Economics

Italian Builders Add $118 Billion Worry to Banks' Problems

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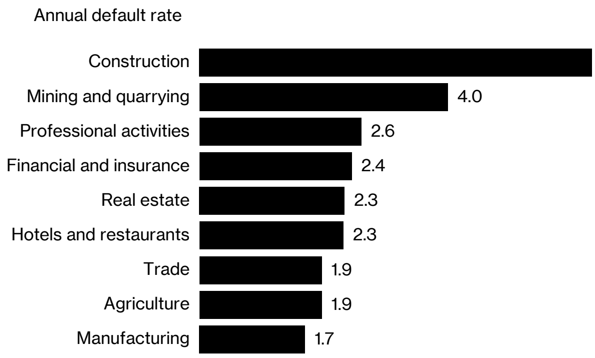
- Three of top six Italian bulders insolvent or restructuring
- Construction sector accounts for highest Italian default rates

Italian banks face a 102 billion-euro headache, just when they're least ready to deal with it.

That's how much they've lent to the country's stumbling construction companies, according to data from the Bank of Italy. But with Astaldi SpA readying plans to restructure as much as 2.5 billion euros of debt, three of the top six Italian builders are now either insolvent or negotiating with creditors. The construction sector accounts for the highest default rates in Italy, the data show.

Risky Building

Loans to Italian construction companies keep reporting top default rates



Source: Bank of Italy, 12 months ending in June

Italy's banks are already reeling from the impact on their capital levels of soaring government bond yields. They're also sitting on a 260 billion-euro pile of non-performing loans -- the biggest in the European Union -- left over from the last financial crisis and recession. With total loans held by Italian banks exceeding 2 trillion euros, losses by the builders are unlikely to pose a systemic risk on their own but the problems in the sector couldn't have come at at worse time.

"Italian banks face a double doom loop because of their exposure to construction companies loans and to sovereign bonds," said Carlo Alberto Carnevale Maffe, a professor of business strategy at Milan's Bocconi University. "Insolvency risk for builders is on the rise and banks are on the hook for billions in loans and guarantees to these firms."

The builders are feeling the pinch from years of government spending cuts, foreign ventures gone sour and slow growth. Last month Astaldi, Italy's second-largest builder, filed for creditor protection and has until March to present a restructuring plan to avoid defaulting on 1.6 billion euros of bank loans and 890 million euros of bonds. Astaldi debt maturing in December 2020 is currently quoted at less than 35 cents on the euro, according to data compiled by Bloomberg.

At Stake

The country's number three construction firm Condotte SpA filed for insolvency in July, while Trevi Finanziaria Industriale SpA, the country's sixth largest, is seeking to cut 250 million euros from its debt pile. Thousands of jobs within these companies and the survival of subcontractors are also at stake.

The banks are not just on the hook for loans to struggling construction firms. Together with insurers, they have committed as much as 23 billion euros in guarantees to the largest builders. These help firms win contracts by demonstrating projects will not be disrupted by financial stress. Astaldi, Condotte and Trevi alone accounted for around 5 billion euros in these arrangements last year, according to data compiled from company statements.

Read more: Europe's Building Firms Caught Amid Rising Debt, Falling Profits

New accounting rules that were introduced this year, known as IFRS 9, state that banks must book provisions for losses on loans and guarantees in advance if the builder is at risk of collapse. That means provisions against the debt of struggling builders may soon start showing up on bank balance sheets during the next earnings season.

"In Italy, it's the real economy that can generate a banking crisis," said Luigi Buttiglione, founder of research and advisory firm LB-Macro Ltd. "Lenders' exposure to construction and infrastructure can be one of the triggers."

The risk posed by ailing builders to banks' core capital is small compared to their 375 billion-euro holdings of Italy's government bonds and the 780 billion euros they have lent to companies in total. But the problem is serious enough for it to have been discussed at the highest levels of government.

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A plan to combine the assets of ailing builders with the help of state-owned Cassa Depositi e Prestiti SpA was presented earlier this year to Carlo Calenda, Italy's former economic development minister, according to people familiar with the matter. After Italy's Five Star Movement and League came to power, Calenda was replaced and the proposal's fate remains uncertain, the people said, asking not to be identified because it isn't public.

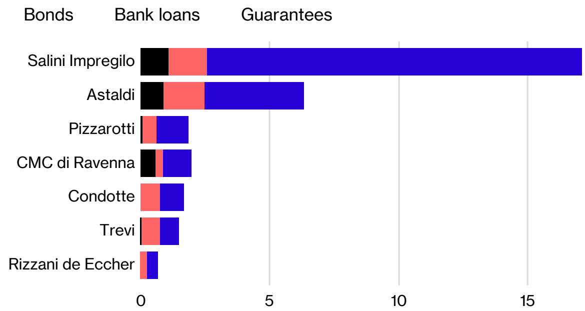
Officials at the ministry didn't respond to emails seeking comment on the proposal.

The pressure on Italy's builders is part of a malaise that's afflicted the industry Europe wide, namely a tightening of public spending that's made a once-lucrative supply of government contracts dry up. The last two years saw Spain's Abengoa SA and Isolux Corsan SA impose huge losses on creditors, while U.K.'s Carillion Plc collapsed under the weight of its debts in January.

Italian state spending on infrastructure has fallen about 70 percent over the last 10 years, according to Filippo Monge, adjunct professor of Construction economics at the University of Turin.

Lenders on the Hook

Total debt and guarantees of Italy's biggest builders



Source: Bloomberg data, companies earnings, Moody's
FY17 data. Condotte and Trevi FY16 data.

Adding to lower government spending, a gradual change in procurement rules starting in the 1990s has forced builders to manage concessions instead of being paid for projects. That meant builders have funded work by loading up on more debt, often through the bond market, which is now becoming harder to service amid dwindling profits.

“All those firms who have not adjusted their operating, financial structure and skills to compete under current market rules are struggling and will continue to do so,” said Adriano Bianchi, managing director at adviser Alvarez & Marsal in Milan. “Also because of regulatory changes, they may pose a systemic threat to the whole financial system.”

– With assistance by Giovanni Salzano

(Adds Astaldi bond price in fifth paragraph.)