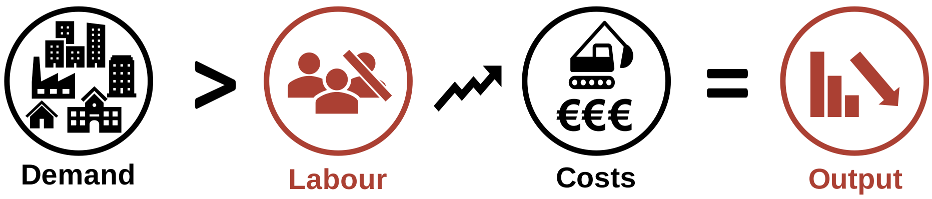
Corporates Outlook 2019/Construction: Credit risks rise, more mergers beckon as growth slows

Europe's construction sector faces modest revenue growth and mostly stable profit margins in 2019, but the credit outlook is in danger of deteriorating as the business cycle turns, particularly for smaller companies with less international reach.

Slowing economic growth and persistent labour shortages are set to weigh on construction activity in Europe after six years of growth. We have revised our forecast for 2019 and 2020 down to 2.0% yearly growth from our 2.5% forecast in December 2017.

Stable demand for residential construction – supported by demographic trends, increased household income and low mortgage rates – faces capacity constraints in some regions, relatively high construction costs as well as the prospect of rising lending rates. In contrast, civil-engineering activity remains buoyant and we see an increase in non-residential output given stock under development is still below the 10-year average for Europe's major markets. Demand for office space for most of Europe's major cities remains robust.



For the largest companies in the sector, namely those that have diversified beyond their home markets and have prominent positions in civil engineering and concessions, the outlook is relatively stable. The biggest companies by revenue – such as France's Vinci SA, the Spanish-German tandem ACS-Hochtief and Sweden's Skanska AB – will benefit from Europe's continued low interest rates, their exposure to other higher-growth markets, responsible for more than half of sales in some cases, and higher-margin, government-backed projects. We expect growth in the proportion of their non-European revenues in 2019 and 2020 compared with 2014-17, partly reflecting significant outbound M&A activity in the past year. Hochtief AG and Atlantia SpA acquired Abertis in a joint EUR 16.5bn deal. France's Bouygues SA acquired ALPIQ for CHF 0.9bn, while local rival Eiffage SA acquired Meccoli, Kropman Group and EDS.

On the other hand, cash flow is likely to come under pressure, from increased capital spending and more deal-making for larger firms, and from labour costs for the overall sector. Tight labour markets in some regions, notably in Germany and the UK, are pushing up costs, especially in hiring sub-contractors. Where labour markets are less stretched, much of the available workforce is unskilled – as it is in France, Spain and Poland – making it hard for companies to improve productivity.

Rising construction costs are particularly problematic in the residential segment. Combined with relatively low housing prices and rents in the suburbs compared with more sought-after central metropolitan locations, they are discouraging developers from going ahead with new projects despite pent-up demand.

In these circumstances, the credit outlook is less benign for smaller firms, typically those with revenue below EUR 1bn. They face tougher competition from multinational corporations in their home markets – especially in sourcing skilled employees, which hampers their ability to respond to changing market conditions – while lacking exposure to higher-growth markets outside Europe. Should the downturn prove severe, smaller companies will become prey for larger construction firms.

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Related Research

Rating Methodology: European Construction Corporates
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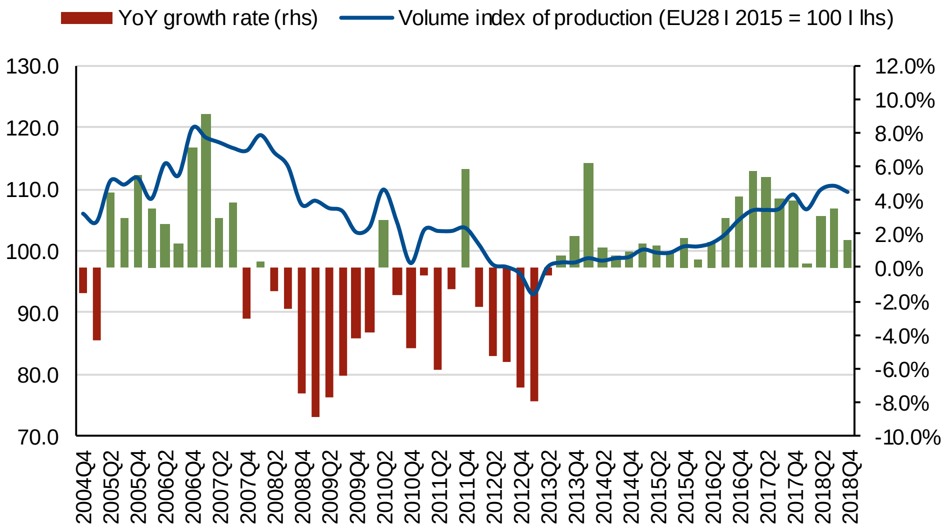
European sector recovery passes its peak

