | - 3.5% | - 13.3% |

Source: Eurostat, VCI

Specialty chemicals and consumer-related chemicals are affected to a still significant but lesser extent. Specialities producers are more diversified than basic chemicals. They supply nearly all industrial sectors. Furthermore, speciality production is less capital intensive and, therefore, less affected by the financial crisis. Detergents and other consumer related chemicals are less sensitive to economic crises, too. Nevertheless, all chemical segments showed a considerable output drop in Q4 2008.

2.2.3 SMEs better prepared for economic crisis

The economic crisis affected large and small chemical companies alike. Most companies reported strong demand drops in many businesses since November 2008. But most companies also have business areas less affected by the demand drop.

Generally, while larger companies typically have more potential for diversification, the current demand decrease may not hit them as badly as highly specialized companies serving volatile markets, e.g. mid-sized companies supplying automotive industry. However, in the chemical industry the majority of SMEs is not focused on a specific downstream industry, which makes them more robust in economic downturns. Other chemical SMEs are operating in niche markets, which are less affected by the economic crisis. On average, SMEs are more robust to the crisis than larger companies, because they are less active in the production of basic chemicals – the segment affected the most by the demand drop. An analysis of Q4 2008 for Germany shows, that the output of SME (less than 500 employees) dropped by 15% compared with Q4 2007, while for all companies the output declined by 17%.

The financial crisis has a stronger negative effect on larger companies. Due to past acquisitions, leveraged buyouts and stock buybacks, the chemical sector is more leveraged than before and poorly positioned to weather this downturn. Some companies are already heading for bankruptcy while others are forced to sell out assets to pay down debt. These problems occur mainly in larger companies. Smaller family-owned companies took less risk and used the recent boom to improve their capital base. In other words, the chemical SMEs are better prepared for the sluggish economic environment than some big players.

2.3 The transmission channels

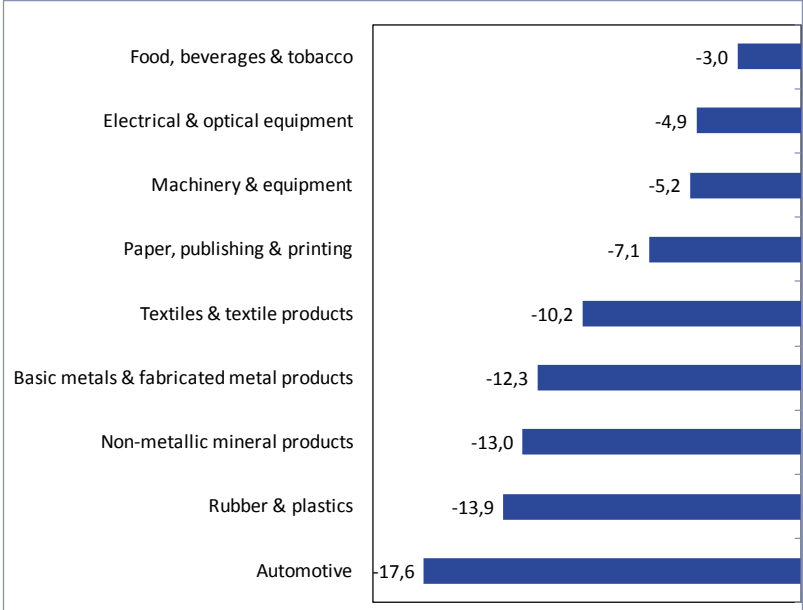
The collapse of industry output in Europe – particularly of the chemical industry – was not expected even though the above mentioned imbalances and the problems of the financial markets have been known for months. In 2007, construction slowed and the subprime crisis revealed a fragile credit system. But when the crisis finally took hold in Q4 2008, it became clear that this downturn would be more complex and difficult than most prior slumps.

Macroeconomic models have not been able to predict the starting point of the downswing and to quantify the output drop – neither for GDP nor for industrial production. To understand the sharp drop in chemical production in November 2008 an accurate analysis is needed. Main transmission channels have been the demand shock within the value chain, distortions from the financial markets and highly volatile raw material prices.

2.3.1 The demand shock, over-capacities and the impact of inventories

Construction, automotive, and consumer durables were the first to fall, dragging chemicals down with them. This is currently a widespread opinion. But the decline of the chemical production of more than 13 percent, which was observed in the fourth quarter 2008, cannot be explained by declining private consumption only. With the exception of the strong decline in orders of new cars, the consumption in the European Union so far remained stable.

Figures 5: Output growth in the manufacturing industry, EU27, 4th quarter 2008, yoy in percent



Source: Eurostat, VCI

Nevertheless, the whole industrial value chain came to a sudden halt in November 2008 resulting in a demand shock for the chemicals industry. European industrial production decreased in Q4 2008 by more than 8 percent.

Sectors mostly affected by the crisis are the automotive industry and rubber & plastics. Additionally, in some countries – like Spain – a drop in construction was observed, while this sector remained stable in others, e.g. Germany. Nevertheless, most chemical intensive sectors have been in serious trouble in Q4 2008 resulting in a collapse of European chemicals demand.

The automotive industry has structural problems: For some years, used cars as well as new cars could be sold at large numbers to Eastern Europe. This market is mature now. So are the Western European markets. Additionally, the financial crises stopped the demand for luxury cars. Furthermore, the automotive industry did not meet the needs of the European consumer who was looking for low energy cars. In this environment, registrations of new cars dropped sharply in Q4 2008. Due to weak demand and high inventories, the automotive industry cut back production sharply. This had negative effects to the suppliers - especially for the chemical industry and the rubber & plastics industry.

In a global perspective, over-capacities have been installed during the recent years in the automotive industry, construction and also in the chemicals sector. With declining global demand this became an obvious problem for European producers.

Inventories of most industrial sectors turned out too high considering declining global demand. To tap liquidity in the face of the financial crisis, all sectors have tried to reduce their inventories since Q4 2008 resulting in lower demand for intermediates. Due to weak demand, the inventory run-down will take some time.

2.3.2 Credit crunch in the chemical sector?

Today, a clear deterioration of the financing conditions of companies is observed for most industry sectors⁵. Companies must often provide more securities and receive loans to worse conditions. In particular car industry, shipyards as well as parts of the metal industry and the electrical industry are facing considerable financing bottlenecks. Furthermore, credit insurances became difficult to obtain in these sectors.

Since January 2009, chemical companies have reported a deterioration of the financing conditions. The chemical industry is capital intensive. Therefore, the financial crisis and worsening financial conditions have negative effects for this sector. However, the chemical industry is less affected by deterioration of financial conditions than other sectors⁶. After four successful years, the chemical industry should be able to master the economic downturn.

Large chemical companies face more difficulties obtaining loans. Usually they need bigger loans. With limited opportunities to re-finance for the banking sector, bigger loans often cannot be granted. Additionally, some companies have more need for finance due to acquisitions, leveraged buyouts and stock buybacks in the past. In some cases, highly leveraged companies are going into this downturn. With deteriorating fundamentals and liquidity risks, chemical companies might be downgraded by rating agencies. Then, it could become a serious problem them to refinance their debt. Nevertheless, most European chemical companies are still rated as investment-grade companies.

⁵ KfW-Research (www.kfw.de/DE_Home/Research/index.jsp), February 2009

⁶ VCI survey, February 2009

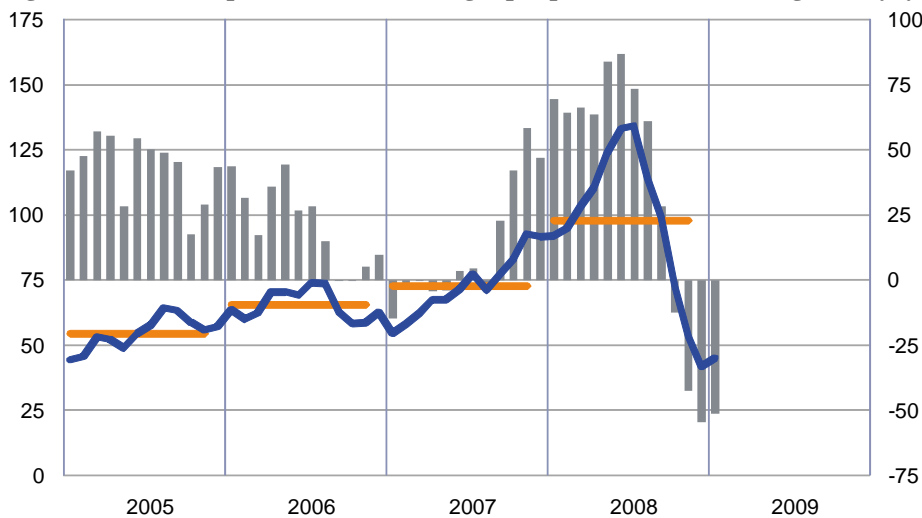
Smaller family-owned companies have improved their capital base in the past. Today, they have no difficulties obtaining loans. However, even the SMEs observe a deterioration of the financing conditions. Especially export insurances became difficult. Furthermore, the difficult credit conditions in downstream sectors are worsening the demand for chemicals.

In conclusion, there is no ‘credit crunch’ in the chemical industry sector, but financial conditions deteriorated and they will continue to worsen in the upcoming months.

2.3.3 Volatile raw material prices

As the crisis was developing, the chemical industry was also hit by volatile swings in raw material prices. During 2008 crude oil prices increased rapidly, peaked in July with an oil price of 140 US Dollar per barrel and prices declined since August. In December crude oil prices were down to 40 US-Dollar per barrel. Naphtha, a crude oil derivative, is by far the most important raw material for the chemical industry. The naphtha price is strongly related to the crude oil price. Naphtha prices peaked in the third quarter 2008 at 660 Euro/t. Thereafter they declined to levels of around 300 Euro/t in December.

Figure 6: Crude oil prices (Brent); average spot price in US-\$/barrel, growth yoy in percent



Source: FERI, VCI

Until summer 2008, the industry was challenged by a strong increase in raw material prices, but in many cases the companies were able to pass on additional costs to their customer. Then, with shrinking oil prices, petrochemical margins began to grow. In Q4 however, rapidly falling oil prices and overcapacities in the petrochemical segment resulted in price declines for key commodity chemicals.

