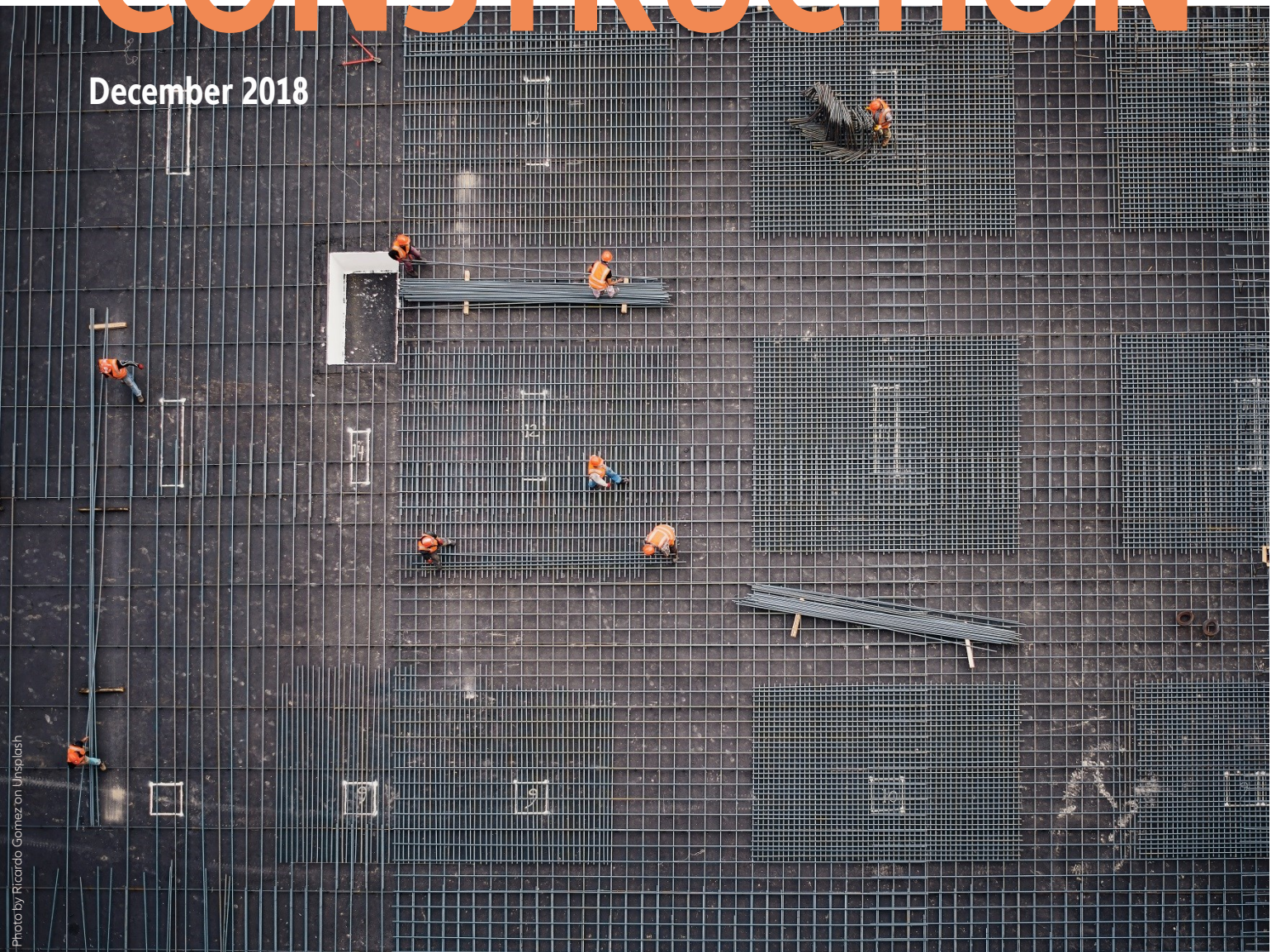


# CONSTRUCTION

December 2018



## SOFT LANDING WITH A LOOSE SEATBELT

- 04 The construction sector worldwide
- 12 Country focus: US, China, France, UK, Germany

# EXECUTIVE SUMMARY



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1. After ten years of growth (2008-2018), we have reached the peak in the global construction cycle. This year will be the turning point for the global construction industry, beginning to cool down gradually to +3% y/y in 2019, from +3.5% y/y in 2018. Over the past decade, most of the growth came from emerging markets (+57% since 2008), while the developed markets have not fully regained their pre-crisis volumes. Going forward, slowing GDP growth and tighter financial and monetary conditions will explain the deceleration in the residential sector (+3% y/y in 2019, after +3.5% y/y in 2018, and +4% y/y in 2017). Necessary fiscal discipline and the impetus of e-commerce respectively explain the limited boost to expect from the infrastructure and commercial segments.
2. While growing for the past decade, the construction sector did not “repair the roof while the sun [was] shining” to quote J.F. Kennedy. According to Euler Hermes’ proprietary data, on millions of companies across 70 countries, average sector risk ratings for demand, profitability, and liquidity did not improve. As a result, the sector is less prepared for a downturn. Preparedness is essential since construction is a crucial part of all economies (advanced and emerging) and plays a role in magnifying or reducing the impact of a cyclical slump. As a first sign of a turnaround, in the first three quarters of 2018, there were 41 large bankruptcies of construction companies (turnover exceeding EUR50m), more than in the retail sector (39).
3. Five construction outlooks for 2019:
  - a. The US: Construction is estimated to grow by +3% y/y in 2018 and +2.1% y/y in 2019. The residential market shows warning signs. Demand and operating margins below pre-crisis level.
  - b. China: Construction to grow by +4.2% y/y in 2018 and by +4% y/y in 2019. Rising leverage and high liquidity risk.
  - c. France: Construction to expand by +1.6% y/y in 2018, and +1.5% in 2019. Weaker demand and operating margins. Liquidity, after a long period of improvement, is starting to show the first signs of stress.
  - d. The UK: The sector is set to grow by +0.5% y/y in 2018 and +1.5% in 2019. Recovering demand, but crippled profitability and deteriorating liquidity. The uncertainty over Brexit continues to weigh on business and consumer confidence.
  - e. Germany: Construction to grow by +2.9% y/y in 2018 and +2.8% y/y in 2019. Solid demand and profitability. However, liquidity has stopped improving and is showing first signs of deterioration.