European construction output saw a turnaround in 2013-14 on the back of support for infrastructure projects provided by the EU and European Investment Bank (EIB). After the significant recovery in Europe – with construction growth well outpacing GDP growth (2.4% in 2017, 2.0% in 2016) and EU28 output increasing year on year by 4.0% in 2017 and 4.2% in 2016 – output became muted in 2018 at just 1.7% year on year (November). This was driven by capacity constraints in Germany, which led to negative 2.2% year-on-year growth to November 2018, well behind the last three years' CAGR of 2.7%. Building activity in both the UK (2.8% and 4.9%, respectively) and Sweden (-2.6% and 1.2%) also declined strongly and could not be offset by faster growth in civil engineering. This was mainly due to Brexit uncertainties in the UK and to recent, extensive credit restrictions on Swedish companies and individual households.

Figure 1: Construction output in Europe



Source: Scope Ratings, EUROSTAT

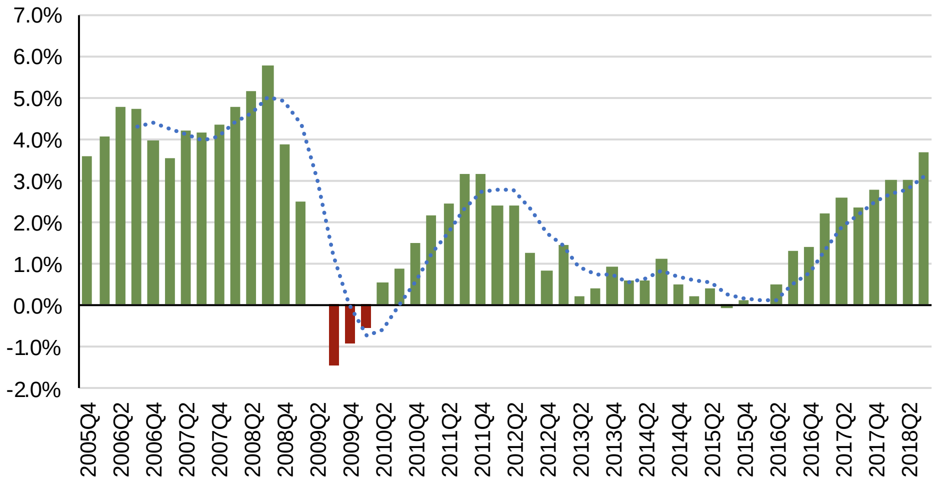
Civil engineering drives output growth in 2018

Diverging growth between building and civil engineering was observed across almost all of Europe. Building activity was driving growth until civil engineering took over during 2018, with YoY growth of 3.7% until November 2018 (while the building sector recorded negative 0.7%). The latter is in line with our forecast from the previous year, where we predicted increased civil engineering output based on financing initiatives (e.g. 'TEN-T connecting Europe', ESI Funds and CEF – the latter two in 2017/18) and on state-run projects, which continue to enjoy low funding costs induced by the ECB's quantitative easing since March 2015.

Domestic supply chain pressure as stable demand meets staff shortages

The industry will continue to suffer staff shortages in the foreseeable future, especially as the need for skills has risen significantly. Negative impacts include being unable to respond to market needs, losing project bids, and failing to innovate. According to the European Construction Sector Observatory (2018), the skill gaps in France, Spain and Poland and labour shortages in the UK and Germany are particular threats to industry growth. Moreover, staff numbers in Europe, despite recovering from the trough in 2013, are still growing slower than demand. This will result in supply chain pressures and a sharp increase in prices charged by subcontractors.