Table 1: Crude oil price and contract prices of primary chemicals

| Crude oil price and contract prices of primary chemicals | Q1/06 | Q2/06 | Q3/06 | Q4/06 | Q1/07 | Q2/07 | Q3/07 | Q4/07 | Q1/08 | Q2/08 | Q3/08 | Q4/08 | Q1/09 | Q2/09 | Q3/09 | Q4/09 |
|--|-------|-------|-------|-------|-------|-------|-------|-------|-------|--------|-------|-------|-------|-------|-------|-------|
| crude oil in US-\$/b | 61,92 | 69,83 | 70,11 | 59,73 | 58,07 | 68,73 | 75,04 | 88,97 | 96,67 | 122,39 | 115,6 | 55,84 | | | | |
| percentage change | 8,8 | 12,8 | 0,4 | -14,8 | -2,8 | 18,4 | 9,2 | 18,6 | 8,7 | 26,6 | -5,6 | -51,7 | | | | |
| naphtha in Euro/t | 442 | 471 | 469 | 406 | 416 | 486 | 490 | 552 | 561 | 631 | 656 | 332 | | | | |
| percentage change | 3,3 | 6,6 | -0,4 | -13,4 | 2,5 | 16,8 | 0,8 | 12,7 | 1,6 | 12,5 | 4,0 | -49,4 | | | | |
| in US-\$/t | 532 | 592 | 597 | 525 | 546 | 655 | 669 | 801 | 841 | 985 | 989 | 431 | | | | |
| percentage change | 4,5 | 11,3 | 0,8 | -12,1 | 4,0 | 20,0 | 2,1 | 19,7 | 5,0 | 17,1 | 0,4 | -56,4 | | | | |
| ethylene in Euro/t | 785 | 865 | 900 | 900 | 855 | 890 | 925 | 945 | 1023 | 1038 | 1228 | 1120 | 520* | | | |
| percentage change | -4,8 | 10,2 | 4,0 | 0,0 | -5,0 | 4,1 | 3,9 | 2,2 | 8,3 | 1,5 | 18,3 | -8,8 | -53,6 | | | |
| propylene in Euro/t | 785 | 825 | 830 | 865 | 820 | 850 | 878 | 888 | 945 | 927 | 1015 | 953 | 430* | | | |
| percentage change | -3,1 | 5,1 | 0,6 | 4,2 | -5,2 | 3,7 | 3,3 | 1,1 | 6,4 | -1,9 | 9,5 | -6,1 | -54,9 | | | |
| benzene in Euro/t | 643 | 711 | 823 | 784 | 776 | 851 | 760 | 710 | 742 | 787 | 870 | 433 | 180* | | | |
| percentage change | 7,2 | 10,6 | 15,8 | -4,7 | -1,0 | 9,7 | -10,7 | -6,6 | 4,5 | 6,1 | 10,5 | -50,2 | -58,4 | | | |
| o-xylene in Euro/t | 710 | 782 | 913 | 800 | 777 | 880 | 861 | 725 | 767 | 853 | 920 | 637 | 480* | | | |
| percentage change | -7,8 | 10,1 | 16,8 | -12,4 | -2,9 | 13,3 | -2,2 | -15,8 | 5,8 | 11,2 | 7,9 | -30,8 | -24,6 | | | |
| p-xylene in Euro/t | 812 | 852 | 1030 | 887 | 827 | 893 | 834 | 764 | 791 | 876 | 967 | 622 | 500* | | | |
| percentage change | -3,2 | 4,9 | 20,9 | -13,9 | -6,8 | 8,0 | -6,6 | -8,4 | 3,5 | 10,7 | 10,4 | -35,7 | -19,6 | | | |

Source: ICIS, VCI

*Values refer to January

This sharp drop in prices is resulting in significant inventory de-stocking at customer levels. The accumulation of inventories is postponed. Customer industries hope to be able to buy products at a cheaper price in a few months time. At the same time the demand for basic chemicals fall dramatically, because of the production cuts in key customer industries.

The majority of companies will show inventory write-downs because of the rapid deterioration in raw material prices. In the medium term however the lower raw material costs will be supportive for the European chemical industry because it will provide substantial relief to working capital in the medium term. But this effect will take some time to work through the value chain.

2.3.4 The weak Euro could help in the future

In July 2008, the Euro/US-Dollar exchange rate reached 1.60 Dollars, when the economic outlook in the U.S. worsened due to the effects of the financial crisis. Since mid-August, the Euro has devaluated against the US-Dollar due to poor economic prospects for the Euro area. Meanwhile the exchange rate is down to 1.25 US-Dollars per Euro which has been the lowest level since two years. One reason for the weakening of the Euro seems to be an extensive repatriation of foreign investments of the United States.

Figure 7: Exchange rate, Euro/US-Dollar, monthly average



Source: FERI, VCI

A weak Euro improves the price competitiveness of European producers – chemical industry and its customers. However, in the current crisis, the chemical industry cannot benefit from this situation, because of weak foreign demand. Nevertheless, the strengthening US-Dollar will be supportive for the export-orientated European chemicals industry and its customers in the medium term.

2.4 The industry response: actions to deal with the changed environment

The chemical industry is fighting on two fronts. One is the economic downturn, which for itself should not be a problem, because the industry is well prepared to manage the cycle. But on the other hand, there is the financial crisis. The key to short term survival is liquidity and this situation makes the chemical industry reacting different than in previously downturns.

Since the beginning of the crisis, chemical companies have quickly ordered spending freezes on everything from selected capital expenditure projects to corporate travel expenses. The sluggish demand, high inventory levels and overcapacities forced many companies especially in the basic chemical segments to reduce production levels and to shut down plants. Some measurements are expected to be temporary, but others could be permanent. At the same time, reductions of overtime and holiday accounts were used to reduce costs, which were followed by short-time working⁷.

These measures were necessary but only short-term. Some companies have already responded with cost cuts on a permanent basis, plant closures, layoffs and/or reduced salaries. As in all downturns, this is probably only the start. In the following months, we will see cost improvement programmes, whether by streamlining overhead functions or by increasing sales force effectiveness. Furthermore, companies will restructure their operations, initiate structural changes and actively seek out opportunities in this recession, as soon as they can better estimate the fundamental demand decline. In addition to cost savings, lower investment budgets for 2009 and 2010 and a realignment of product portfolios should be expected.

Nevertheless, the landscape of the European chemicals industry will change. Some companies will not be able to survive. The strategies might also change. We should expect some concentration within the fragmented industry as well as a shift towards more diversified companies. Companies may also re-consider portfolio strategies, not focussing too much on mostly growth driven, short-term share-holder-value oriented segments but also consider investing into more stable segments, even if growth perspectives are more moderate.

In the long term, customer industries will have a strong demand for new materials, substances and technologies provided by the chemicals industry. The European chemical industry will meet the customers' needs. Therefore, even in the current crisis the companies will not cut their R&D budgets. In the long run, innovation is their most important success factor.

2.5 The policy response and its impact on the chemicals sector

In the current crisis, classic economic policy measures, such as lowering interest rates, are not appropriate any more. Therefore, as soon as the global recession and the financial crisis became visible, many countries have started to fight the crisis using other policy measures.

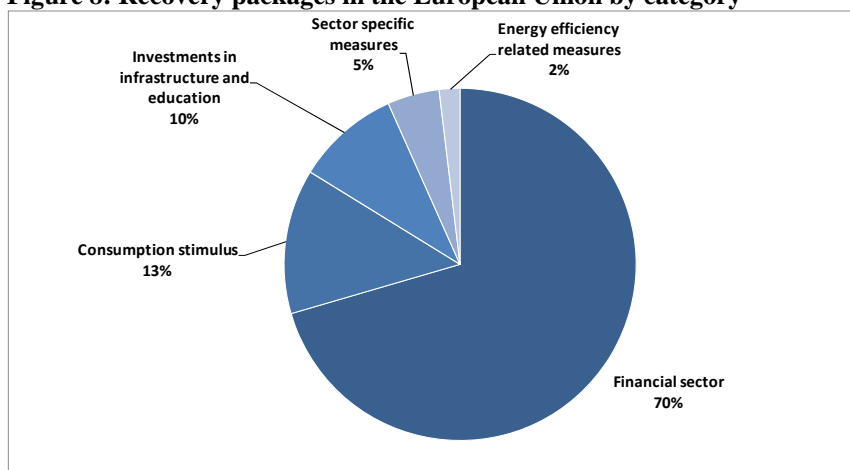
⁷ In Germany, short time working is an instrument that companies can use to avoid redundancies in difficult economic situations. During short-time work, employees work less for a maximum of 18 months. The loss in earnings incurred is partly compensated by short-time working benefits paid by the Federal Employment Agency.

After the Lehman disaster, everybody was afraid of a collapse of the financial system. The policy makers in industrialised countries responded quickly and the national authorities established rescue plans for the banking sector. The collapse of the financial system was avoided, but even today it is still far away from normalization. The industry needs a functioning financial sector. This is especially true for the capital intensive chemical industry. The rescue plan for the banking sector was indispensable. Now, the banking sector has the responsibility to provide the industry with sufficient capital.

However, even extensive rescue plans for the banking sector were not able to avoid a global recession. Industry output dropped worldwide in Q4 2008 and the world economy slipped into a deep economic and financial crisis. Many countries reacted with national recovery packages. Most measures can be assigned to the following categories:

- Increasing public investments in infrastructure and education
- Stimulate consumption (e.g. temporary reduction in the VAT or other tax reductions)
- Energy efficiency related measures
- Measures to stabilize specific sectors
(e.g. the automotive industry: scrapping incentive in Germany and France)

Figure 8: Recovery packages in the European Union by category



Source: VCI estimations based on recovery plans in Germany, U.K., France and Italy

Figure 8 gives a rough overview for the share of each category. Most money was spent for the financial sector followed by measures to stimulate investments and consumption. Sector specific measures and energy efficiency related measures account for 7% of all expenditures.

The impact of the recovery measures on chemicals business is limited to the short term. Stabilizing the financial sector is very important for the capital intensive chemical industry, but the banking sector remains very cautious. Other measures like consumption stimulus or public investments will need some time to make an impact on the chemical demand. Sector specific measures might stabilise the chemical business in the upcoming months. The EU chemical industry is at the beginning of the value chain and measures benefitting downstream industries such as construction and automotive will therefore have a positive effect on the European chemical demand, too.

However, expenditure programmes, where public administrations - instead of companies and consumers - spend money, have their disadvantages. Such programmes may be suitable to stabilize economic imbalances in the short term. But they also distort competition and create desires for the future.

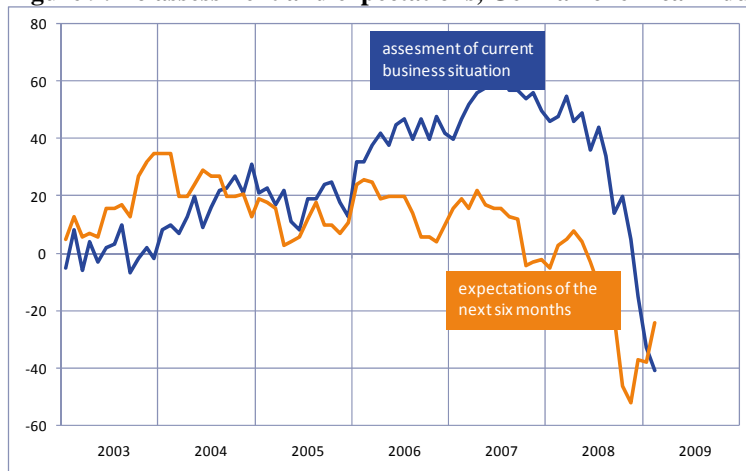
The chemical industry is more in favour of measures which have a positive long term impact on the economy. Investments in infrastructure and education as well as measures to increase energy efficiency will help the economy not only today. In the future, the industry will benefit from a highly qualified workforce and a good infrastructure. Some recovery plans identify opportunities to enhance the energy-efficiency of the housing stock and public buildings. The chemical industry can make great contributions in this area. Notably measures in respect of insulation will generate win-win situations: for the construction sector, for the consumer, for the chemical industry and for the environment.