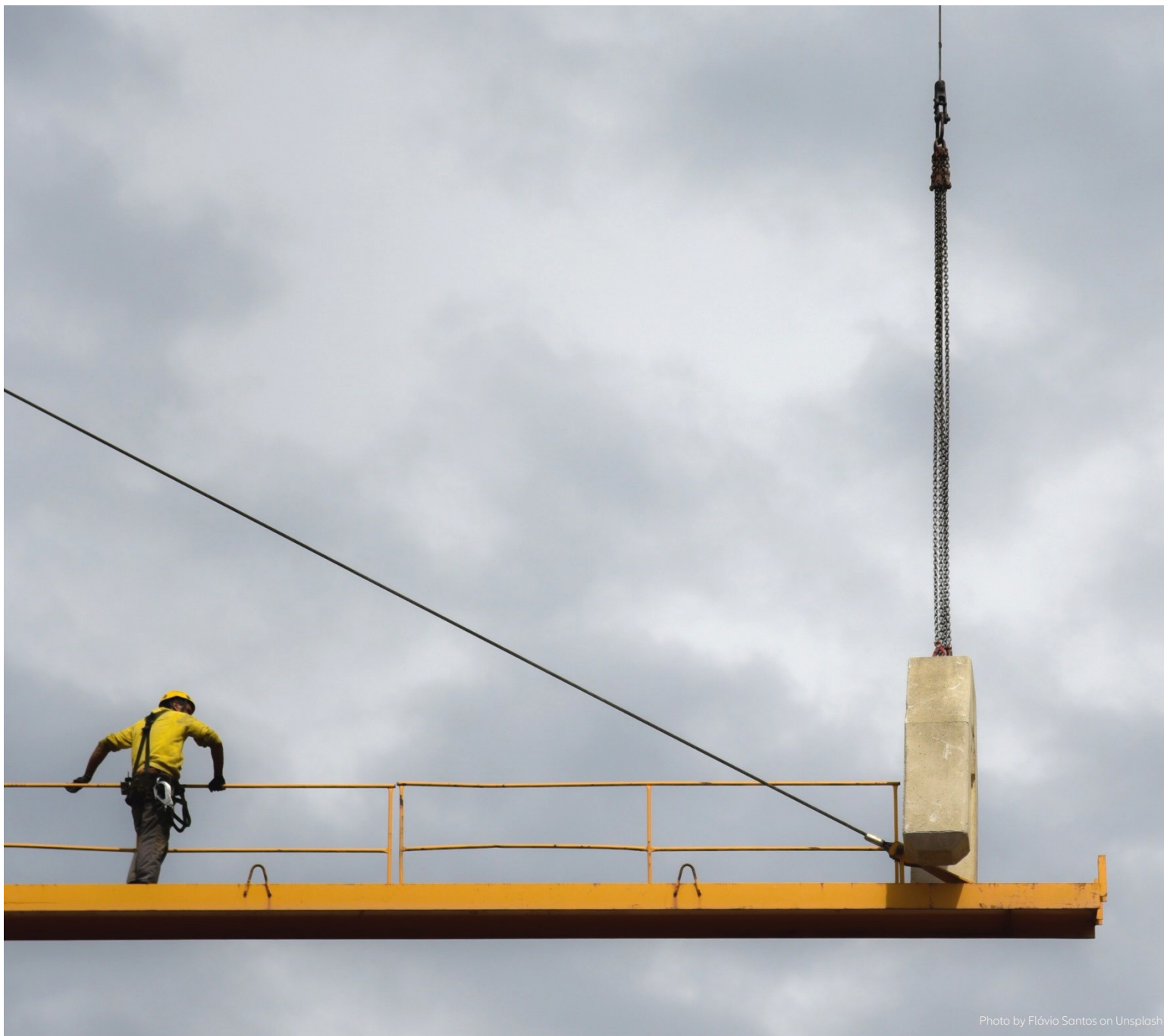


Photo by Flávio Santos on Unsplash

Construction companies with a turnover exceeding EUR50m that went bust in Q1-Q3 2018

**41 cases**

# GLOBAL CONSTRUCTION

## A SOFT LANDING WITH A LOOSENDED SEATBELT

### The global construction cycle has peaked in 2018

We expect the global construction industry to grow by +3.0% in 2019, after +3.5% in 2018, and +2.7% in 2017. 2018 was the fastest growth rate during the current global construction cycle (2008–now) and quicker than the world economy (+3.2% expected in 2018). However, this year is likely to be the turning point for the worldwide construction industry, meaning that from 2018 onwards growth will begin to cool down gradually, in line with global GDP growth. Indeed, we have reached a peak in the global economic business cycle (global GDP growth of +3.1% in 2019) which means a couple of sectors would need to adapt to an environment of fragile demand prospects and more restrictive monetary and financing conditions.

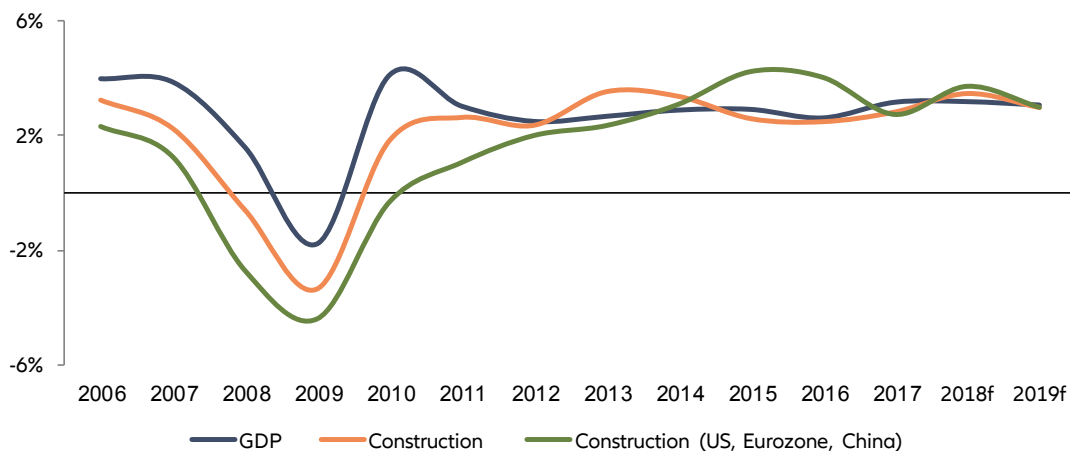
The cyclical nature of the construction sector has strengthened over the past years, which suggests that the sector growth will be dragged down by the rising interest rates and tighter credit conditions in Western economies (with the Eurozone starting in H2 2019) and the economic growth slowdown in China.

These collectively represent close to 55% of the global construction industry. Generally, the duration of a growing cycle in the construction sector averages around eight years, and we are already beyond this length.

**Emerging markets have been responsible for most of the growth; they will explain most of the deceleration**

Emerging markets (+57% since 2008) have been the main contributors to the growth of the global construction industry, as the developed markets have not even fully regained their pre-crisis volumes. The volume of goods and services produced by the global construction industry has grown by +23% since 2008, which equals, roughly, a +2% increase per year. That is half the level of growth seen in previous expansionary cycles. This suggests the sector is not in an overbuilding phase, a typical late-cycle feature which could be followed by a strong correction. In addition, such a performance is worse than that of the global economy, which has been growing at an average annual growth rate of +2.5% during the same period.

**Chart 1** Global construction industry vs global GDP (real USD, %change y/y)



Sources: OECD, National Statistical Offices, Allianz Research analysis



Yet, we expect the emerging economies to suffer from higher uncertainty related to trade particularly and much more challenging credit conditions, alongside the progressive tightening of the US monetary policy and a deterioration of global political risk. In this context, instability will prevail in many emerging economies, putting construction projects at risk. At last, China is expected to have less recourse to infrastructure projects to support its economy over the medium term.

**Though residential, commercial and infrastructure segments will decelerate,**

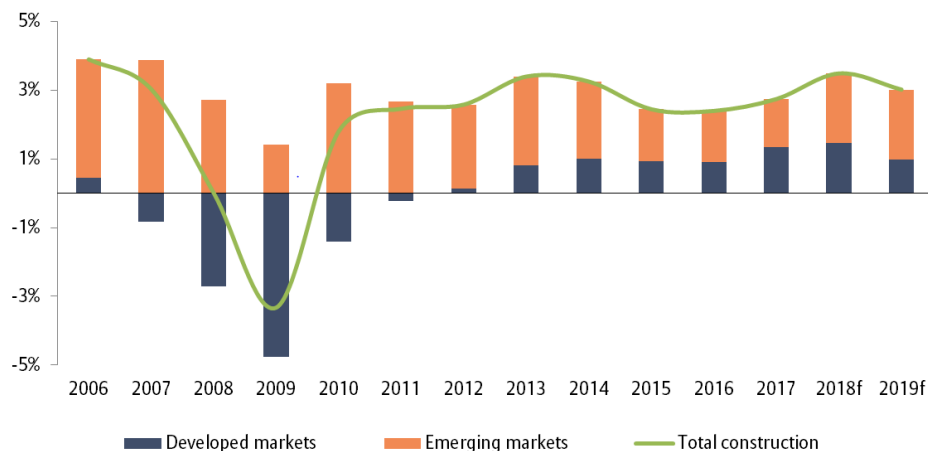
**the residential sector sets the tone**

The deceleration started in the residential construction in 2017 (+4.2%), which was bad news for the global construction, as the residential sector represents 40% of the global construction industry.