Figure 2: Output price in construction, YoY change



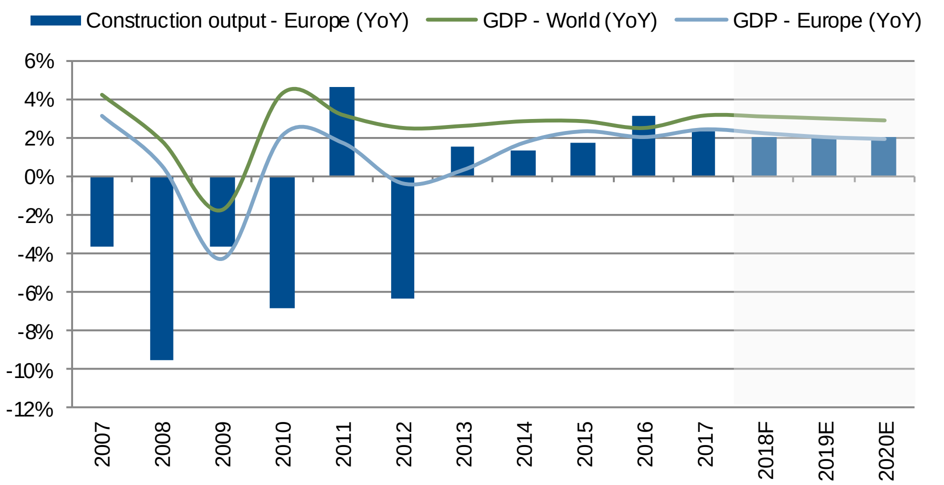
Source: Scope Ratings, EUROSTAT

Ultimately this impairs profitability of construction corporates, even those with strong top-line growth. The European Commission's 'Construction 2020 Action Plan', launched in 2013, has begun tackling these issues. In any case, initiatives at national level are expected to only bear fruit in long term. Skill shortages in particular have led to supply-demand imbalances in recent years, resulting in prices surging not only for real estate (see also Scope's real estate outlook) but also for construction. As such, prices are expected to dampen demand going forward, foremost for residential construction.

Construction output barely surpassing GDP growth in 2019 and 2020

As a result, we believe construction output will barely surpass GDP growth in the next 24 months and have revised down our 2019-20 forecast to 2.0% from 2.5% in December 2017. Our assumptions are driven by i) flatter economic growth, partially offset by ii) healthy growth in civil engineering, and iii) increased non-residential output, as stock under development remains below the 10-year average for major European markets while meeting a strong demand for space (see also Scope's real estate outlook). Even though we anticipate stable demand for residential construction – supported by demographic trends, increased household income and low mortgage rates – capacity constraints in several jurisdictions, relatively high construction costs and a forecasted rise in mortgage rates will set a ceiling for further growth.

Figure 3: Construction out Europe vs. GDP growth



Source: EUROSTAT, European commission, World Bank, Scope

M&A with focus on vertical integration to counter supply chain pressure

2018 saw major M&A activity in Europe, with total deals estimated at USD 26bn (-25% YoY). To name a few: Hochtief and Atlantia jointly acquired Abertis for EUR 16.5bn, Bouygues acquired ALPIQ for CHF 0.9bn, and Eiffage acquired Meccoli, Kropman Group and EDS. We expect further consolidation, especially as construction companies typically aim for greater size to improve economies of scale, increase geographical diversification, and strengthen their position in worldwide bidding processes. M&A is forecasted to focus on i) vertical integration, to counter supply chain pressures by increasing own capacities and productivity via technological assets, according to Deloitte; and ii) horizontal diversification, to stabilise margins and gain more customers abroad. The latter is evidenced by high outbound M&A volume among European engineering and construction corporates: USD 9.5bn in Q3 2018 YTD, surpassing local M&A deals at USD 8.6bn.

Consolidation will benefit from the still relatively low cost of capital, empowering companies to reach targets of market leadership or diversification.