2.6 First signals for a better future?

A survey of the VCI in February 2009 showed that the chemical industry has not yet reached the bottom line. More time is needed to unwind the imbalances and to reach some form of equilibrium. The first quarter will be hard for the industry, but there are first signals for a better future:

- The demand destruction in Q4 2008 and the very weak start in 2009 were partly driven by the inventory run-down throughout all customer industries and also within the chemical value chains. It can be expected, that the situation will improve in the upcoming months with the end of the inventory cycle. This is not a sign of an overall recovery, but some kind of normalization within the downward trend. Meanwhile, inventories within the chemicals industry are low⁸.
- The share price discount, the current very depressed situation and the stock market will most likely reward a more predictable environment. If this becomes apparent, most of the potential stock market performance of the current year could take place within some weeks.
- The 'ifo assessment' graph has fallen to the 'ifo expectations' graph (see figure 9 below) and expectations are improving: A change to the better never happened before the current assessment came down to the future expectation level. In February, 'ifo hope index' (i.e. ifo expectations minus ifo assessment) turned to the positive territory.

Figure 9: ifo assessment and expectations, German chemical industry



Source: ifo-institute, VCI

⁸ VCI survey, February 2009

- Petrochemical prices are bottoming out. Indications for February are above the January level. The stabilized oil price and the stronger US-Dollar are the main reason. For downstream industries it should become clear that it does not make sense any more to speculate on lower prices for base chemicals. Therefore, demand for basic chemicals is expected to increase in the upcoming month.
- First announcements about plants put on-stream again e.g. Yara (Ferrara fertilizer plant), AkzoNobel (all four chlorine plants) and BASF (cracker in Ludwigshafen)
- First signs for improvements in end-user markets. For example scrapping incentive in Germany and France reduces car inventories of the automotive industry faster than expected.
- There is hope that the policy response could help to overcome the crisis⁹.

3. PROJECTIONS FOR 2009 AND BEYOND

At the end of 2008, the European chemical industry was in a deep recession: production volumes collapsed. The decline was in the double digits. Chemical prices fell significantly. Domestic sales and exports dropped sharply. The capacity utilization went down to 75%. Some companies had to shut down plants. The business confidence fell to historically low levels.

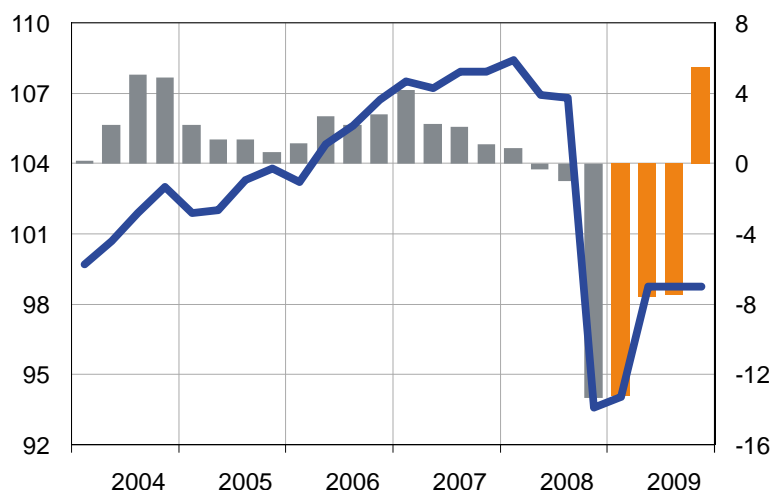
At the beginning of 2009, the situation remains tough and difficult to predict. Due to the weak demand, the inventory run-down within the value chains will take longer than expected. Most companies make their production plans on a day to day basis. January and February will once again show a double digit decline in European chemicals production. This estimation is in line with the pessimistic assessment of the actual business situation in February 2009.

The economic environment will not improve in the next months. On the contrary most experts revised their economic forecasts downwards. In 2009, the world economy will remain in a trough. Investments and consumption will be weak all around the globe.

However, there are first signs of improvement in the chemical sector. Oil prices seem to have reached the bottom, and the correction of petrochemical prices will have materialized soon. The plant shutdowns will lead to low inventory levels. In March, more and more announcements of normal production levels could be expected. This should give the markets further confidence for future planning, which will of course be at a substantially lower level.

⁹ VCI survey, February 2009; 'cefic views on the economic crisis and suggestions for the implementation of the European Recovery Plan, January 2009

Figure 10: Chemical industry output, EU 27, production index 2000=100, growth yoy in percent



Source: Eurostat, VCI forecast

In 2009, European chemicals output (including pharmaceuticals) is expected to be 4% lower than 2008. For the chemicals sector (excluding pharmaceuticals) the decline will be around 6%. This forecast includes a ‘normalisation’ of chemicals demand in the second quarter (figure 10). Time is needed to overcome the crisis. Therefore a global recovery should not be expected before 2011. This means that 2009 and 2010 will remain difficult for the European chemical companies.

With its innovative products and system solutions, the European chemical sector helps companies in all industries to become innovative and thus it can lay the foundation for further growth. The European chemicals sector will keep its research and development expenditures on high levels and will continue to invest in growth. This is an important contribution combating the current economic crisis. Europe needs its strong industry sector to pull the economy out of the recession.

The long term prospects for the chemical industry are favourable: Economic growth is strongly connected to advances in chemistry. Looking ahead, the actual challenges for humanity require new solutions, many of which can only be implemented through new materials and new technologies provided by the chemicals industry. European chemical companies are innovative and well prepared to meet the challenges.

4. BEST POLICY RESPONSE TO OVERCOME THE CRISES AND STIMULATE GROWTH IN THE CHEMICALS SECTOR

To overcome the crisis and to stimulate growth – not only in the chemical sector – the European chemical industry needs:

- A reorganisation of the financial system – the capital intensive chemical depends on a functioning global financial system. The current crisis has shown that financial sector instability seriously threatens the industrial sector. The global financial system needs a new regime.

- An industry friendly policy- a sustainable strategy is needed, which makes Europe a more successful industry location and, consequently, more resistant to crises. Preserving and expanding this industry location means primarily creating an investment-friendly environment, promoting research, strengthening SMEs, and improving infrastructure. What was good and necessary before the crisis, is now becoming even more urgent.
- Furthermore, the European Union and the Member States should not create any extra obstacles and burdens for industry. Measures which reduce the regulatory burden are needed. Taking into account the huge cost for the chemical industry caused by REACH and the ETS-regime, the chemical industry asks for a better regulation which makes existing legislations more stringent and cost effective. New regulations, should always take into account its consequences on the competitiveness of the European industries.
- No protectionism – In the current crisis, national governments are tempted to protect their own industries and to promote single companies or sectors. Even though these measures might have temporary positive effects, there is a broad consensus among economists that protectionism is not welfare-enhancing in the long run. If government intervention is necessary in order to prevent systemic risks or to avoid a collapse of key industries, these measures must have a time limit. In any case, markets have to remain open. Europe benefits from international trade. Therefore, market access is crucial for the European industry sector. Exports have always been a growth engine for the European economy.

Impacts of the financial and economic crisis on the pharmaceutical industry

Benjamin Belot and Anne-Charlotte Pupin

Alcimed

EXECUTIVE SUMMARY

The financial crisis, which hit the world in 2008 has now become an economic downturn. Europe is anticipating a difficult year, with several sectors like automobile or banking already needing bailout plans to save them from bankruptcy.

The healthcare industry is a crucial sector for European economy, as well as for the well being of European citizen. It comprises pharmaceutical and biopharmaceutical companies, and medical device companies. The 2 200 pharmaceutical companies in Europe range from the top 20 big international companies (Pfizer, Novartis, etc.) to medium companies (Menarini, etc.), but also include 1 621 biopharmaceutical companies that are mostly SMEs with 28 employees in average. Regarding medical device companies, 80% of those 11 000 companies are SMEs.

This sector is also characterized by a strong R&D investment. Indeed researching and developing a new chemical or biological entity requires in average 10 years time and costs € 1 059 million. Yet today, almost a quarter (23,7%) of the EU's high-tech products' exports are innovative pharmaceutical products.

Considering that the pharmaceutical industry has been going through a crisis of its own for the last few years, the question remains of whether it can maintain its reputation as a safe harbor in the storm.

To answer this question, we will carefully analyze every angle susceptible of being impacted by the economic crisis:

- The demand in pharmaceutical products and medical devices;
- The stock value of pharmaceutical and biotechnology companies;
- The investments;
- The relations between healthcare providers and the industry and
- The employment within the pharmaceutical sector.

Pharmaceutical and medical device industry: global figures (2006)

| | Medical device industry | Pharmaceutical industry |
|----------------------------|-------------------------|---|
| Production | 63,6 bn€ | 182 bn€ <i>Including</i> <ul style="list-style-type: none"> • 9,1 bn€ for the biopharmaceutical sector • 25 bn€ for the OTC sector |
| Employment | 435 000 employees | 643 000 employees <i>Including</i> <ul style="list-style-type: none"> • 107 000 R&D employees • 32 500 employees for the biopharmaceutical sector |
| R&D expenditure | 3,6 bn€ | 24,3 bn€ |

Sources: *EFPIA, 2008; EUCOMED, 2007; AESGP*

1. IMPACT OF THE CRISIS ON THE DEMAND FOR PHARMACEUTICAL PRODUCTS AND MEDICAL DEVICES

The demand for prescription healthcare is inelastic and independent from the general state of the economy. Indeed, its main drivers *i.e.* the prevalence of diseases, the aging of population *etc* are not likely to be affected by the financial crisis.

On the other hand, over-the-counter drugs, which account for ~15% of pharmaceutical products sales, involve out-of-pocket payment from the patient with little or no help from the healthcare system. Therefore the market is more vulnerable, especially as unemployment increases and personal income does the opposite. Most of the pharmaceutical companies have over-the-counter products in addition to their ethical drug portfolio, therefore they will rely more heavily on the latter in 2009.

However a November 2008 survey conducted by the *German Association of Research-based Pharmaceutical Company (VFA)* among two thirds of the German pharmaceutical industry concluded that about 70% of companies were expecting slightly higher revenues in 2009 compared to 2008.

Same principles apply to the medical device industry. While crucial systems like cardiac or reconstructive orthopaedic implants and consumables like syringes are likely to sustain a solid growth, non-essential devices like cosmetic surgery implants may be negatively affected by the crisis. Furthermore, the credit crunch will make it more difficult for hospitals and private practice to invest in expansive equipment like imaging devices or cutting-edge surgical equipment. As a consequence, delays in the purchases of high-end instruments may be observed, and the four main vendors are expecting to sell mostly mid tier systems in 2009. Thus again only a specific part of the sector will be impacted, *ie.* in France, equipment account for ~ 25% of the market in value.

2. IMPACT OF THE CRISIS ON THE STOCK VALUE OF PHARMACEUTICAL AND BIOTECHNOLOGY COMPANIES

The pharmaceutical industry is going through a state of mutation. Such a structural change was made necessary by the lack of innovation, the decrease of R&D productivity, the increase in regulatory requirement *etc* which prevented the pharmaceutical industry from developing sufficient numbers of innovative high-value products to replace drugs facing patent expiry.