Generally, a recovery or a recession begins in the construction industry sooner than in other non-financial sectors. Indeed, construction belongs to the group of highly cyclical industries, and its cycle is usually leading the overall business cycle because the consumer demand for durable

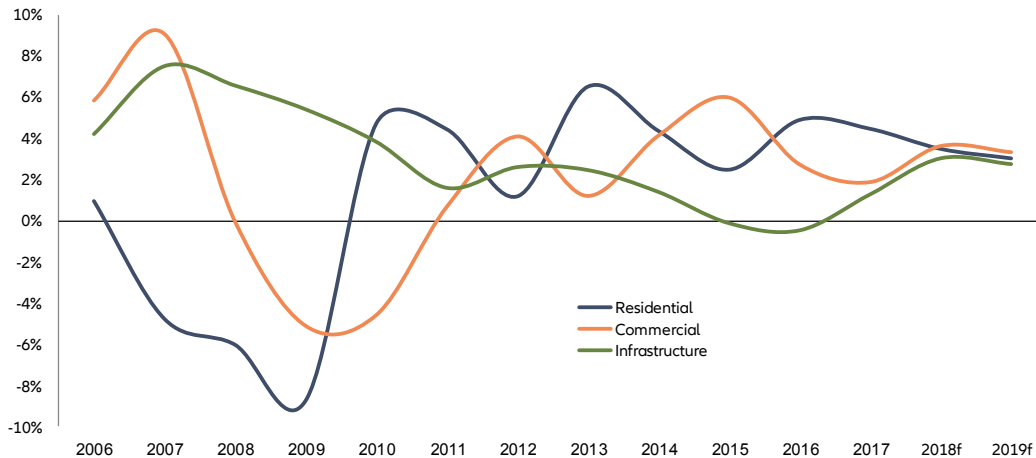
goods has higher interest rate elasticity than for non-durable goods. While household total credit growth remains above GDP growth as they frontloaded mortgages to take advantage of the still low level of interest rates, there are growing constraints in terms of affordability, as house price growth outpaced income growth. In addition, we expect tighter credit conditions to be a drag on households' housing demand. In case of a downturn, we believe households are better equipped than in 2008 as they have rebuild savings while they are not over-indebted.

**Chart 2 Global construction industry growth (real USD, %change y/y)**



Sources: National Statistical Offices, Allianz Research analysis

**Chart 3** Construction industry growth in the largest\* markets (real USD, % change y/y)



\*20 largest construction markets by revenue

Sources: National Statistical Offices, Allianz Research analysis

During the current global construction cycle, the infrastructure sector, dependent on political decision-making, has had a cycle of its own. After nine years of a gradual slow-down, the infrastructure sector started to accelerate from 2016 onwards.

The trend in residential construction has been entirely different. The residential segment has been preceding the commercial segment and has demonstrated the most growth so far (+31% vs. 2008).

The intuition behind the commercial cycle following the residential con-

struction cycle with a certain lag may lie in wealth effects transmitted to the consumer through rising real estate prices.

In other words, the consumer is generally more willing to spend more during the bull market of widely-held assets like residential real estate or stocks, which in turn stimulates the volumes in the commercial real estate market segment.

The deceleration will not spare any of the large sectors of construction. The residential segment will be dragged down by the rising interest rate environment and lower afford-

ability in Western economies.

The commercial segment, which tends to follow the residential cycle, can start to decelerate as early as this year.

The commercial real estate segment also has to deal with problems of its own as it adapts to the structural changes induced by the double-digit growth of global online sales. Neither can we expect the pick-up that started in the infrastructure segment in 2016, after years of underperformance, to be durable, as the global public debt is currently at its highest level post-2008.



12 out of 20 largest residential markets are set to decelerate in 2018.

Overall, the residential sector should post +3.5% growth this year, and +3% in 2019. In the coming years, we expect the residential sectors in each country to follow closely the overall economic cycle of each country. Hence, the slowdown is expected on every developed market except Australia and Germany. India, UAE, China, and Indonesia will be the only large markets where growth in the residential sector is expected to accelerate in 2018.

In 2019 we expect the deceleration to continue on all of the developed markets except Germany, France, Japan, Italy, and South Korea.

The cool down of residential markets will be driven by tightening monetary policy in the US and deteriorating financial conditions on the emerging markets.

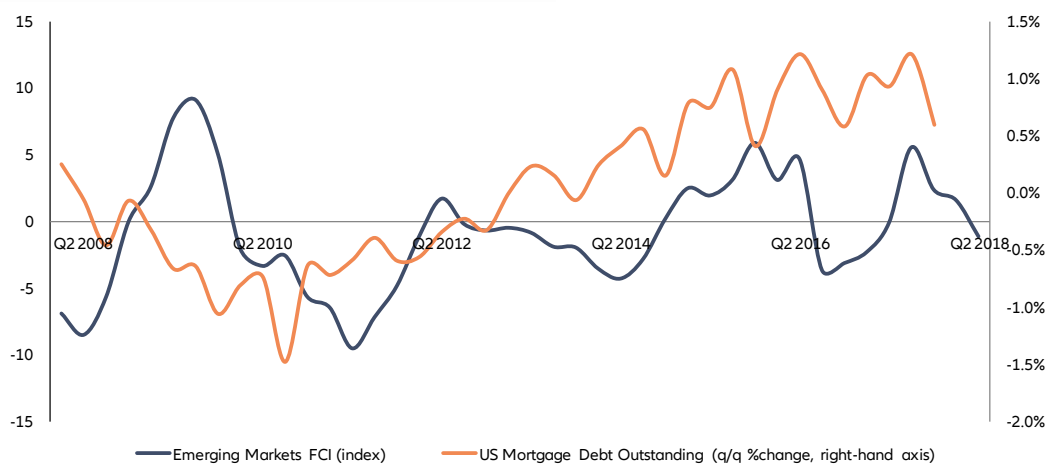
Euler Hermes' proprietary Financial Conditions Index (FCI) tracks the variation of local currencies, equity markets, monetary bases, and key interest rates. It has been pointing to a tightening of financial conditions on the emerging markets since the end of 2017.

**Chart 4** Residential construction volumes growth—top-20 largest construction markets

	2 017		2018f		2019f
1. China	4%	↑	5%	↓	4%
2. US	6%	↓	4%	↓	3%
3. Japan	2%	↓	1%	↑	1%
4. India	2%	↑	10%	↓	9%
5. UK	9%	↓	2%	↓	2%
6. Germany	2%	↑	2%	↑	3%
7. France	4%	↓	2%	↓	2%
8. Australia	-1%	↑	1%	↓	-4%
9. Indonesia	6%	↑	6%	↓	5%
10. Canada	5%	↓	4%	↓	2%
11. Italy	2%	↓	1%	↑	2%
12. Russia	-3%	↓	-4%	↑	2%
13. Brazil	-5%	↑	-1%	↑	3%
14. Mexico	2%	↓	0%	↑	0%
15. Spain	7%	↓	6%	↓	4%
16. South Korea	16%	↓	0%	↑	2%
17. Turkey	8%	↓	4%	↓	2%
18. UAE	-2%	↑	5%	↓	4%
19. Saudi Arabia	-3%	↑	-2%	↑	2%
20. Netherlands	12%	↓	9%	↓	2%
Global	4,2%	↓	3,5%	↓	3%

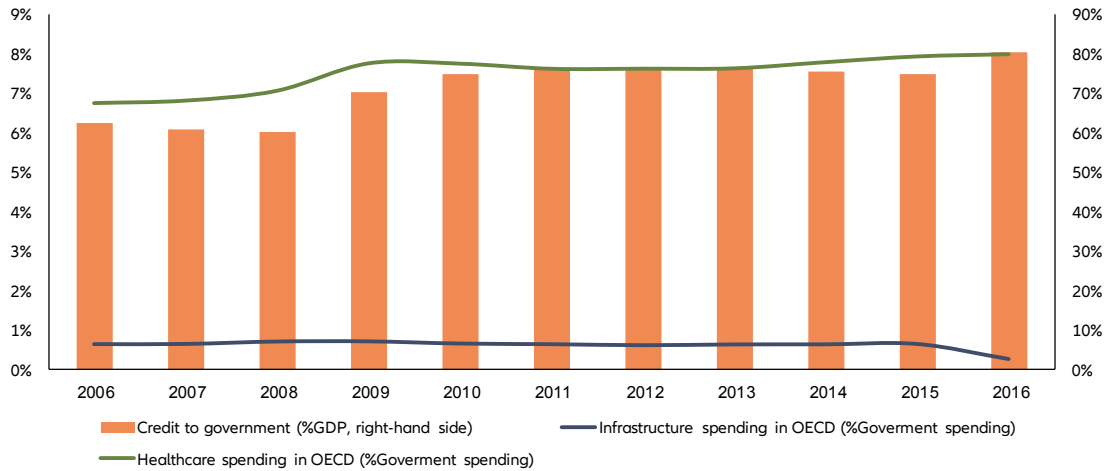
Sources: National Statistical Offices, Allianz Research analysis

**Chart 5** Financial conditions in the US and Emerging markets



Sources: Euler Hermes, board of governors of the Federal Reserve System

**Chart 6** Healthcare vs. infrastructure and global public debt



Sources: OECD, BIS

**No good news expected from commercial or infrastructure construction**

Historically high levels of global public debt give a reason to be doubtful about infrastructure becoming a growth driver anytime soon. During the current global construction cycle, the infrastructure sector has been chronically underperforming due to the underinvestment from the governments that decided to spend their money elsewhere.