Credit outlook 2019

Stable outlook, but first signs of the cycle coming to an end

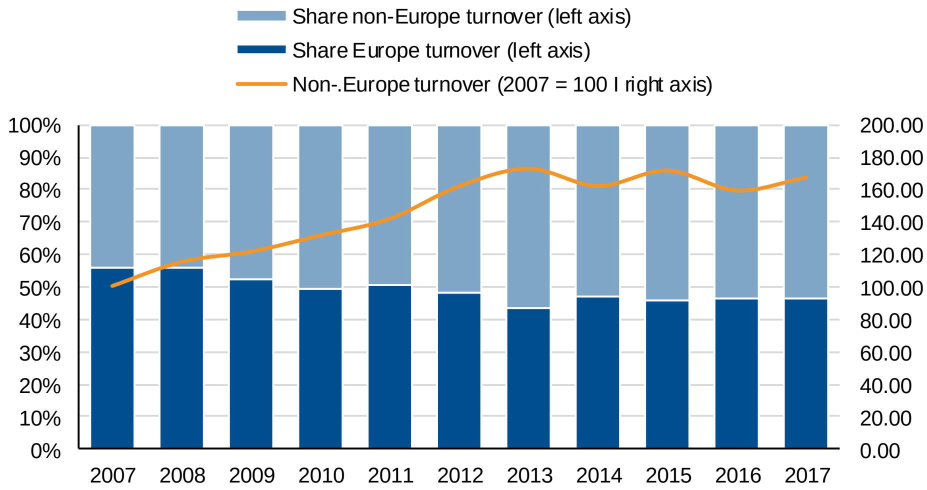
The healthy growth in European construction output during 2017 benefited construction corporates across the board regardless of their size, with revenues growing in line with the industry average. Within Scope's peer group, revenue growth slowed in 2018. This was especially the case for less diversified third-tier corporates (revenues of below EUR 5bn) and those exposed to the cyclical oil and gas sector.

Generally, we expect stable top-line growth for European corporates in 2019, backed by still positive sentiment in continental Europe and across the globe, especially as larger European peers generate over 50% of their revenues abroad. In 2018 we anticipate stronger growth in non-European revenues than in 2014-17, supported by significant outbound M&A among European corporates.

For the next 12 to 24 months, we expect corporates with a high share of civil engineering or concession business to perform the best, with the former benefitting from fiscal stimuli and the latter from stable demand. Moreover, firms focused on the oil and gas sector will see a rebound in revenues in 2019. Oil and gas sector revenues have improved since 2016 on the back of higher demand, and construction for that sector tends to follow the cycle with a 2-3 year delay. Going forward, profitability is expected to remain stable for larger, global companies but to be more volatile for smaller, less diversified ones.

As a result, we expect the business risk profiles for larger construction corporates to remain stable, at the cost of higher capex as more M&A is predicted for 2019. Those of smaller companies (revenues below EUR 1bn), however, are likely to deteriorate. This is for two reasons: i) smaller firms will find it harder to compete domestically, especially as larger firms are better at sourcing skilled workers; and ii) regional diversification is limited among smaller firms, with potential setbacks as the achieved foothold is comparatively small, increasing the exposure to harsh cyclical phases. But smaller firms could find protection within a larger group as a result of the vertical and horizontal integration efforts expected among larger competitors.

Figure 4: Geographical distribution of revenues (European firms)



Source: Scope Ratings, EIC

Financial risk profiles are expected to weaken. Although corporates still benefit from low interest rates and good access to capital markets, the decreasing competitiveness of smaller firms and the likely increase in M&A for larger ones in 2019 will partially erode free operating cash flows and credit metrics.

Brexit: Slowing UK economy to take a toll on sector amid uncertainty

As predicted by Scope in December 2017, downside volatility has increased among UK construction corporates as Brexit-related uncertainties continue to impact growth. In addition, many UK companies were forced to lower prices to secure contracts during the last downturn and could not cope with rising labour and material costs once the markets recovered. Late payment is also a major issue faced by UK construction companies, with over 20% of SMEs paid over a 60-day span. Prominent negative developments during 2018 included Kier Group plc (GBP 4.5bn in revenues), with an emergency rights issue to pay debts (see also Schuldschein Set for Growth in 2019), as well as the default of Carillion plc (GBP 5.2bn). As a hard Brexit is no remote scenario, the credit metrics of UK-focused corporates are likely to suffer from the ongoing uncertainties as well as reduced private demand that will not be offset by fiscal stimuli.

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