In the last few years, pharmaceutical companies' stocks had been underperforming compared to the general market trends, as a reflection of the decline of their business model (*eg.*, the Dow Jones US Pharmaceutical Index fell by 10%, between January 2007 and May 2008, while the Dow Jones Industrial average climbed by 4%). Now, thank to their balance sheet strength and to their unusually small average net debt as a proportion of capital employed (*i. e.* for the top 20 pharmaceutical companies it is just 6%, while the average net debt carried by financial institutions is 95%), major pharmaceutical companies are now considered a safe haven by investors. Indeed, in 2008, pharmaceutical companies have overperformed on the stock market compared to the rest of the industry (*eg.* from the end of June 2008 until the end of September 2008, the Dow Jones US Pharmaceutical Index has risen by 2% while the Dow Jones Industrial Average has fallen by 5% over the same period).

An example of how trustworthy big pharmaceutical companies are in the eyes of investors can be found in the *Pfizer-Wyeth* merger. Five banks have accepted to finance the \$68 billion deal between these 2 companies, who were already among the biggest players in the pharmaceutical industry.

However, the situation is more preoccupying for those smaller pharmaceutical or biotech companies which rely on their stock for capitalization but do not have the financial stability of their counterparts. They are getting very anxious about being able to find the resources to maintain their research programmes. And with their valuation down, hostile takeovers are another subject of concerns.

3. IMPACT OF THE CRISIS ON INVESTMENTS

As damaging as the credit constraint is, it may also be a driver of investment opportunities for companies having cash available. Such is the case for big pharmaceuticals, which have wisely stayed away from the cheap debt game. With private equity capital vanishing (*France Biotech* reported early this year a 79% fall in equity investments in French biotech companies in 2008), they are the only serious buyers in the room for companies in urgent need of cash supply. Therefore they are expected to use this period of time in order to fill their pipelines with innovation.

In January, *Merck & Co.* CEO Richard Clark stated that the company was "aggressively looking" at all types of acquisitions for the coming year. "I think we're in a very good position to make whatever investments are needed," he said. Similar statements were made by other CEOs.

Although these mergers & acquisitions do not all stem from the credit constraint, the credit situation is definitely putting big pharmaceutical companies in a strong position leaving little bargaining power to smaller companies.

On the other side of the spectrum, small biotechnology and niches pharmaceutical companies without revenue and only a few months' cash to survive are clearly exposed, unless they recently secured a round of financing.

For example, *Intercytex Group*, a Cambridge-based maker of treatment for chronic wounds recently announced that it would have to cut about half its 76 staff and halt new projects to save cash. Nick Higgins, its chief executive said: “This is the first time I have had to impose cuts where there has been no failure. Our projects are going well but there is just a shortage of cash”.

Furthermore, a survey of biotechnology companies conducted last December in Norway concluded that half the companies would run out of cash in the next 12-18 months if no action was taken. The government consequently decided to make explicit provision for life sciences and research within its economic stimulus package unveiled last January. The biotechnology component of the package is valued around 300 million euros and according to Bjarte Reve, CEO of the *Oslo Cancer Cluster* “This is the most active political move in Europe regarding support to the biotech industry”. As part of the package, *Innovation Norway*, a state development agency will increase the amount of loans made to research-intensive companies.

In the UK, the *BioIndustry Association* as well as the *Association of Clinical Professor of Medicine* have been ringing the alarm since the end of 2008 about a possible extinction of the sector, which would have devastating effects on both employment and innovation. Although many structural causes are to be blamed for this situation, the credit constraint is making everything more difficult.

Finally, as far as medium-sized European pharmaceutical companies are concerned (*i.e.* companies with revenues are between 500 million and 1 billion euros) the *French Pharmaceutical Companies Association* is predicting a consolidation trend in the next 3 years.

4. IMPACT OF THE CRISIS ON RELATIONS BETWEEN HEALTHCARE PROVIDERS AND THE INDUSTRY

Because of the ongoing trend in regulatory scrutiny and support for generic drugs, the industry is afraid to be put under even more pressure by healthcare providers, in order to contain the costs of drug spending. Indeed, most European countries have state-funded healthcare plans and there is no doubt that with industry bailout plans and with the increase of unemployment, more pressure will be applied on their budget, forcing them to closely monitor healthcare expenses. Despite the aging of population, some expect healthcare spending to decline in the current economic downturn.

AstraZeneca CEO David Brennan has voiced concern in December 2008 about such changes in healthcare policies, hoping that the situation leads to drug makers being allowed to communicate directly to patients in the European Union.

However, pharmaceutical companies are already required to provide more robust pharmacoeconomic and quality-of-life data as a condition of reimbursement approval. With more rigorous assessments of the cost and clinical effectiveness of new drugs already in effect, there seems to be little room for governments to manoeuvre if they want to keep healthcare jobs in Europe.

5. IMPACT OF THE CRISIS ON EMPLOYMENT WITHIN THE PHARMACEUTICAL SECTOR

Although the last few weeks have seen their fair share of downsizing, job cutbacks...in the pharmaceutical industry, these decisions should do not be all regarded as stemming from the crisis. A lot of them are a result of the mutation of the pharmaceutical industry and according to the *French Pharmaceutical Companies Association*, the only effect of the crisis is to accentuate an already existing trend. For example, two thirds of pharmaceutical representative positions in France were terminated in 2008, because the industry cannot rely on heavily promoted blockbuster drugs anymore.

On one hand, *GlaxoSmithKline* indicated in early February that its latest round of job cuts is not related to the global economic downturn but part of a wider restructuring plan. Although no number was specified a portion of these cuts is anticipated to be made in the UK workforce.

On the other hand, *Allergan* (a mid-size pharmaceutical company) announced a 5% reduction in its global workforce, including in its European work force, following disappointing 2008 results.

A November 2008 survey conducted by the *German Association of Research-based Pharmaceutical Company (VFA)* among two thirds of the German pharmaceutical industry concluded that about 41% of companies expected to keep the same number of employees, while 33% anticipated a reduction in their workforce in 2009.

More unemployment should also be a consequence of the short debt supply turned off in the biotechnology industry. Biotech companies are already experiencing jobcuts to face the ongoing financing constraints and survive all along 2009.

Finally, with all the mergers & acquisitions mentioned earlier, post-acquisition layoffs (sometimes referred to as “trimming the fat”) are also to be expected in the process. As an example, the Pfizer and Wyeth merger is expected to result in a reduction of 10% of jobs. Further, for companies such as mid pharma companies or biotechs, who have already made everything they could in order to cut costs will look to mergers as their last chance to reduce expenditures. Therefore the sector concentration on employment is expected to significantly reduce employment in the 2 coming years.

CONCLUSION

Although the pharmaceutical industry is affected by the economic downturn, the crisis it is going through is much more structural than punctual. On the one hand, big pharmaceutical companies should be sticking to their reputation as a safe harbor in the storm. What they need is not a bailout plan like the automobile industry or the banking sector but adjustments to help them go through their mutation period. Nevertheless, they are anxious about a possible impact on their over-the-counter business. Stricter drug review procedures as well as cost-cutting measures from healthcare providers are also a subject of worries.

The medical device industry is also likely to be relatively protected, except for companies selling expansive high-end equipment (*eg.* medical imaging) requiring important investments or companies selling non-crucial devices like cosmetic surgery implants.

On the other hand the credit constraint will hit biotech companies and small to medium specialty pharmaceutical companies hard and several of them are likely to need some help with their funding at some point and some governments have already started taking actions. In Norway for example, the government set up 300 million euros stimulus plan for research-based biotechnology companies. Part of this package will be devoted to making it easier for such companies to secure loans, on which they completely depend to further advance their drug pipeline. Not only are thousands of jobs at stakes here but also Europe's competitiveness in terms of medical innovation.

Finally, as cost cutting becomes more necessary than ever, consolidation is to be awaited in the pharmaceutical sector, including mergers between mid-size pharmaceutical companies. This trend could negatively affect employment as lay offs are to be expected in the process.

The Impact of the Economic Downturn on the Food Sector

Ben Cooper, just-food analyst

EXECUTIVE SUMMARY

This report aims to give an overview of the impact of the economic downturn on the EU food sector and look ahead to the likely prevailing effects during 2009.

It is based on official statistics; company reports and trading statements; data and position papers published by food industry associations and campaign groups; market research; and interviews with industry advocates, personnel from food companies, academics and campaigners.

1. The EU food sector in 2008/2009

- The food industry is a vital component in the EU economy. It is the leading employer in the EU, accounting for around 13.5 % of the total workforce, and generating a turnover of EUR 913 billion in 2007.
- Notwithstanding national variations, recessionary effects are being felt in the food industries in all countries.
- While food is proving more resilient to the downturn than other consumer goods, food companies large and small are seeing a pronounced commercial impact.
- Large, international companies are coping better than SMEs. But most major companies are predicting continuing or escalating recessionary effects during 2009, and some have downgraded forecasts.
- SMEs in the food industry are suffering most acutely, particularly from the shortage of credit. SMEs play a significant role in the EU food industry, accounting for 48.5 % of the sector's turnover and 63.0 % of its total workforce in 2007. The weakened state of so many small- and medium-sized companies could precipitate some consolidation over the coming year.
- Industry advocates are urging governments to support the food industry with policy initiatives. In particular, governments are being asked to address the issue of access to credit and export credit insurance for SMEs, and defer payment of employment taxes.

2. Retail and consumer trends

- Consumer response to the downturn and retailer activity varies from country to country. For example, mainstream supermarket chains in the UK are placing markedly greater emphasis on price promotion and value lines, while this has not been observed to a significant degree in Sweden.
- The accelerated growth in the discount sector underlines how price has become the dominant factor for consumers. Growth in discount retailing will be fastest in countries where the discount segment is relatively undeveloped such as the UK, Ireland and Spain.
- The picture of consumer behaviour is complicated. The recession has certainly fuelled growth in budget lines but in general consumers are becoming more conscious of the price/quality ratio, so 'economising' doesn't always mean trading down.

- Ethically-sourced food products appear to be holding up better than the organic segment.
- Changes in food-buying patterns resulting from the downturn could impact on dietary health, and academics believe these effects will require monitoring.

3. Country profiles: Impacts across a cross-section of EU markets

- Analysis of individual country trends confirms the variation in effects of the recession between EU member states. Among the countries examined in detail in this section, the Irish food industry appears to be the worst affected by the recession. On the other hand, Sweden and Finland reported only a minor impact.
- Industry representatives confirm the general increase in price-consciousness among consumers across most markets.
- Exposure to the credit crisis varies from market to market but is a factor in most. Where it is an issue, SMEs are suffering more acutely.
- Currency devaluation is helping food exports in some countries, such as Sweden and the UK, but in countries where currencies have devalued food companies are seeing costs rising significantly. Indeed, industry representatives in the UK feel the latter effect is outweighing the benefits of the former.
- The issue of the cost and availability of export credit insurance appears to be a concern virtually across the board.