However, the need for infrastructure investment has never been higher, with the ever-growing population of

urban areas, the electrification of mass transit and the increasing demand for connectivity from almost half of the world's population still without internet access.

The OECD database suggests that while the importance of spending on infrastructure in OECD countries has more than halved during the current global construction cycle, the share of other parts of the government's budget has grown during the same period.

Healthcare spending is one of the best examples of a spending category with growing importance across all OECD countries.

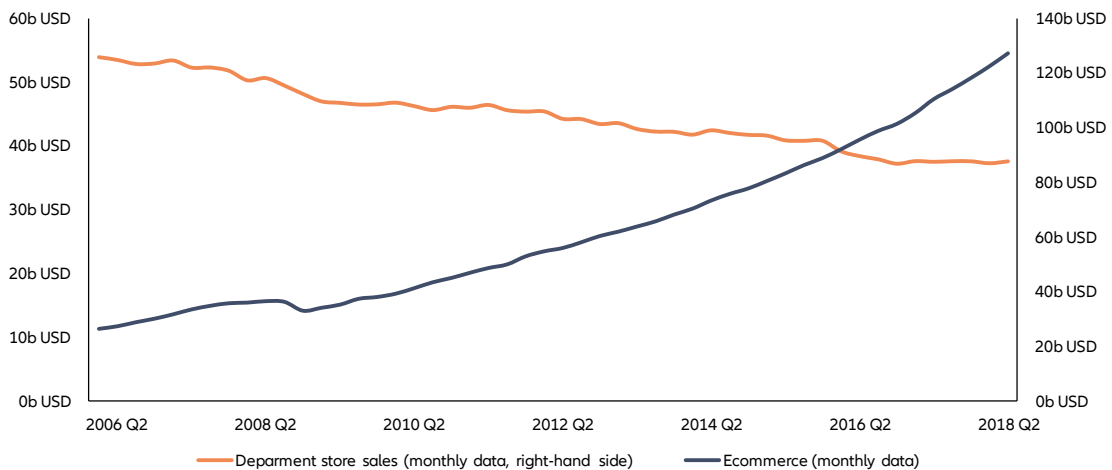
It is also doubtful that growth will pick up in the commercial construction segment because there is an increasing pressure from the double-digit growth of online sales.

The US is the most typical example of how traditional brick and mortar stores are losing clients to digital outlets.

Of course, the intensity of the trend in US retail is much higher than in other countries because of the historical oversupply of the retail space per person.

However, it is a good illustration of the challenges faced by all of the developed markets.

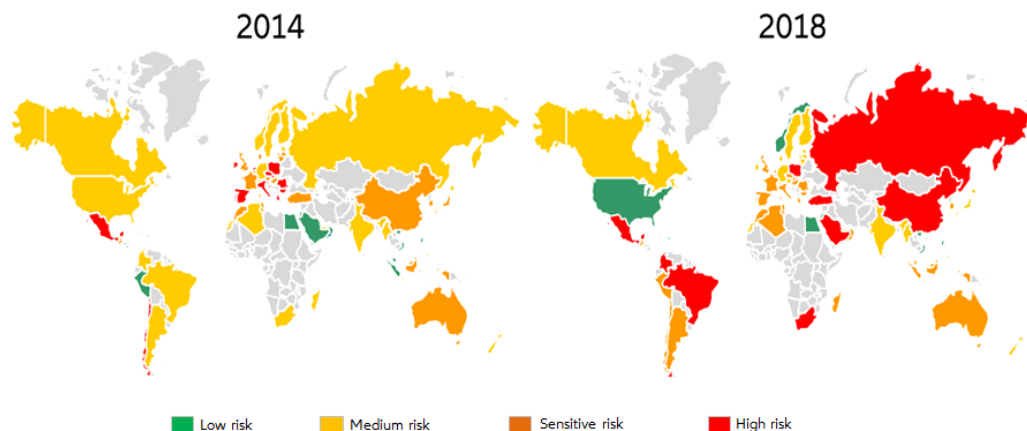
**Chart 7** Department store sales vs. E-commerce in the US



Source: US Census Bureau



Chart 8 Sector Risk in construction 2014 vs 2018



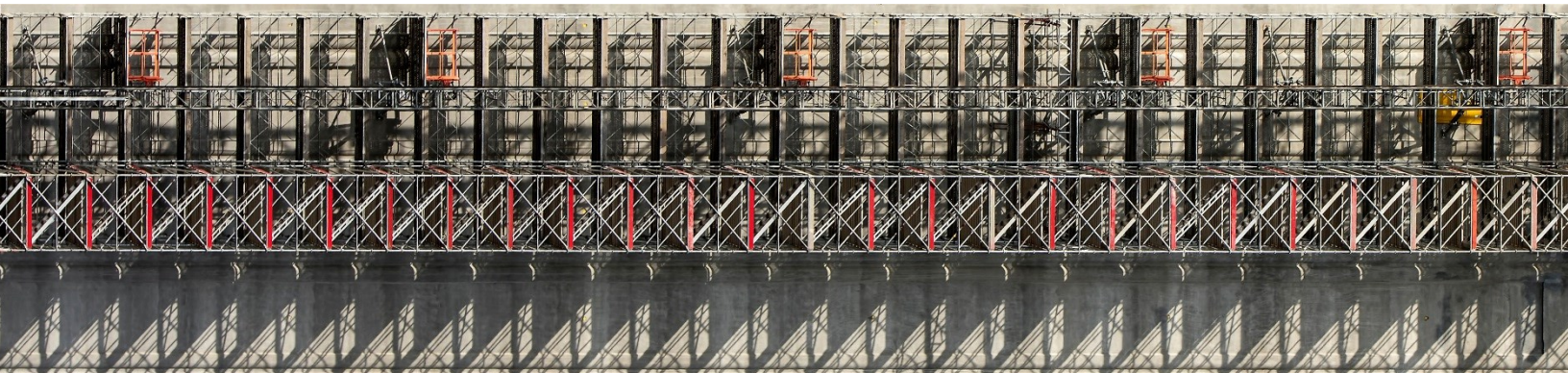
Source: Euler Hermes

**The industry is less prepared for the downturn than it should be: little pass-through from output growth to construction sector fundamentals**

Despite the healthy expansionary global business cycle, the construction sector has been incapable of building buffers and fully recovering from the 2008 crisis. That makes it a good candidate for being the biggest victim of the next crisis. Euler Hermes' internal database captures the financial health of construction companies on the 69 construction markets based on the local expertise of our network of credit analysts and financial data since 2012.

Our local experts are reporting every quarter their sentiment regarding demand, profitability, liquidity and business environment in each sector in EH portfolio. Our findings show that the current sector risk level in the construction industry in the 69 construction markets around the world is not a cause for celebration. The data precisely suggests that while the global macroeconomic environment has shown considerable improvement, at the same time the construction sector has seen its average risk grade deteriorate. That is a worrying finding because it means that the construction industry is approaching the end of cycle unprepared.

Currently, construction is the second riskiest sector in our portfolio, second only to metals. As of Q3 2018, more than two-thirds of the construction markets around the world have been graded "sensitive risk" or "high risk" compared to only half of these markets at the end of 2014. Sector risk in construction increased synchronously across different geographies, which is surprising as the performance of the construction industry is reliant mostly on the internal factors of each country, such as consumer spending, availability and cost of credit, state of consumer and government finances etc. which have been far from synchronized in all the countries in question.

