2020 Construction Outlook

The European construction sector's credit outlook is stable. The strong order backlog coupled with enduring capacity constraints, mostly related to labour, will outweigh the impact of cooling demand for new projects.

Corporates, Scope Ratings GmbH

Executive summary

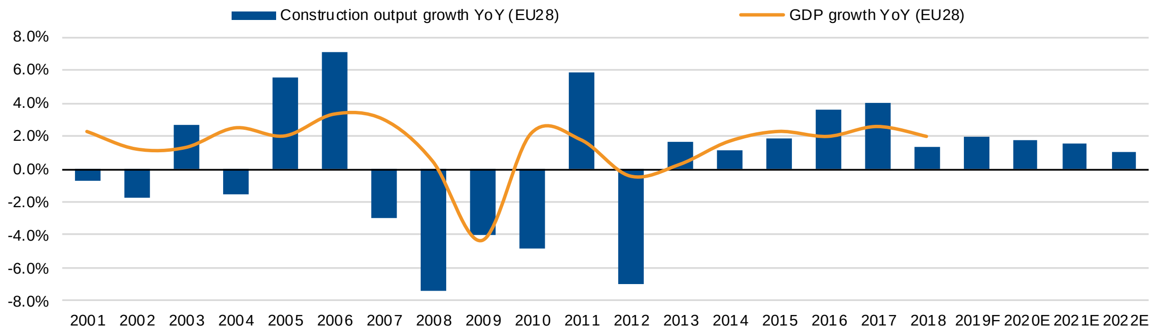
The European construction sector's credit outlook is stable. The strong order backlog coupled with enduring capacity constraints, mostly related to labour, will outweigh the impact of cooling demand for new projects.

We forecast relatively robust output growth of 1.5% to 2.0% in 2020, gradually decreasing to 1% by 2022 (Figure 1), despite the impact of the slowdown in the European economy on order intake.

The main trends we expect for 2020 are:

- Capacity constraints in regional construction markets will mitigate the impact of a decline in new orders.
- Contractors' strong order backlog provides visibility on revenues for 2020.
- Demand continues to outstrip supply in most segments of Europe's real estate market.
- EU-backed funding for infrastructure projects remains available: many countries have not fully taken up their allocation of the 2014-2010 European Structural and Investment Funds (ESI funds).

Figure 1. Construction output growth vs. GDP



Source: EUROSTAT, Scope Ratings

- EU member states are yet to conclude negotiations over the next round of ESI funds, generating some longer-term uncertainty over the scale of future infrastructure funding.
- The EU's decision to sign off on a 'green deal' in December 2019 promises relatively secure long-term prospects for environment-linked construction activity.
- Maintenance construction work will gain in importance over new building activity in the medium term.
- Domestic supply-chain pressures offset slower sector growth but pose a long-term threat.
- Tier 1 and 2 companies with global reach are best placed to cope with industry headwinds.
- Financial pressure is more acute for small, regional firms exposed to government-funded projects.

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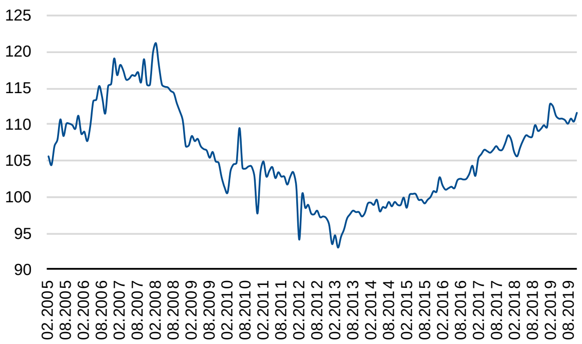
Key themes for 2020

Solid growth in 2019 output

Construction output in the EU grew in 2019 for the sixth year in a row - +2% YoY as end-November 2019 in line with our forecast – continuing a turnaround which began in 2013-2014 when the EU and the European Investment Bank (EIB) provided support for infrastructure projects in the wake of the euro area financial crisis. The state-backed stimulus has helped ensure a significant recovery, with growth in the construction industry outpacing overall GDP growth in the region (Figure 1). Euro area growth was just 1.2% last year and is forecast to slow slightly in 2020 (see also Scope's Sovereign Outlook 2020).

Construction companies have benefitted from a full order backlog but continue to operate under significant capacity constraints which have held back revenue growth. This set of circumstances has favoured companies with the most bargaining power in terms of securing new contracts and procuring materials and labour. Top 10 European contractors have gained more market share judging revenue growth of +9% for the 18 months to end-June 2019 for their European activities compared with revenue in 2017.