1. THE EU FOOD SECTOR IN 2008/2009

1.1 The EU food industry key facts and figures

The significance of the food and drinks industry to the economy and culture of the European Union can hardly be overstated:

- it is the largest manufacturing sector in the EU;
- it is the largest employer in the EU;
- it is a net exporter;
- it has a large proportion of SMEs.

The food and drink industry is the largest manufacturing sector in the EU, with a turnover in 2007 of EUR 913 billion, according to the European Confederation of Food and Drink Industries (CIAA).

It is also a net exporter, with exports of EUR 54.7 billion in 2007, versus imports of EUR 52.7 billion (CIAA).

The food industry is also the leading employer in the EU, accounting for around 13.5 % of the total workforce.

Moreover, SMEs play a hugely significant role in the EU food industry, accounting for 48.5 % of the sector's turnover and 63.0 % of its total workforce in 2007. In fact, the industry is notable for its relatively fragmented structure in comparison with sectors of a similar scale within the EU, comprising as it does as many as 308 000 individual companies in 2007.

1.2 Food sector performance in 2008

The worsening economic climate in 2008 has clearly taken a heavy toll on the EU manufacturing sector but the effects on the region's food markets will, for a variety of reasons, show a different pattern from other manufacturing sectors:

- there will be less impact in terms of consumer sales levels than other industries;
- there will be a wide disparity between effects in different countries.

CIAA has not yet collated EU-wide figures for 2008 but interviews with industry associations in various representative countries, conducted for this report, appear to confirm the general expectation that the food sector has not suffered as acutely from the worsening economic conditions as other consumer markets.

This is supported by the most recent trend data, collated by Eurostat from national statistics sources. This shows that while year-on-year inflation-adjusted retail sales of food, drink and tobacco fell back in 2008, the fall was not as marked as trends being reported in other non-food retail sectors.

Table 1: EU 27 inflation-adjusted retail sales year-on-year growth, 2004/2008

| | 2004 | 2005 | 2006 | 2007 | 2008 |
|-----------------------|------|------|------|------|-------|
| % change year-on-year | 2.0 | 1.6 | 1.4 | 0.4 | - 1.0 |

Source: Eurostat, 2004/2008.

However, for the food industry recession has followed a period of extreme volatility in commodity prices, marked notably by a significant inflationary spike in 2007/2008 followed by deflation in the second half of 2008. Many food companies were already suffering from the effects of this volatility, underlined by the recent trend in food retail prices.

Table 2: EU 27 food consumer price inflation, 2004/2008

| | 2004 | 2005 | 2006 | 2007 | 2008 |
|----------|------|------|------|------|------|
| % change | 1.9 | 1.1 | 2.4 | 3.5 | 6.7 |

Source: Eurostat, 2004/2008.

As the food industry will not see the kind of contraction in sales seen in other manufacturing industries, the balance between food and non-food sectors in the EU is set to change over the coming year. The share of the food and drink industry within the total manufacturing sector in the EU has shown variations of no more than one percentage point since 1999. That pattern is certain to be disrupted in 2008.

The growth of food and drink sector turnover has been on a par with other manufacturing sectors in the EU between 2000 and 2007. This pattern is also set to change. While many manufacturing industries will be falling back in terms of output over the next year or so, food and drinks industries in EU countries have a far better chance of maintaining growth or at least remaining flat in real terms.

However, research for this report suggests some significant variation across different EU countries in terms of resilience to recessionary pressures, and the extent of the damage the downturn has inflicted on national food and drinks industries.

1.3 Performance of major European food companies

1.3.1 Nestlé

The world's second largest agri-food company is based in Europe, if not actually in the EU, and Europe accounts for 26 % of its sales. The notion that food is a more resilient category during a recession is borne out by Nestlé's recently-announced 2008 results:

- Group turnover up 2.2 % to CHF 109.9 billion (EUR 74.1 billion);
- Food and beverage sales up 2.1 % to CHF 102.4 billion;
- Net profit up 69 % to CHF 18.0 billion (boosted by major disposal);
- EBIT (earnings before interest and tax) up 4.5 % to CHF 15.7 billion.

However, Nestlé's Zone Europe had the slowest growth of its three geographical regions, with organic growth of 5.6 %, versus 10.3 % in Zone Americas and 12.2 % in Zone Asia, Oceania and Africa. Double-digit organic growth was observed in Eastern Europe, and positive organic growth in 'key Western European markets, such as France and Great Britain'. Zone Europe EBIT margin increased by 20 basis points.

Commenting on the impact of the recession, CEO Paul Bulcke said: 'The global business environment in 2008 was affected by a number of unforeseen events, especially in the latter part of the year. Economies around the world have significantly weakened over the last few months and it is likely that developments could further impact consumer demand.' Nevertheless, for 2009, Nestlé remains committed to an organic growth target 'at least approaching 5 %, as well as a further improvement of the EBIT margin in constant currencies'.

1.3.2 Unilever

Anglo-Dutch food and household goods group Unilever reported its 2008 results in February:

- Turnover up 1 % to EUR 40.5 billion;
- Operating profit up 37 % to EUR 7.17 billion (boosted by disposals);
- Net profit up 28 % to EUR 5.29 billion (boosted by disposals).

Western Europe showed underlying sales growth of 1.3 %, against 7.4 % for the company as a whole. However, Unilever stated that pricing had contributed 3.8 % growth with volume lower by 2.4 % for the year.

It added that ‘volume consumption in our markets has reduced and shoppers are increasingly looking to economise on their purchases’.

Moreover, Unilever said the fourth quarter had seen ‘reduced volumes, dilution from disposals and exceptionally high increases in input costs put pressure on margins’. It said it expected cost pressure to ease beyond the first quarter of 2009. But CEO Paul Polman said that ‘given the current economic uncertainty I believe it would be inappropriate at this stage to provide an outlook specifically for 2009 or to reaffirm the 2010 targets’.

1.3.3 Danone

French dairy-based group Danone posted its 2008 results in February:

- Sales were up 8.4 % to EUR 15.2 billion;
- Trading operating income was up 12.3 % to EUR 2.3 billion;
- Underlying net income was up 15 % to EUR 1.3 billion.

Once again, growth in Europe has lagged behind other regions. For the year, sales in Europe grew by 5.1 %, against 16.3 % for Asia, 13.2 % for the Rest of the World and 8.4 % for the group as a whole. The worsening climate in the fourth quarter is reflected in slowing sales growth to 2.6 % in Europe, against 18.5 % for Asia, 8.6 % for the Rest of the World, and 6.0 % for the entire business.

As it announced its results, the company said: ‘As anticipated in the macro-economic scenario described by Danone in November 2008, the global economic environment has further deteriorated in the past three months, resulting in a slowdown in most markets in which the group operates, including in a number of emerging countries.’

It added that the scenario for 2009 remains that current consumption patterns in its key emerging and developed markets will continue over the balance of the year, with no significant improvement or dramatic breakdown. As a result, the company said it was targeting full-year like-for-like sales growth in 2009 ‘a few points below’ its medium-term guidance of 8-10 %.

1.3.4 Lactalis

French dairy group Lactalis, an unlisted company, recorded turnover of EUR 9.6 billion in 2007, 54 % of which was outside France. It employs 34 500 people.

No financial data is yet available for 2008, but in September the company announced it would be rationalising Camembert production at its plant in Saint-Maclou, Brittany, in response to falling sales since the start of the year and rising milk prices. The move would allow the company to rationalise costs, Lactalis said.

The company made acquisitions in Poland, Switzerland and Romania during 2008. In October, UK subsidiary Lactalis McLelland unveiled a GBP 1 million-plus TV ad campaign for its Seriously Strong cheese brand, the first TV campaign for the brand in four years.

1.3.5 Royal FrieslandCampina

Two large Dutch dairy cooperatives, Friesland Foods and Campina, merged late last year to form FrieslandCampina, soon renamed Royal FrieslandCampina:

- The merged business has sales of around EUR 9.1 billion;
- It employs 22 000 people in 100 production and sales locations in 24 countries.

Clearly it is too early for comparable financial data. But in August, Friesland posted a dramatic drop in net profit to EUR 29 million, from EUR 79 million, for the first half of last year, hit by sharp rises in raw material costs.

When the merger was announced chairman-designate Kees Wantenaar said current economic conditions and the liberalisation of the dairy sector make a merger more necessary than it did a year ago, when the two groups first agreed to merge.

1.3.6 Associated British Foods

UK-based international food and retail group Associated British Foods (ABF) reported its 2008 results in November:

- Turnover was up 7 % to GBP 8.2 billion;
- Underlying pre-tax profit was up 3 % to GBP 632 million;
- Underlying operating profit was up 7 % to GBP 664 million.

ABF is not only involved in food production, with subsidiaries such as British Sugar, but also non-food retailing through its Primark business which has stores in the UK, Ireland and Spain. While exposure to non-food retailing during the downturn could have represented a threat, it appears that, owing to its price proposition, Primark has been one of the few non-food retail chains to prosper in the current conditions.

In November, CEO George Weston said: ‘Consumer spending in many parts of the world has been under pressure for some months. Despite this, Grocery, Agriculture and Primark all delivered strong sales and profit growth. While faced with a general economic downturn, we remain committed to the group’s expansion and development, most notably in Sugar and Primark.’

The chairman’s statement said: ‘The year saw steadily worsening economic conditions with sharp rises in input costs, particularly raw materials and energy, and falling consumer confidence.’

ABF issued a further trading statement in January for the 16 weeks to 3 January, stating group revenue had risen by 15 % at constant exchange rates in line with expectations, with Primark sales 18 % ahead. The group benefited from the weak pound, particularly in its grocery and ingredients divisions. However, lower consumer demand had resulted in weaker sales to the foodservice sector, the company said. In December, the company acquired Spanish sugar producer Azucarera Ebro for EUR 385 million.

The company said it was ‘immune from the worsening economic climate and particularly the pressure on consumer spending’, and has budgeted for ‘little change in net earnings for the full year’.

1.3.7 Vion

Vion is an unlisted company and as such will not be reporting its 2008 performance (sales in 2007: EUR 7.1 billion, net profit EUR 126 million) until April 2009. But in January 2009 the Netherlands-based meat processor said it would be shedding 820 jobs in the UK, where some 14 500 of its 16 000 employees are based. The rationalisation was attributed to over-capacity in the meat processing sector, and was linked to a loss of business with Marks & Spencer.

1.3.8 Danish Crown

Danish meat processor Danish Crown reported its 2007/2008 financial results in November:

- Sales up 6 % to DKK 47 billion (EUR 6.3 billion);
- Operating profit down 3 % to DKK 1.8 billion;
- Net profit down 19 % to DKK997 million.

Danish Crown, a cooperative and the world's largest meat exporter, said the financial crisis came to dominate the end of the financial year which is having a severe impact on its member owners, but the crisis had shown that the cooperative system is a strong and lasting ownership structure.

Its annual meat exports of around EUR 3.4 billion represent around 4 % of Denmark's total exports and 43 % of the country's agricultural exports.

The company announced in January that it planned to close two production sites in the UK as part of a restructuring following a number of acquisitions in recent years.