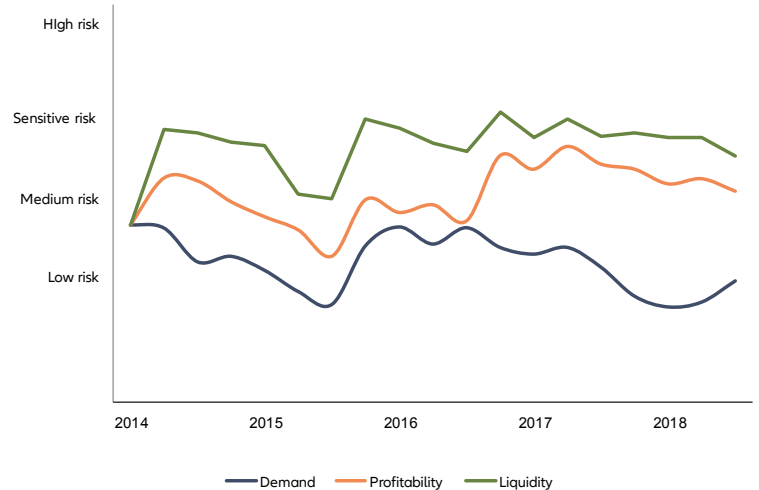


**Liquidity, demand, and profitability at stake**

According to our sector risk ratings, liquidity, demand and profitability have all three deteriorated over the past four years.

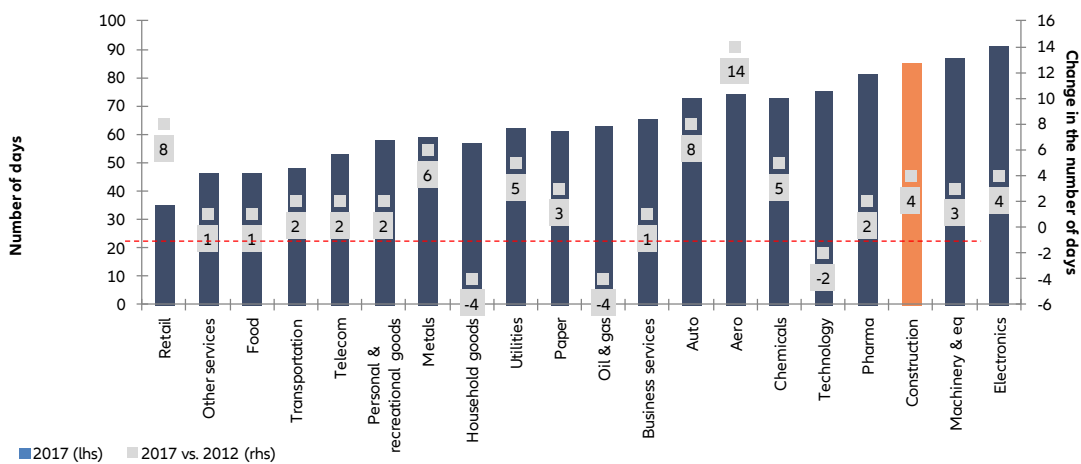
Liquidity has historically been, and will remain, the most significant pain point for the industry on the global scale. Roughly, in two-thirds of the 69 construction markets, the liquidity risk has either increased or stayed the same since 2014. The elevated liquidity risk has also been confirmed by our research in payment delays, suggesting that construction remains among the top three worst performing sectors when it comes to payment delays.

**Chart 9** Average Sector Risk by subcomponent (2014 = 100)



Source: Euler Hermes

**Chart 10** Average Days Sales Outstanding (DSO) by sector



Sources: Bloomberg, Euler Hermes

Demand has barely recovered in some of the largest construction markets.

The volume of growth in the construction markets in developed economies was negative (-0.4% CAGR) during the current global construction cycle (2008–now).

In some of the largest construction markets, such as France, Germany, Italy and the US the demand has still not recovered to the pre-crisis volumes.

**Chart 11** Volumes growth in the top-20 largest construction markets (% change from 2008 to 2018)

1. China	↑127%
2. US	↓0%
3. Japan	↑17%
4. India	↑53%
5. UK	↑14%
6. Germany	↑2%
7. France	↓-12%
8. Australia	↑22%
9. Indonesia	↑91%
10. Canada	↑25%
11. Italy	↓-38%
12. Russia	↓-17%
13. Brazil	↓-12%
14. Mexico	↑7%
15. Spain	↓-45%
16. South Korea	↑18%
17. Turkey	↑101%
18. UAE	↓-1%
19. Saudi Arabia	↑41%
20. Netherlands	↑8%

Source: National Statistical Offices

Profitability has been under increasing pressure from rising input costs, most notably labor costs. It is not news that many construction markets are fighting skilled labor shortages which are limiting construction activity and increasing labor costs at the same time. Most worryingly, the average age of workers is rapidly growing. Figures show it now stands above 40 years old compared to 36, back in 1985. In addition, staff turnover in the construction sector is one of the highest among all sectors (above 20%) which in turn increases firms' operating costs. The decrease in the global unemployment rate has accompanied a steady rise in labor costs over the same period. More than 50% of publicly traded construction companies have reported an increase in the share of labor costs during the current global construction cycle. From 2006 the median share of revenue that goes to payroll among the publicly traded construction companies has increased from 8.8% in 2006 to 10.3% in 2017. For a quarter of the companies in our sample, the increase was higher or equal to 20%. As a result, the synchronous deterioration across a wide range of geographies is also noticeable in the latest major insolvencies statistics over the first nine months of 2018. Asia-Pacific is the leading region for major insolvencies in the construction industry (18 major insolvencies registered over the first nine months of 2018).

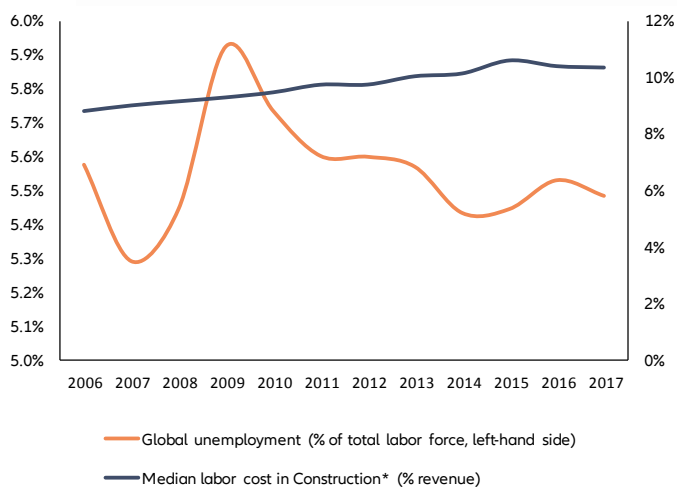
**Chart 12** Change in unit labor cost in the construction sector (% change 2017 vs. 2008)

France	↑	32%
Australia	↑	23%
Italy	↑	19%
Poland	↑	18%
Germany	↑	17%
UK	↑	3%
Netherlands	↑	2%
China*	↑	60%
South Korea*	↑	10%
US*	↑	8%
Canada*	↑	0.40%
Spain	↓	-20%

Sources: OECD, National Statistical offices, Allianz Research estimates

\*non-farm business sector used for the US, estimates based on economy-wide data for China and South Korea, estimates based on manufacturing sector for Canada

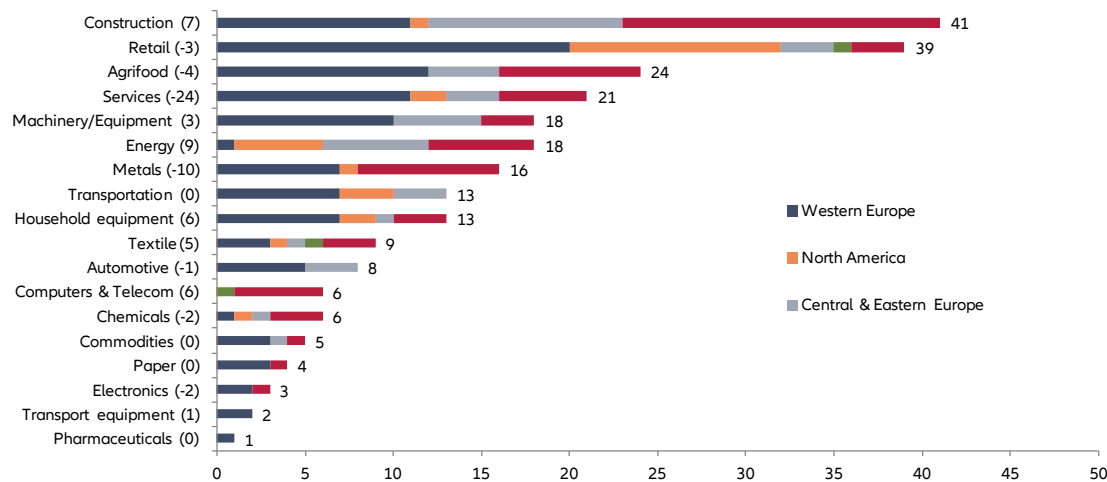
**Chart 13** Global unemployment and labor costs in Construction