Figure 2. Construction output EU28 (2015=100)



Source: EUROSTAT, Scope Ratings

Growth in output in 2019 was led by civil engineering rather than building, notably in the euro area's two largest economies: up 7% in Germany and up 6% in France.

Cyclical slowdown on its way

We forecast output growth of 1.5% to 2.0% in 2020 gradually decreasing up to 2022 (1% - see also Figure 1). However, underlying conditions remain favourable in the short to medium term despite the prospect of a decline in new orders as the economy slows.

1. Capacity constraints in regional construction markets should partially mitigate the impact of reduced order intake.
2. Contractors' full order backlog provides visibility on revenues for 2020.
3. There is ample financing available for new infrastructure projects given the under-utilisation of the latest round the EU's European Structural and Investment Funds (2014-2020) programme.
4. Demand for new building – notably office, residential and industrial - continues to outstrip the capacity of the construction sector to supply it across much of Europe.

Capacity constraints: near-term antidote to slowing growth; longer-term risk

Constraints within the construction industry's supply chain will partially offset the impact of slowing growth in new orders on the financial performance of companies in the sector – but they pose a long-term threat.

The industry's shortage of employees – and skilled employees in particular - has risen significantly in recent years. The phenomenon ensures at least some short-term stability in revenues. The skills gap is predominantly a problem in France, Spain and Poland. Labour shortages are a factor in the UK and Germany where they pose a threat to the construction industry's growth prospects according to the European Construction Sector Observatory (2018) beyond 2020. Even though the number of people employed in European construction has recovered from its trough in 2013, employment growth has lagged behind the increase in demand. The jobs and skills shortages have multiple consequences such as:

- Constraining corporate responsiveness to new market opportunities, tenders;
- Limiting capacity for innovation;
- Creating bottlenecks in the supply chain which can increase costs as supplier and subcontractors exploit market conditions to increase prices;
- Preventing strong revenue growth from translating into improvements in profit.

The European Commission's 'Construction 2020 Action Plan', launched in 2013, has taken steps to tackle these issues, but the there is a long lead time for initiatives such as training more qualified workers to bear fruit.

In the meantime, the bottlenecks in the construction sector have spilled over to the property market, contributing to surging real estate prices in recent of years (see our Corporate Real Estate Outlook 2020), while also leading to higher construction costs. We expect subdued levels of new construction in the residential sector in particular, in the near term, given current prices.

Strong order backlog supports output

The healthy order backlog in the construction sector gives management good visibility for 2020 revenues. However, the expected decline in order intake through the year will impair the sector's longer-term growth potential.

Order backlog of the largest European contractors grew 1.8x as strong as total construction output in Europe since 2014. The 10 largest European contractors increased their estimated combined order backlog in Europe by 24% to an estimated EUR 125bn (as at their last reporting date) from EUR 101bn as at YE 2013. Total order backlog jumped to EUR 251bn from EUR 228bn, pointing to strong diversification outside Europe during recent years. The current order backlog is roughly equivalent to 2019 revenue, providing some assurance that revenues this year will at least match last year's revenues.

Figure 3. Construction backlog (EUR bn)

	Backlog H1 2019 (est. % Europe)	Backlog/revenues[1] (est. Europe)
Grupo ACS	62.9 (12%)	2.1x (2.1x)
Hochtief AG	16.9 (22%)	2.3x (3.1x)
Vinci SA	36.9 (83%)	1.0x (0.9x)
Bouygues[2]	31.5 (80%)	1.1x (1.9x)
Salini Impreglio SpA	17.2 (54%)	3.2x (3.2x)
Technip FMC	22.1 (36%)	2.2x (2.4x)
Skanska AB	19.7 (50%)	1.1x (0.9x)
STRABAG SE	18.3 (76%)	1.2x (1.1x)
Eiffage SA	14.9 (95%)	1.0x (1.0x)
Ferrovial	11.4 (88%)	2.3x (1.6x)

Source: public information, Scope Ratings

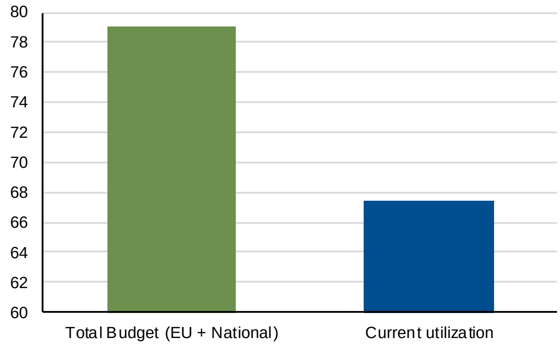
However, the likely reduction in order intake from 2020 to 2022 (caused by subdued economic growth, capacity constraints, increasing construction costs and uncertainty around the end of the EU funding cycle) will limit the sector's growth potential in 2021 to 2022.