1.3.9 Arla

In January, Danish/Swedish dairy cooperative Arla announced it was downgrading its budgeted performance for 2009 in response to the economic conditions:

- Budgeted net turnover: DKK 47 billion (EUR 6.3 billion);
- Budgeted net profit: DKK 899 million.

In December, Arla had downgraded its expectations for 2008 from profits of around DKK 900 million to DKK 600-700 million.

The company said it had become clear in the autumn that 'the financial crisis had developed into an economic crisis with consumers opting for cheaper dairy products and, in certain markets, avoiding buying them altogether'. The company said its investment earnings had been hit by falling share prices and foreign exchange losses.

Also, the market situation changed from a global shortage of milk in 2007 to a milk surplus at the end of 2008, which caused global market prices to fall, a trend further exacerbated by the financial crisis.

1.3.10 Südzucker

German sugar producer Südzucker AG made no reference to worsening economic conditions when reporting its third-quarter results in January:

- Revenues were up 5 % for the first nine months to EUR 4.6 billion;
- Operating profit was up 4 % to EUR 184 million;
- Revenue for the year was forecast at EUR 5.8-6.0 billion, against EUR 5.8 billion in 2007/2008;

- Full-year profit forecast to be EUR 230-260 million, against EUR233 million last year.

As a result of factory closures precipitated by EU sugar market reforms early in 2008, the company's workforce contracted by 1 542 to 18 279. The company created 257 new jobs in its special products and fruit operations.

1.4 Impacts on SMEs

The European food sector may boast some enormous multinational corporations, but in many countries the industry supports a huge number of SMEs, and country industry associations are concerned that it is these companies which are likely to suffer most acutely during the recession. In particular, they are the hardest hit by the credit crisis.

Among the government actions being recommended by CIAA and national food industry federations are the following:

- state support to address credit availability and export credit insurance;
- creation of a mediator to help SMEs address issues with credit institutions;
- cutting electricity and gas prices to the level of competitor economies;
- reducing employment taxes in labour-intensive sectors such as food;
- state support for productivity enhancement measures at company level.

CIAA also warns that some of the worst effects of the crisis have not yet been reflected fully in much of the available sales data. 'The effects of the crisis cannot be really seen in current trade data which goes up to the third quarter of 2008,' CIAA says. 'We would expect this to become more visible and stringent in 2009.' CIAA forecasts greater pressure on overall sales and on exports, with SMEs being particularly vulnerable.

It has also been pointed out by analysts and industry associations that the vulnerability of SMEs could lead to concentration in the food sector, particularly in countries such as Italy where the industry is particularly fragmented. It goes without saying that merger and acquisition activity will be constrained by credit availability, but for companies that are well financed the opportunities for expansion through acquisition are plentiful.

Therefore a degree of concentration in the EU food market is to be expected over the coming year or so, and in countries where consolidation is required to boost competitiveness, food industry strategists will view this as a benign or even positive consequence of the downturn.

1.5 Industry longer-term policy recommendations

Looking longer-term, CIAA is providing input into the High Level Group on food and drink industry competitiveness, and has made a raft of policy recommendations covering the following areas:

- improving access to competitive agricultural raw materials of required quantity and quality;
- improving access to export markets and enhancing a level playing-field;
- boosting research and development programmes and innovation;
- improving the EU regulatory framework and ensuring enforcement.

CIAA concludes: 'Many of these recommendations become even more important at times of crisis'. These policy recommendations can be viewed in full at http://www.ciaa.eu/documents/brochures/CPT00209E_Annex1.pdf

1.6 Chapter conclusions

As a major employer, income generator and source of exports, the food and drink industries represent vital components in the economies of all EU members and the EU as a whole.

The performance of the food sector has varied significantly from country to country. The collective industry organisation, CIAA, has not collated its figures for 2008 and its analysis of recent months is impressionistic in nature.

Official sales statistics support the general contention that the food retail market is more resilient during economic downturns.

Major food companies report recessionary impacts on their business in recent months but, judging from their results, appear in general to be coping well with the pressures.

Europe-based multinational food companies are generally experiencing lower growth from Europe than other areas of the world.

Most major companies are predicting continuing or escalating recessionary effects during 2009, and some have downgraded forecasts.

SMEs in the food industry are suffering most acutely, particularly from the shortage of credit. The weakened state of so many small- and medium-sized companies could precipitate some consolidation over the coming year. SMEs currently account for as much as 48.5 % of the sector's total turnover.

Industry advocates urge policymakers to provide assistance to food companies, particularly SMEs, in gaining availability to credit and export credit insurance and reducing costs, including employment taxes.

2. RETAIL AND CONSUMER TRENDS

2.1 Changes in consumer behaviour

Clearly the level of impact of the recession on consumer demand has varied from country to country, but some common trends have emerged, and principal among these is, not surprisingly, that consumers are becoming more price-conscious.

Daniel Lucht, a retail analyst at Verdict Research, says that while food is more insulated against the downturn than other retail categories, there has been a generally discernible 'shift to value' in European food shopping.

Using the UK as an example, reference to consumer research undertaken by market researcher Mintel is illuminating. As early as September 2008, Mintel published research suggesting that in the previous 12 months, 41 % of shoppers have switched to cheaper brands, while 34 % have cut down on premium food products.

Mintel also revealed that 66 % of shoppers were looking for promotions more often than a year ago, while 29 % were spending more time comparing prices in the supermarket than a year before.

Analysts and industry advocates alike are keen to differentiate between simply shopping for the cheapest food and seeking a better price/quality ratio. The validity of this distinction is supported by research in the UK from IGD, a retail analyst which focuses on the grocery sector, and is to a degree borne out by remarks from food industry advocates in other European countries later in this report.

IGD found that while over half of respondents to a survey it conducted in the UK in August said they had been economising over the past six months, only 10 % felt they had compromised on quality. As IGD chief executive Joanne Denney-Finch puts it: 'Economising is not always down-trading.'

While most of the market research cited here relates to the UK, Verdict Research believes the trading down and emphasis on private label being observed in the UK is being seen on a widespread basis across the EU.

2.2 Growth in the discount segment

One sector of the food retail market that seems to be doing well out of the recession is the hard discount segment, represented by international players such as Aldi and Lidl, as well as national chains such as Colruyt in Belgium, Leader Price in France and Mercadona in Spain.

Discount retailing is more established in some European markets than others, with Germany certainly having the most mature discount retailing segment. Daniel Lucht forecasts gains for discount retailers across all EU markets in the coming year, with the strongest gains in percentage terms being seen in markets where the discount sector remains relatively undeveloped, such as the UK, Ireland and Spain.

According to market analysts TNS, discounters grew their share in the UK grocery segment in the 12 weeks to 30 December against the same period in 2007. Aldi's share rose most sharply, from 2.7 % to 3.2 %, but gains were also observed for Lidl and Iceland. TNS also observed that the supermarket chains to register the strongest growth were those with a strong value proposition, notably Morrisons (up 0.4 percentage points to 11.9 %) and Asda (up 0.2 points to 16.9 %). Meanwhile, Waitrose, Sainsbury's and Marks & Spencer lost ground.

In the Mintel survey mentioned earlier, 31 % of adults said they were more likely to shop at discounters than before.

2.3 Other impacts on the retail market

Supermarkets have reacted to price-consciousness among consumers and to heightened competition from discounters by increasing the number of value lines they carry and placing greater emphasis than ever on price promotion. There has also been growth in the private-label segment as a result of recessionary pressures.

While the extent of this trend varies significantly from market to market, the overwhelming consensus among retail industry analysts is that this trend will continue during 2009.

The impact on smaller grocery outlets and convenience stores appears harder to assess. While there are reports in Ireland that food companies servicing the convenience store sector have been acutely hit by the recession, the Association of Convenience Stores in the UK suggests that neighbourhood stores are gaining a benefit from the downturn, with some consumers making more frequent local shopping trips using cash, rather than major shopping trips to larger stores. In research carried out by Mintel in August 2008, 21 % of shoppers said they were walking to the shops more often than during the previous six months. This benefit is counterbalanced, however, by the general adverse business pressures prevailing on small retailers, in particular the lack of access to credit.

2.4 Food prices

Having seen the significant inflationary spike in food prices in 2007/2008, the EU food sector has seen significant food retail price deflation in the second half of 2008.

The consensus view among industry associations is that shop prices have reached relative stability at the current time. However, opinion is divided about the extent to which some inflation could return in the second half of 2009.

Industry groups in some countries are forecasting minor retail price inflation in the second half, while others forecast further price stability. There is consensus that current retail trends will continue to exert deflationary pressures on the food market, though not to the degree being seen in non-food sectors.

While the volatility and inflation seen in raw material costs in 2008 appears to be past, currency fluctuations remain a key factor in forecasting what will happen to food prices. Analysts have pointed out that even if raw material prices on international markets only increase marginally, countries where currencies have substantially devalued over the past year will be buying in a significant amount of inflation during 2009. It is also likely to vary substantially from category to category within the overall food segment.

Daniel Lucht believes that currency shifts could certainly be a factor affecting UK prices in the second half of the year. With the 30 % devaluation in sterling, UK companies will clearly be importing inflation. In general, Lucht believes the degree of food retail price inflation will be dependent more on what happens to oil prices rather than other commodity prices which are still falling. He forecasts that in euro markets significant inflation in food prices this year is not that likely.

2.5 Potential impact on ethical/organic growth

The last few years has seen rapid growth in ethically-sourced products and organic food. This growth has varied from country to country, with the UK, for example, leading the way for Fairtrade goods. But in countries which have seen strong growth in these areas, there is a fear that growth could slow down dramatically or even reverse into decline as a result of the recession. The likelihood of such an impact depends on a number of factors.

In the first place, it is often taken as a given that ethical products are more expensive than mainstream equivalents so, therefore, in hard times they become more of a discretionary choice. While price differential remains a factor in the organic market, in Fairtrade products there are plenty of examples where price parity with mainstream counterparts has been all but achieved, for example in instant coffee and bananas.

Second, the degree to which such purchases are discretionary needs to be carefully considered. The evidence is that the consumers buying into these markets are highly motivated and committed, and will move away from these products with extreme reluctance; so in that sense, for some consumers the purchases are far from discretionary.

Market research suggests the small Fairtrade segment is relatively robust across a number of core European markets, but there is more fragility in the organic sector. Looking at the UK, in its *Shopper Trends 2009* report, IGD reports sustained demand for Fairtrade food products, but states that the number of consumers opting for organic products in the UK has fallen by 5 % over the last year.

This is reflected to a degree in the analysis of the consumer base for organic food by the UK's organic advocacy and certification organisation, the Soil Association. The Soil Association believes the recessionary impact on the organic sector represents a 'mixed picture', and rubbishes the idea that the organic market has collapsed. However, the Soil Association says its own research shows that while 80 % of organic food is bought by committed buyers, 20 % is bought by consumers on an occasional basis, and would therefore appear to be rather more discretionary in nature.

2.6 Potential impacts on diet and health

Recession-influenced changes in consumer behaviour raise concerns about the consequences for dietary health. As the key trend appears to be trading down, there is concern among campaigners and academics that this will result in poorer diet and an escalation in diet-related health problems, such as obesity and diabetes.