Sources: World Bank, Bloomberg

\*Bloomberg sample of 207 construction companies based on the following BICS classification: homebuilders, infrastructure, building subcontractors, non-residential

**Chart 14** Number of major insolvencies\* by sector and region in 2018 Q1-Q3 (change compared to the same period last year in brackets)



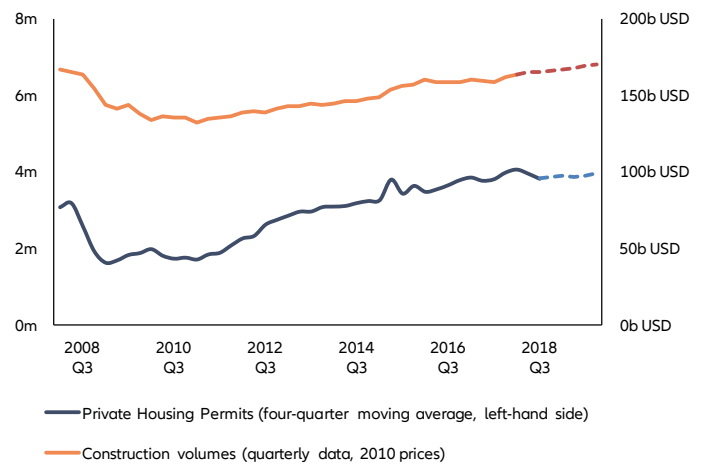
Source: Euler Hermes \*Companies with a turnover exceeding EUR50m

# COUNTRY FOCUS US

**Construction to grow by +3% y/y in 2018 and +2.1% y/y in 2019. Residential market shows warning signs. Demand and operating margins below pre-crisis level.**

Construction volumes in the US are expected to grow +3% y/y in 2018 and +2.1% y/y in 2019. Construction volumes have still not recovered to the pre-crisis period. The demand growth has reached a peak in 2018 and will be decelerating over the coming years. The very recent housing permits data has been disappointing (even if adjusted for the impact of the recent hurricanes). The growth engine is clearly running out of steam this year, with headwinds on both the demand side and the supply side. Despite trade, fiscal and monetary policy risks, the economy should keep the momentum heading into 2019, albeit at a slower pace. The recent trade agreement between the US, Mexico, and Canada removes the NAFTA-related uncertainty but may lead to intensifying trade games with China.

**Chart A** Construction permits and total construction volumes



Sources: Bloomberg, Euler Hermes

**Chart B** Profitability of a median listed construction company in the US



**Deterioration of profitability is expected in 2018.** The median operating margin among listed construction companies in the US has not recovered to the pre-crisis level (7% in 2017 vs. ~10% pre-crisis). Profitability is to remain under pressure in 2018 considering the slowdown of demand and the rising financing and labor costs. The decrease in expected profits in the construction sector has translated into homebuilders becoming one of the worst performing sectors on the US equity markets this year.

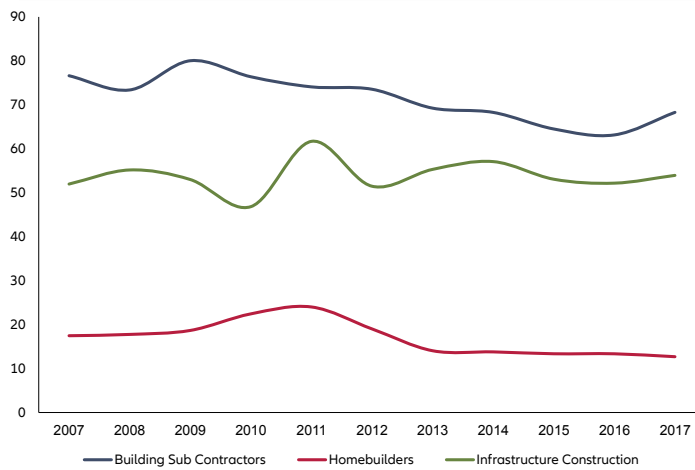
Sources: Bloomberg, Euler Hermes



Photo by rawpixel on Unsplash

Current liquidity remains adequate as the revenue growth in the industry during this cycle has been accompanied by well-managed working capital. We expect sector insolvencies this year to decrease -8% on par with the overall increase of insolvencies in the US economy.

**Chart C** DSO of a median US construction company by segment (days)



Sources: Bloomberg, Euler Hermes

# COUNTRY FOCUS CHINA

**Construction to grow by +4.2% y/y in 2018 and +4% y/y in 2019. Rising leverage and high liquidity risk.**

We expect the construction volumes growth to slow down to +4.2% y/y in 2018 (vs +4.4% y/y in 2017) and to +4% y/y in 2019.

Volumes on the Chinese construction market have seen an almost four-fold increase since the last quarter of 2006.

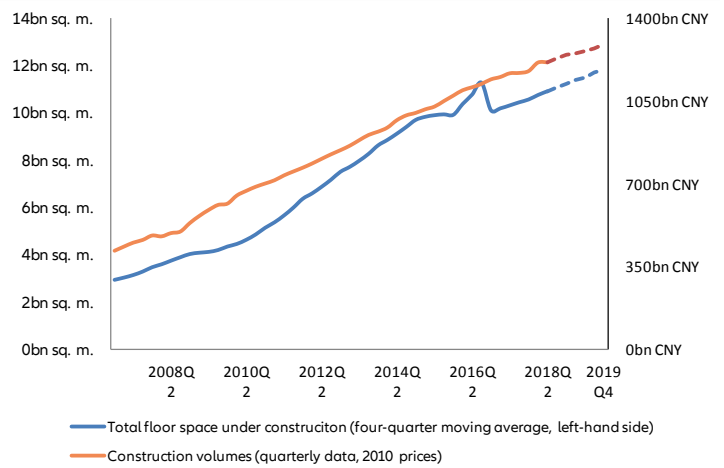
Such an impressive growth has been achieved on the back of the 25-year housing boom period.

We expect the strong growth in construction to continue, albeit at a slower pace, as the government continues to take measures to prevent a rapid price crash.

Fears of slower-than-planned economic growth are growing. This may translate into more stimulus measures from the government. On the fiscal side, a large set of measures have been already enacted (tax rebates, support to SMEs and Infrastructure projects, etc.).

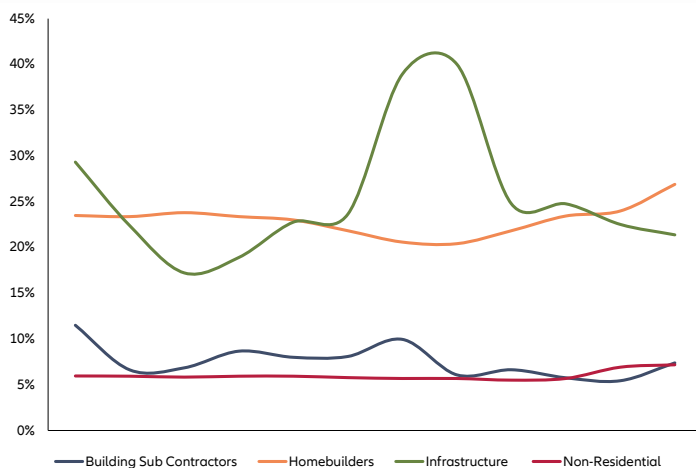
However, the impact has not been visible up to now. Infrastructure spending, one of the largest contributors to the economic slowdown, has continued to decelerate (+3.3% y/y in the first nine months of 2018, from +4.2% y/y in the first six months of 2018).