Utilisation of EU funds

State-run and EU-funded civil engineering projects are important determinants of activity in the European sector, but the end of the current EU funding cycle (2014 to 2020) creates at least some near-term uncertainty about future projects, hence a possible dip in orders next year. The EU did sign off 'green deal' in December 2019 potentially lifting long-term prospects for European environment-related construction activity.

In addition, unused funds from the most recent EU funding cycle promise to sustain civil engineering activity this year (Figure 4).

Figure 4. Utilisation of EU funds in EUR bn (2019)[3]



Source: European commission, Scope Ratings

Most EU governments have some fiscal room to increase spending on infrastructure development (see Scope's Sovereign Outlook 2020) especially those countries running budget surpluses or small deficits such as Germany and the Netherlands. Low funding costs - with near record low, if not negative, interest rates and accommodative monetary across Europe - should help.

From 2021, we believe maintenance construction will gain further importance over new building activity. This will particularly be driven by management's avoidance of higher-risk green- or brownfield developments, the scarcity of available land plots (thus steep increases in prices) as well as the potential boost from the EU "green deal". The green deal has a special emphasis on tackling climate change, so we expect some of the funding to be dedicated to upgrading Europe's real estate stock (real estate consumes 40% of global energy annually and accounts for more than 20% of international carbon emissions according to Research at Northumbria University). However, there is still uncertainty around final funding for the EU's priority areas of tackling climate change, EU cohesion and agriculture. Member states have different priorities while the EU will have to adjust its budget to reflect a reduction in available funds after the UK's 31 January exit from the EU.

Supply-demand imbalance

In the short-term, the construction sector will benefit from continuing positive business momentum driven by the supply-demand imbalance for most of property types across Europe's main real-estate markets (see also Corporate Real Estate Outlook 2020). Rising wages, improved consumer purchasing power, low financing rates are among the factors fuelling demand for residential and commercial property. However, this is likely to falter in the medium term as the slowdown of the European economy rubs off on household and corporate spending.

[1] For the last twelve months to end-June 2019
[2] Bouygues Construction, Bouygues Immobilier, Colas
[3] Includes budget and utilization for European Cohesion Fund and European Regional Development Fund (themes: Network Infrastructures in Transport and Energy and Climate Change Adaptation & Risk Prevention.

Longer term, structural imbalances favouring demand over supply in the construction industry are set to remain in place, represented by five main trends: 1) global population growth, 2) urbanisation, 3) increases in living standards, 4) digitalisation and 5) the search for sustainable building methods and products.

Chinese contractors enter Latin America by acquiring stakes in third-tier Spanish contractors

In 2019 we observed the emergence of China as an important player in the EU public works market. Chinese companies also opened a large platform to carry out their international expansion to Latin America, where Spanish groups have a high market standing compared with European rivals.

In civil engineering, China took the first step in Spain when the JSTI group bought Eptisa in 2016. More recently, Técnicas Reunidas, Iberdrola and Naturgy finalised an agreement to sell Grouped Entrepreneurs to another Chinese corporation. China Railway Construction Corp. (CRCC) has agreed to purchase 75% of Aldesa, and China Road and Bridge Corp. (CRBC) has done the same with a majority stake in the Galician Puentes Group.

We forecast more attempts from Chinese construction to buy into other European third-tier contractors to facilitate market access in Europe and Latin America.

Credit outlook is stable

We expect stable top-line growth for European corporates in 2020, backed by still positive business sentiment in continental Europe and across the globe, especially as larger European peers generate over 50% of their revenues abroad.

For the next 12 months, we expect corporates with a high share of civil engineering or concessions activities to perform the best, with the former benefitting from fiscal stimulus and the latter from stable demand. Firms focused on the oil and gas sector also saw 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 two- to three-year delay. We expect stable profit margins for larger, global companies, but more volatile ones for smaller, less diversified construction firms.

The business risk profiles for larger construction corporates remain stable. Those of smaller companies (revenues below EUR 1bn), however, are likely to deteriorate: 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, leaving them more vulnerable to any cyclical downturn.

One consequence could be sustained merger and acquisition activity as smaller construction companies are courted by either i) larger players with an eye on vertical and horizontal integration or ii) by Chinese companies looking for inroads to Europe's construction sector or other regions where European companies are well represented, such as Latin America.

M&A activity will lead to higher leverage at the acquiring companies if the slowdown materialises as expected. However, we do not expect immediate negative impact on the companies' financial risk profiles, given their current financial headroom.

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