The overall premise for this is that cheaper food tends to be less healthy. This is supported by substantial amounts of data showing more diet-related problems in lower socio-economic groups.

Tim Lang, professor of food policy at London's City University, says that when food budgets are squeezed there will be a tendency for consumers to choose more foods that are higher in salt, sugar and fat. Lang says there may be some positive health consequences arising from the recession, for example with people walking more rather than driving, but fears a negative impact on diet health as a result of the shift downmarket in food shopping.

Interestingly, the British Retail Consortium, which represents food retailers in the UK, said retailers were placing a lot of emphasis on fresh food pricing and that sales of fresh food in the UK were going up, which it said could mean a positive health impact from the recession.

Research from IGD also suggests the picture is more nuanced than it might appear. A consumer survey it conducted in the UK last summer suggested that shoppers were buying more fresh food and preparing more food at home rather than buying processed food products.

Above all, Lang believes the multiplicity of impacts arising from the recession makes in-depth study of exactly how the downturn is impacting food consumption of vital importance.

2.7 Chapter conclusions

While food sales are, for obvious reasons, holding up better than non-food, there is evidence of significant trading down and price-consciousness among consumers across many EU markets.

The picture of consumer behaviour, however, is complicated. Sales of budget lines are growing strongly but price/quality ratio is becoming increasingly important across all areas of the market, so 'economising' doesn't always have to mean trading down.

The effects on the retail market, in terms of sales and retailer activity, vary from country to country.

The accelerated growth in the discount sector underlines how price has become the dominant factor for consumers.

Mainstream retailers are reacting to discounter growth by placing more emphasis on value lines, price promotion and private label.

Price-consciousness among consumers and aggressive discounting should have a deflationary impact on food retail prices, but currency shifts in some markets will exert upward pressure. On balance, if there is retail food price inflation in the second half of the year, in most countries it is unlikely to be significant.

Ethically-sourced food products appear to be holding up better than the organic segment.

The downturn is likely to have effects on eating habits and diet. While some experts expect a negative impact on dietary health, opinion is divided. But careful monitoring of how the recession impacts on patterns of food consumption is seen as vital.

3. COUNTRY PROFILES: IMPACTS ACROSS A CROSS-SECTION OF EU MARKETS

3.1 Germany

3.1.1 Key statistics

- Food and beverage turnover up 5.6 % to EUR 155.0 billion (Federal Statistical Office/BVE);
- Consumer price inflation: 2.6 %; food and beverage price inflation: 6.0 % (Federal Statistical Office/BVE);
- Exports up 15.0 % to EUR42.4 billion (27 % of total production) (Federal Statistical Office/BVE).

3.1.2 Commentary

- The German food industry association, Bundesvereinigung der Deutschen Ernährungsindustrie (BVE), is forecasting nominal growth of 1-2 % for the German food sector in 2009.
- BVE forecasts 1-2 % consumer price inflation for food for 2009.
- Producer prices will be under pressure until the middle of the year; with a weak increase in second half, BVE forecasts.
- BVE expects employment in food production to fall by 0.5 % during 2009.
- Regarding the availability of credit, some 25 % of BVE member companies said, in a survey conducted at the beginning of January, that they had problems getting credit. BVE says this is a particular problem for SMEs.
- In addition, a third of BVE members said they had problems obtaining export credit insurance.
- In retail, some 85 % of BVE members predicted that the discount sector would grow during 2009, as a result of recessionary pressures. Germany already has a very well established discount sector. BVE forecasts that the discount sector's share of the food retail market would increase from its current level of 43 % to 45 % during 2009.

3.2 UK

3.2.1 Key statistics

- In January 2009, food retail sales were 6.8 % up on January 2008 figures (BRC-KPMG);
- Annual food retail price inflation increased to 7.5 % in January 2009 from 6.2 % in December, while non-food retail showed deflation of 2.1 % compared to January 2008 (BRC-Nielsen);
- Inflation-adjusted food, drink and tobacco retail sales rose by 1.6 % in 2008 (Eurostat).

3.2.2 Commentary

- Although food is generally viewed as a robust consumer sector during economic downturns, the UK's Food and Drink Federation (FDF), believes the current recession is causing more problems for food producers than previous downturns because of the combination of adverse factors. 'This particular downturn appears to be causing more headaches than previous economic slowdowns, because consumers and customers are becoming more value-conscious, but our members are also simultaneously having to deal with volatile raw materials and energy prices, fallout from the "credit crunch" and a collapse in the value of the pound,' FDF states.
- FDF also believes that the loss of value of sterling (the UK currency) has provided more problems in terms of rising costs than opportunities for increasing exports. 'The current economic situation is affecting the whole of the food industry and there are an increasing number of reports about the pressure on sales and factory closures in our sector. The weak pound is affecting the cost of importing agricultural raw materials more than it appears to be boosting exports at this stage.'
- Regarding commodity prices, FDF believes the situation remains 'volatile' in spite of the fall in prices in the second half of 2008. 'The weakness of the pound has unfortunately wiped out the gains many UK manufacturers might have seen from recent drops in commodity prices.'
- The credit crisis has also been a serious issue for the FDF's member companies. 'Some members have reported difficulties in obtaining capital facilities to fund growth,' the FDF says.
- FDF members are also concerned about the withdrawal of trade credit insurance, which the FDF has raised with the UK government. The FDF says it welcomes government initiatives such as Enterprise Finance Guarantee for SMEs, but this has not addressed the problems of larger companies.
- While the FDF alludes to consumers being more value-conscious, it believes it is a 'mixed picture'. In fact, the FDF gives some credence to the suggestion that during downturns consumers continue to indulge in food while foregoing more substantial purchases and eating out less. 'There have been a number of reports suggesting that shopping habits are changing – with consumers trading down and becoming more value-conscious. However, it is a mixed picture. While people are eating out less, for instance, they are also buying luxury products to eat at home to compensate.'
- According to industry analyst IGD: 'Food and drink is holding up well, suggesting an industry that is recession-resistant. It is also highly adaptable and very much in tune with its shoppers, tailoring product offers to their changing needs. IGD consumer research demonstrates that shoppers are increasingly price-sensitive, with 36 % mentioning price as a main driver of product choice today, compared with 29 % this time last year. But while they are shopping around for the best value, they are not, in general, letting the recession get in the way of enjoying the high standard of food and drink they consume at home. Support for ethical shopping – for example free-range, Fairtrade and local foods – continues to grow. Animal welfare, in particular, is high on shoppers' agendas with one in five (20 %) looking for high standards, compared with one in eight (13 %) a year ago.'

3.3 Sweden

3.3.1 Key statistics

- Food and beverage retail sales were up 5.7% in 2008 to SKR 258.4 billion (EUR 23.1 billion) (LI);
- Food and beverage retail price inflation in 2008: 6.9 % (LI);
- Inflation-adjusted food, drink and tobacco retail sales were down 0.6 % (Eurostat).

3.3.2 Commentary

- According to the Swedish food producer organisation, Livsmedelsföretagen (LI), there have been signs of more cautious spending in the food retail sector but ‘not to an alarming degree’.
- The worsening conditions towards the end of the year is shown by nominal food retail sales growth of 3.1 %, just over half of the annual rate of growth, according to LI.
- A recent survey among LI members suggests average forecasts for nominal revenue growth for 2009 in the region of 5-6 %. Food inflation for the year is forecast to be around 3-4 %.
- Significant devaluation of the kronor against both the euro and US dollar has helped exports, though the cost of raw material imports has risen.
- At the consumer level, LI does not see a significant increase in discounting. Sweden’s food retail arena is very stable, with three companies – ICA, Coop and Axfood – controlling 90 % of the market. While there is private label, the sector is not characterised by severe price competition and discounting. However, German discount chain Lidl now has a market share approaching 3 % and this is expected to grow during 2009.
- The recession follows a period of sustained rises in disposable income, and with tax cuts and decreasing interest rates, food spending as a percentage of disposable income has been decreasing for some years. This makes Sweden’s food industry relatively sanguine in the face of worsening times.
- Regarding credit availability, the preliminary results from LI’s recent survey suggests that SMEs in food production and retail are still finding there is credit available, as banks see the food sector as a safer bet during recession than other sectors.

3.4 Netherlands

3.4.1 Key statistics

- Food industry turnover up 4 % in 2008 to EUR 61.9 billion (FNLI estimate);
- Annual food price inflation for 2008: 5.8 % (Eurostat);
- Inflation-adjusted food, drink and tobacco retail sales up 1.1 % (Eurostat).

3.4.2 Commentary

- The Dutch food industry association, Federatie Nederlandse Levensmiddelen Industrie (FNLI), states that so far the impact of the downturn has not been as serious as seen in other industries in the country, as food tends to be less affected by upswings and downturns. It adds that promotional activity in the retail market had boosted sales in the last couple of months, but that could result in lower sales over the next few weeks as consumers have stocked up.

- The FNLI says there has been ‘a lot of pressure’ on margins for food producers because of promotion in retail. Furthermore, while commodity prices are lower than they were last year, they remain higher than they were in 2007. The FNLI is forecasting rises in commodity prices in the next couple of months which will mean margin pressure for food producers ‘on both sides’.
- The lack of availability of export credit insurance and working credit is a growing problem for food companies in the Netherlands, says the FNLI, which is campaigning for government aid on the credit insurance. It says credit problems for producers are being exacerbated by retailers prolonging payment terms.
- At the consumer level, there is a general shift from brands to private label, though this is a trend that has been observed for the past two years.

3.5 Belgium

3.5.1 Key statistics

- Inflation-adjusted food, drink and tobacco retail sales down 0.7 % in 2008 (Eurostat);
- Food industry turnover up 11.4 % in the first nine months of 2008 versus 2007, but up only 6.3 % in the third quarter year-on-year (FEVIA);
- Food retail sales fell by 2.5 % in the third quarter of 2008 from the second quarter (FEVIA);
- Annual food price inflation in 2008: 6.3 % (Eurostat).

3.5.2 Commentary

- Belgium’s Fédération de l’Industrie Alimentaire (FEVIA), which represents food producers, says the drop in retail and industry sales in the third quarter marked the beginning of the slowdown. While food sales rose by 11.4 % in the first nine months of 2008, FEVIA anticipates the fourth quarter will show ‘a rapid deterioration’.
- In November, there was a dramatic 38 % increase in temporary unemployment in the food sector, indicating a significant reduction in production, though FEVIA notes that in December there was no increase against December 2007, suggesting the situation has not got any worse.
- FEVIA forecasts zero food inflation for 2009 as a whole.
- FEVIA says these are ‘difficult times’ for its members who are selling into the foodservice segment, but those selling into retail are seeing sales increases. There is growth in the ready meals doing well in supermarkets, FEVIA reports.
- The prevailing growth trend in the hard discount sector will be intensified by the recession, FEVIA forecasts.

3.6 Italy

3.6.1 Key statistics

- Food industry sales up 6 % in 2008 to EUR 120 billion (Federalimentare);
- Exports up 10 % to EUR 20 billion (Federalimentare);
- Retail food price inflation for 2008: 5.6 % (Eurostat);
- Food industry domestic sales down 2 % in the last quarter of 2008 (Federalimentare).