**Chart A** Total floor space under construction and total construction volumes



Sources: Oxford Economics, National Bureau of Statistics of China

**Chart 25** Profitability of a median listed construction company in China



Sources: Bloomberg (sample of 51 companies with headquarters in Mainland China), Euler Hermes

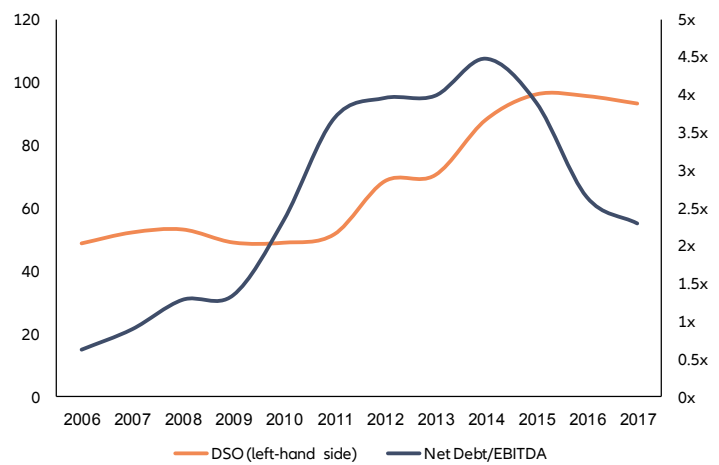
Operating margins are expected to stay stable. The median operating margin among the listed construction companies in China is currently weaker than during the pre-crisis period (median 12% EBITDA/Revenue in 2017 vs. median ~13% in the pre-crisis period). Profitability has historically varied significantly in different market segments. The residential and infrastructure segments currently have larger financial buffers than other segments of the market.



Corporate insolvencies look set to climb in China in 2018 (+50% y/y estimated in 2018), and the construction industry will remain an important contributor to the increase.

High gearing ratios and unfavorable payment conditions have historically been the biggest pain point for Chinese construction companies.

**Chart C** Payment delays and leverage of listed construction companies in China



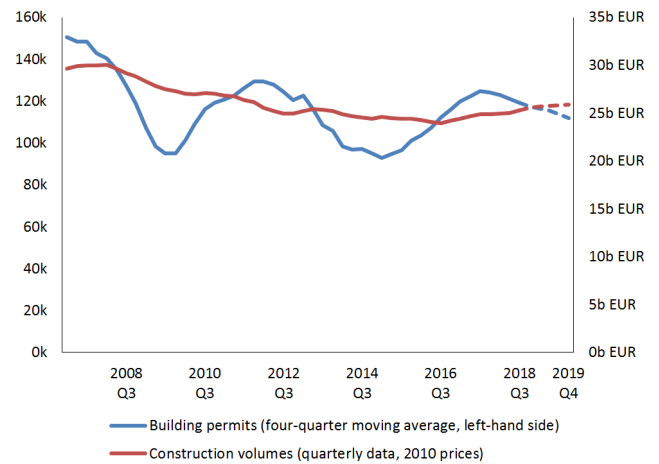
Sources: Bloomberg (sample of 51 companies with headquarters in Mainland China), Euler Hermes

# COUNTRY FOCUS FRANCE

**Construction to grow by +1.6% y/y in 2018, and +1.5% in 2019. Weaker demand and operating margins. Liquidity to show the first signs of stress.**

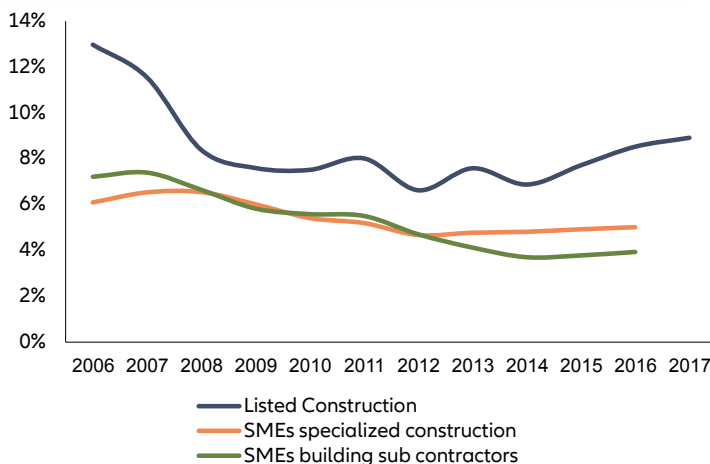
Volume growth is expected to slow down to +1.6% y/y in 2018 (vs +2.5% y/y in 2017) and to decelerate further at +1.5% in 2019. The volumes have not been rebuilt during the current global construction cycle (2008–now). The year 2018 will be a difficult one for French construction, especially for the residential subsector. For now, the outlook for 2019 does not paint a brighter picture. Since Autumn 2017, the building permits and housing starts data has been disappointing. As of August 2018, the cumulative 12-month building permits data is pointing to a -7.9% decrease y/y, while the housing starts data for the same period points to a -10.2% decrease y/y (+14% and +17% in August 2017 respectively).

**Chart A** Construction permits and total construction volumes



Sources: Insee, Allianz Research analysis

**Chart B** Profitability of a median listed construction company in France



Sources: Bach, Bloomberg, Euler Hermes

**The operating margins are expected to deteriorate in 2018.**

The median operating margin (EBITDA / Revenue) among French-listed construction companies is currently close to 9%. During the current cycle, French construction companies have failed to rebuild their margins to the pre-crisis level (13% pre-crisis EBITDA margin). SMEs' margins took the worst hit during the current cycle.

In 2018, companies find themselves between a rock and a hard place, with decreasing revenues on one hand and increasing costs on the other hand stemming from the increasing prices of construction materials as well as energy and labor costs.





photo courtesy of pixabay.com under CC0

Long client payment delays of French construction companies (average DSO for listed construction companies in France was 75 days in 2017 vs. 68 days in 2016) continue to plague the sectors' liquidity. The cumulative 12-month insolvency statistics as of August 2018 points to a -5% decrease compared to the same period last year. However, the drop has not been universal across companies of different sizes. During the same period, the companies with annual turnovers between 5 and 15 million euros have registered an increase in the total number of insolvencies. Sector deceleration in 2018 will bring more bad news related to liquidity.

The 40 billion euro project Grand Paris Express is gaining speed and will help partly compensate for the lackluster demand in the Paris region. A new legislation dubbed the "Loi ELAN" is expected to help bring down the barriers to construction (lower the cost and the number of procedures needed), and the "Loi PACTE" is an attempt to improve the business climate for SMEs by simplifying certain insolvency procedures and making tax rate adjustments for SMEs.

# COUNTRY FOCUS UK

**Construction to grow by +0.5% y/y in 2018 and +1.5% in 2019. Recovering demand, but crippled profitability and deteriorating liquidity. Uncertainty over Brexit continues to weigh on business and consumer confidence.**

Overall, we expect growth to slow down to +0.5% y/y in 2018 (vs +7.1% y/y in 2017) and slightly pick up in 2019 (+1.1% y/y).

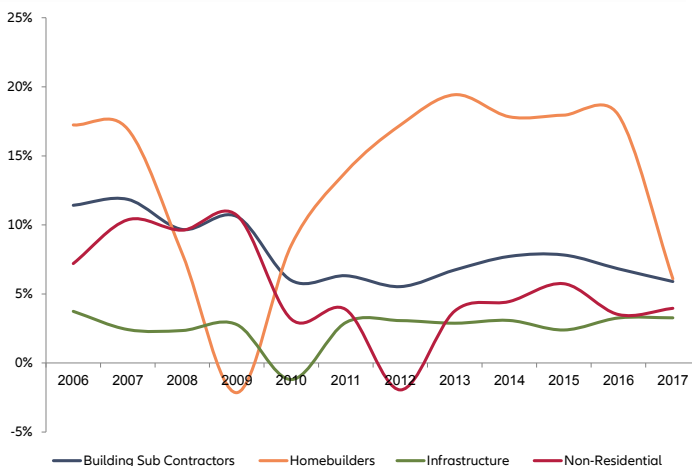
Construction volumes have demonstrated an improvement during the current global construction cycle by roughly +16% (2018 vs. 2008). At the end of Q2 2018, the residential building permits and the building starts numbers were down -6% and -4% year-on-year, respectively. Mortgage approvals remain resilient, which suggests the sector will not face a demand crisis but lower demand has cut housing price growth by half since the pro-Brexit vote. The non-residential construction sector demand was also hit by the collapse of Carillion, which was a major source of revenue for thousands of small subcontractors in its value chain.

**Chart A** Housing starts and total construction volumes



Sources: Department of Communities and Local Government, Euler Hermes

**Chart B** Profitability of a median listed construction company in the UK



Sources: Bloomberg, Euler Hermes

**The operating margins of UK construction companies will remain under pressure in the near future.**

The median operating margin (EBITDA/Revenue) among listed construction companies in the UK has deteriorated from 11% at the end of the previous cycle to the current level of around 9%. Over the recent period, the trend has been negative for all the subsectors of the UK construction market.

In 2018 the operating margins continue to get squeezed from the rising real wages and building material prices. At the end of the first six months of 2018, the median operating margin stood at 6.8%, which is a 1% drop from the same period last year. At the end of the first six months of 2018 the median operating margin stood at 6.8%, which is a 1% drop from the same period last year.



Photo by Roman Fox on Unsplash

**The negative trend in insolvencies started at the beginning of 2018 is set to continue.** The top-line growth during this economic cycle has not been achieved to the detriment of working capital management. In fact, the median DSO has shown considerable improvement since the pre-crisis period. The overall liquidity in the sector is currently getting tighter as Q1 2018 insolvency statistics suggest a +10% increase y/y, and the negative trend in insolvencies is expected to persist this year.

**Uncertainty over Brexit will continue to weigh on business and consumer confidence in the coming months.** In addition, monetary and financial conditions are becoming tighter. There are two main questions for the construction sector that are yet to be

clarified post-Brexit. The first question is related to how the new agreement will affect the labor shortages faced by the industry. Since mid-2016 there was 102K less migration from EU vs. +70K more from non-EU. Hence, unfilled job vacancies rose by more than 6% y/y in June 2018.

We expect this trend to intensify in the coming months as the weak sterling (1.06–1.09 at end-2018 with a temporary relief in H1 2019 to 1.14) will lower the attractiveness of EU non-UK workers in the sector. The second question is related to the deal's impact on the cost of the construction materials (60% of building materials are imported from the EU). We expect a Norway-type agreement which implies the UK will stay in the Single Market. On top of that,

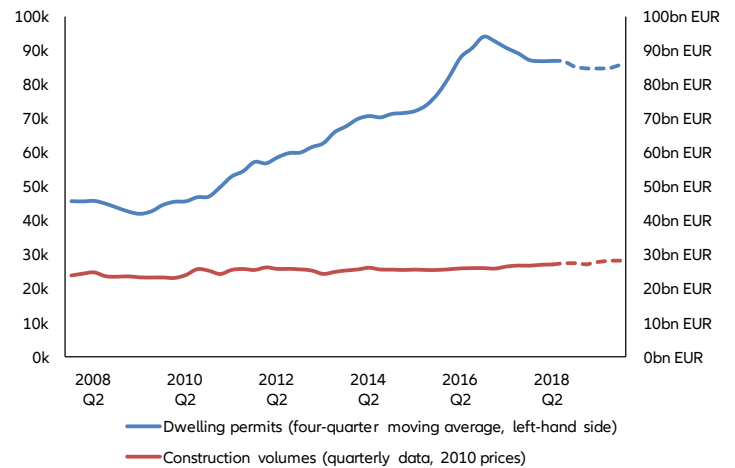
the outlook of infrastructure construction also remains uncertain as the European Investment Bank through the Juncker Plan was a significant provider of funding for major infrastructure projects in the UK (EUR2.7bn).

# COUNTRY FOCUS GERMANY

**Construction to grow by +2.9% y/y in 2018 and +2.8% y/y in 2019. Solid demand and profitability. However, liquidity has stopped improving and is showing first signs of deterioration.**

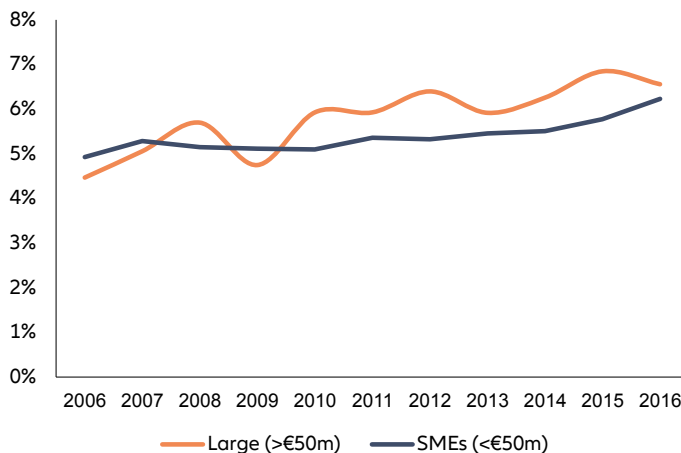
The construction volumes are estimated to slow down to +2.9% y/y in 2018 (vs +3.2% y/y in 2017) and decelerate further to +2.8% y/y in 2019. The construction sector demand has remained resilient during the current global construction cycle (2008–now). The revenue growth of German construction companies has been driven to a greater extent by increasing prices than by volumes. The latest construction permits data is pointing to an overall slowdown of the German construction market. Moreover, private consumption (favorable employment and wage trends) and investment activity (high capacity utilization, favorable financing conditions, and relatively low corporate debt) support growth in the sector, while economic sentiment, clouded by the trade conflict with the US, has had an impact on economic activity as shown in Q3 2018.

**Chart A Construction permits and total construction volumes**



Sources: German Federal Statistical Office, Euler Hermes

**Chart B Profitability of a median construction company by segment in Germany**



Sources: Bach, Euler Hermes

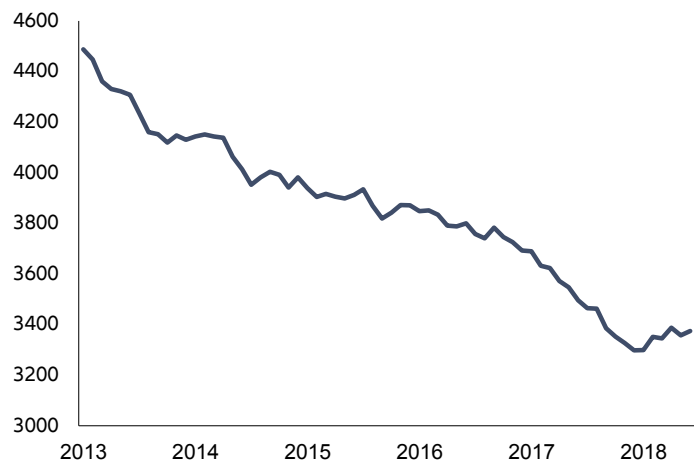
**Operating margins are expected to remain resilient.** German construction companies have managed to recover their margins to the pre-crisis level during the current global construction cycle.

The current median operating margin (EBITDA / Revenue) is estimated at 6% which is comparable to the pre-crisis period. The German homebuilders' profitability has been boosted by the highest residential property price increase among the largest construction markets in Europe (+50% compared to their peak value before 2008).



The latest insolvencies data point to the end of the period of improvement in sector liquidity. Insolvency statistics have reached historical lows during the current cycle. The payment delays have also shown considerable improvement during the same period. However, since the beginning of the year, the insolvencies among construction companies have started to pile up. The slowdown of the sector this year should continue to weight on sector liquidity, so the negative trend in insolvencies is set to continue throughout 2018.

**Chart C** Number of insolvencies of German construction companies



Sources: DeStatis, Allianz Research

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Such deviations may arise due to, without limitation, (i) changes of the general economic conditions and competitive situation, particularly in the Allianz Group's core business and core markets, (ii) performance of financial markets (particularly market volatility, liquidity and credit events), (iii) frequency and severity of insured loss events, including from natural catastrophes, and the development of loss expenses, (iv) mortality and morbidity levels and trends, (v) persistency levels, (vi) particularly in the banking business, the extent of credit defaults, (vii) interest rate levels, (viii) currency exchange rates including the EUR/USD exchange rate, (ix) changes in laws and regulations, including tax regulations, (x) the impact of acquisitions, including related integration issues, and reorganization measures, and (xi) general competitive factors, in each case on a local, regional, national and/or global basis. Many of these factors may be more likely to occur, or more pronounced, as a result of terrorist activities and their consequences.

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