3.6.2 Commentary

- The Italian food industry trade association, Federazione Italiana dell'Industria Alimentare (Federalimentare), described 2008 as a good year for the industry, with strong exports and strong domestic sales, until the final quarter when recessionary pressures began to tell.
- In the final quarter of 2008, domestic sales were 2 % down against the last quarter of 2007 and Eurozone exports were down 1 %. Federalimentare forecasts a 2 % drop in food industry sales in 2009.
- Federalimentare forecasts relative stability in commodity prices, after the declines at the end of 2008, with possibly some small price increases in June and July.
- With regard to the credit crisis, Federalimentare states that access to credit has not been a problem for the majority of the food production sector in Italy, and is not likely to be during 2009. Of the 6 500 producers that make up the food production segment in Italy, the majority of which are self-financed SMEs, Federalimentare estimates only about 3 % have problems related to the credit crunch.
- Federalimentare does forecast that there will be some concentration in the industry during 2009, some of which will be recession-related. However, the association believes the industry is in need of some concentration, and states this may represent one positive that might come out of the current crisis.
- Regarding consumer consumption patterns, Federalimentare states that consumers are looking more closely at the price/quality ratio, though the trend towards heavy discounting is not that pronounced, certainly not on the scale seen in the UK or Germany. It forecasts the discount sector will increase its share of food retail from 7 % to 9 % during 2009.
- While the trend towards hard discounters may not be that strong in Italy, Federalimentare predicts that sales of more expensive Denominazione d'Origine Controllata (DOC) products may suffer during 2009 as consumers gravitate towards mid-priced brands.

3.7 Czech Republic

3.7.1 Key statistics

- Inflation-adjusted retail sales of food, drink and tobacco down 1.8 % in 2008 (Eurostat);
- Food price inflation in 2008: 8.1 % (Eurostat).

3.7.2 Commentary

- The Czech food industry association, Potravinářská Komora České Republiky (PKČR), states that industry sales were more or less flat in 2008.
- PKČR says there is no evidence yet of a marked change in consumption patterns but anticipates that demand for cheaper food products will increase during 2009, along with some migration from mainstream supermarkets to discounters, if current economic trends continue or worsen.
- PKČR forecasts stability for food prices in 2009, with perhaps some slight deflation.
- PKČR also states that many of its members report problems related to access to credit and says there is a threat of an increased rate of company failures during 2009 if current conditions prevail.

3.8 Romania

3.8.1 Key statistics

- Inflation-adjusted retail sales of food, drink and tobacco down 11.5 % in 2008 (Eurostat);
- Food industry sales in the first nine months of 2008: EUR 7.01 billion (2007 full year: EUR 10.1 billion) (Romalimenta);
- Food price inflation in 2008: 9.9 % (Eurostat);
- Food price inflation in December 2008 versus December 2007: 6.3 % (Institute of National Statistics/Romalimenta).

3.8.2 Commentary

- The Romanian food industry association, Federatia Patronala Romana din Industria Alimentara (Romalimenta), reports that the effects of the recession on food companies have not been that severe so far, with the recession only beginning to have an effect at the end of 2008. However, the industry group expects the industry to begin feeling the impact more acutely from March 2009 onwards.
- Romalimenta says food companies are finding harder to maintain sales and margins, and forecasts increased sales of cheaper products during 2009.
- Regarding the credit crunch, Romalimenta says there is a 'severe' lack of available credit for companies in Romania, particularly as foreign investors have diverted funds back to their own countries. Credit is rare, the group says, with interest rates now at 15-20 %.

3.9 Finland

3.9.1 Key statistics

- Inflation-adjusted retail sales of food, drink and tobacco were up 0.4 % in 2008 (Eurostat);
- Food price inflation in 2008: 9 % (Eurostat)

3.9.2 Commentary

- According to the Finnish food and drink industry association, Elintarviketeollisuusliitto (ETL), food exports from January to November 2008 grew by 3.7 % to EUR 1.3 billion. However, currency devaluations in Sweden and Russia at the end of the year have had a negative impact, resulting in an estimated EUR 100 million reduction in export revenues, ETL says.
- However, ETL says the impact of the downturn on the domestic market has 'not been severe'. But due to growing unemployment, there has been 'a small shift' to cheaper food products among consumers.
- Food accounts for around 12 % of household expenditure in Finland, according to ETL figures. As this represents a relatively small proportion of expenditure, ETL says most households 'have not changed their buying habits at all'.
- ETL adds that maintaining margins in 2008 has been a challenge for food and drinks companies, with raw-material costs rising by 13 %. Companies have only partially been able to pass on these increases to customers.

3.10 Ireland

3.10.1 Key statistics

- Retail sales of food, drinks and tobacco were up 1.5 % in value in 2008 but down 2.4 % in volume (Central Statistics Office/FDII);
- Food price inflation in 2008 was 6.5 % versus a general inflation rate of 4.1 % (FDII);
- Food and drink exports in 2008 down by 6.5 % to EUR 8.16 billion;

3.10.2 Commentary

- There is a strong case for suggesting that the Irish food and drinks industry has been the worst hit by the recession of any in the EU. The depth and extent of the downturn in Ireland is well documented and, added to that, its food industry is arguably more central to its economy than for any other EU country.
- According to figures from the country's food and drinks federation, Food and Drink Industry Ireland (FDII), the Irish food manufacturing sector has an annual gross output of more than EUR 18 billion, and accounts for 65 % of total Irish manufacturing exports.
- FDII puts total employment linked to the sector at nearly 230 000 and says the food and drinks industry is as 'important to Ireland as car industry employment is to Germany'.
- FDII reports anecdotal evidence from its members to suggest that much larger retail sales decreases were evident in some food categories than is shown in the official statistics.
- Ireland's three largest retailers control over 70 % of the market, but the discount sector, led by Aldi and Lidl, is growing from its current level of 10 %. Food companies selling into the convenience retail segment are suffering acutely, FDII says.
- The Irish food segment has also suffered severely from the loss of trade to cross-border shopping in Northern Ireland, as a result of the weakness of sterling. According to FDII, UK retailers Asda and Sainsbury's now have a 2.5 % share of the Irish food retail market despite not having a single store in the Republic. 'This is having a devastating impact on retail sales in border regions,' says FDII.
- The weak pound is also affecting exports, as some 43 % of Irish food exports are destined for the UK. 'The 30 % drop in the value of sterling has had disastrous consequences for a low-margin industry like food and drink,' says FDII. 'Effectively our EUR 3 billion-worth of exports to the UK is now worth almost EUR 1 billion less.' Of the remaining Irish food exports, some 31 % go to other EU states, and 26 % to countries outside the EU.
- The recessionary effects on food sector unemployment are severe, according to FDII. The total sector workforce comprises 46 000 direct employees and 60 000 indirect employees. Industry estimates are that 2 000 jobs have been lost since the beginning of 2009, and a further 2 000 will be lost by the end of April.
- So far, FDII says, job losses have been mainly among large food companies, but it expects 'many of the future losses will be in SMEs and that it will be accounted by companies going completely out of business rather than simply shedding jobs'.
- The lack of credit and 'limited and expensive' credit insurance is further exacerbating the problems, according to FDII.

- The FDII is calling for government help for the industry during the recession, including: the suspension of PRSI (pay-related social insurance) payments for two years for companies in sectors where sales to the UK account for more than 40 % of total exports; other tax deferral programmes; a special marketing compensation grant for companies to overcome exceptional market distortions; government loan guarantee and loan subsidy schemes; and a state-backed guarantee scheme for export credit insurance.
- FDII concludes: ‘Without some temporary, targeted supports, too many businesses which were strong and viable prior to the onset of the financial crisis could, in the period of this recession, succumb to the adverse climate and go out of business or dramatically downsize with a huge loss of employment.’

3.11 Food sales growth for remaining EU markets

Table 3: Growth in retail sales of food, drink and tobacco, 2008

| Country | Percentage change 2008 v 2007 |
|-------------------------------|-------------------------------|
| European Union (27 countries) | -1.0 |
| Bulgaria | 2.6 |
| Denmark | -1.2 |
| Estonia | -0.5 |
| Greece | -0.8 |
| Spain | -3.2 |
| France | -1.0 |
| Cyprus | 8.3 |
| Latvia | -8.0 |
| Lithuania | 2.4 |
| Luxembourg | -2.9 |
| Hungary | -1.3 |
| Malta | n/a |
| Austria | -1.4 |
| Poland | 0.4 |
| Portugal | 2.0 |
| Slovenia | 5.6 |
| Slovakia | 2.7 |

Source: Eurostat, 2007/2008.

3.12 Chapter conclusions

Closer examination of trends in individual countries confirms the variation in effects of the recession across the EU food sector.

Reports from industry representatives confirm the general increase in price-consciousness among consumers across most markets.

Currency shifts are impacting on both exports and the cost of importing raw materials.

Exposure to the credit crisis varies from market to market but is a factor in most. Where it is an issue, SMEs are suffering more acutely.

The issue of the cost and availability of export credit insurance appears to be a concern virtually across the board.

Judging by submissions from industry advocates, the Irish food industry appears to be the worst affected by the downturn.

Paucity of consistent, accurate and up-to-date information from some countries makes detailed analysis of the precise picture in certain markets problematic.

4. CONCLUSION

It is never good to begin a report with caveats, though it is sometimes necessary to conclude with one or two.

This report aims to give an overview of the recessionary impacts on the EU food sector. Given the scale of the industry, the geographical spread and the complexity of the issues, there are obvious limitations in scope.

Moreover, the impact is hitting countries at a varying pace. The food sectors in some countries are yet to report a dramatic impact, while others are palpably suffering right now. Particularly in the markets where the impacts are hitting later, market data that is both recent and accurate is required, and is not necessarily forthcoming.

Those reservations notwithstanding, certain key conclusions can be drawn from this research:

- There is a significant impact on the EU food sector arising from the recession.
- Its effects vary substantially from country to country.
- Official sales statistics and evidence from industry organisations support the general contention that the food retail market is more resilient than non-food sectors during economic downturns.
- Nevertheless, the food retail market is being impacted, with greater price sensitivity being shown by consumers, heightened price promotion among mainstream retailers, and growth in the discount sector.
- While commodity markets have stabilised after the severe and disrupting cost spike last year, concerns remain that currency devaluation in some markets will push up costs in 2009. At the same time, price competition in the retail sector should have a deflationary impact on consumer prices. According to the consensus of estimates, in most markets such food retail price inflation that there will be later this year will be relatively modest.
- In spite of showing lower growth in their European business than in other parts of the world, Europe's multinational food companies have suffered far less acutely than SMEs.
- For SMEs, the lack of availability of credit and the cost or lack of export credit insurance are pressing concerns. Industry advocates urge policymakers to assist food producers in these areas.
- Industry organisations in countries most badly affected are urging governments to offer deferral of employment taxes to food companies.
- The downturn may have a negative impact on growth in the organic sector in some countries, and likely impacts on dietary health require monitoring.