Construction in France: What recovery?

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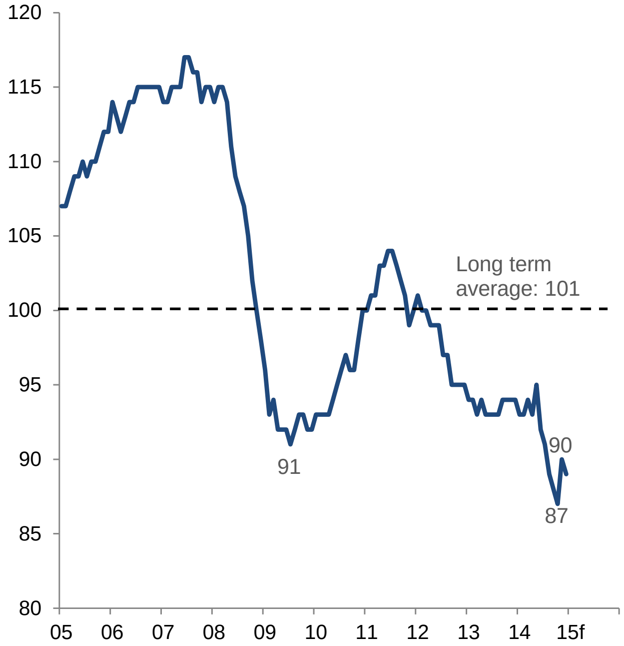
Executive summary

- After seven years of recession, output in the construction industry is expected to contract a further -1.6% in 2015.
- The sector seems to have hit bottom however and there are signs that it will gradually start recovering in 2016, with output rising +0.7% overall.
- Activity in the Civil engineering segment is expected to continue to decline in 2016 (by -0.5%) and will threaten the survival of many construction companies, which depend on short-term funding sources for 60% of their financing.
- It will take some time before we see a drop-off in business insolvencies in the sector (a total of 30,000 are expected in 2015 and 2016) or an improvement in the employee situation (net job destruction of 79,000 is forecast over these two years).

Against a background of sustained recession, confidence is increasing slowly from its low point of October 2014 and +0.7% growth may be expected in 2016

Although the business confidence index has strengthened to 90 in September 2015, it is still well below its long-term average of 101 from 2005 to 2015. Since October 2014, it has risen slowly from 87, its lowest point over this ten-year period (see chart 1).

Chart 1: Business confidence index (100 in 2010)



Sources: INSEE, Euler Hermes

The construction industry is expected to take advantage of the growth potential of residential construction and strategic infrastructure projects, which are increasingly innovative and complex. For example, the ”Grand Paris” project – 200 km of public transport lines and 70,000 housing units a year – is estimated to be worth EUR26bn and is expected to generate hundreds of thousands of jobs, with some projects continuing until 2030.

The construction sector will contract once again in 2015, by -1.6%, bringing output to -20.4% below its level of 2008. However, the decline expected in 2015 is less than the -3.6% observed in 2014 and could mark a turning point toward timid growth of +0.7% in 2016. Some segments of the sector will not be so lucky however, such as Public Works which will continue to shrink in 2016 by -0.5%, due to the time required to launch large public works projects (see chart 2).

Signs of recovery are appearing in all segments and across indices, but the improvement is not so impressive taking into account it comes on the heels of dismal performance over the last few years

The number of housing starts continued to fall in 2015 (by -2.8% at the end of August 2015 year-to-date, vs. a -10% drop in 2014). During this time, the number of building permits issued had fallen by -2.6% at end-August, vs. an -11% drop in 2014. This improvement reflects the stabilization of permit issuance (about 347,000 since April 2015) and points to **a likely pick-up in housing starts in 2016** (see chart 3).

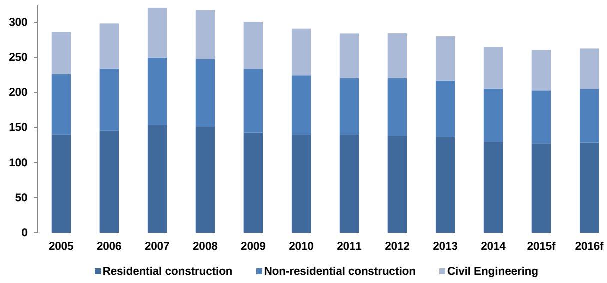
This demand is supported by various structural factors, which include average annual population growth of 0.5%, the current shortfall in housing of least 350,000 units and the appetite of French consumers for home ownership and for detached houses in particular, for which sales are up +6% in 2015. Demand is further supported by the relative decline in the price of homes, due mainly to the sluggish economy.

Housing is therefore somewhat more affordable. The ratio of the average home price to average household income (which was 6.7 in 2014) has fallen back to its long-term average of 6.4. We expect this trend to continue in 2016 and to boost residential construction. Although home prices were volatile from 2005 to 2011, they have been declining steadily since 2012. Instead of bursting, the property bubble has been slowly deflating.

High unemployment, which has been stable at about 10% since 2013, has caused household investment to fall for eight consecutive quarters. Although **investment spending is expected to gradually strengthen**, this will not be enough to reverse the overall trend in 2015 (a -4% decline is likely), which will continue to weigh on the sector's activity in early 2016 (see chart 4).

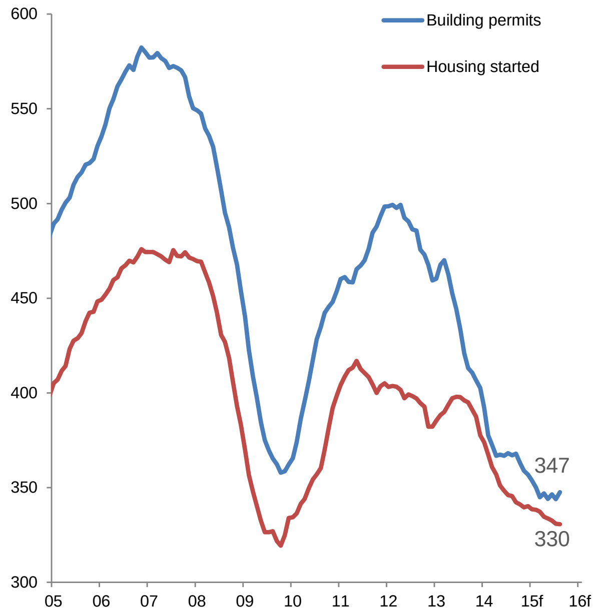
The increase in purchasing power will be particularly **beneficial for home maintenance and improvement purchases**, which generally involve less expenditure. This market will benefit from the renovation of vacant housing units (7%), which must be fixed up before they can be sold, and from the need to bring 75% of housing stock into compliance with new environmental standards, representing a total expenditure of 0.8 % of GDP.

Chart 2: Activity by major segment (in EUR bilion – prices in 2010)



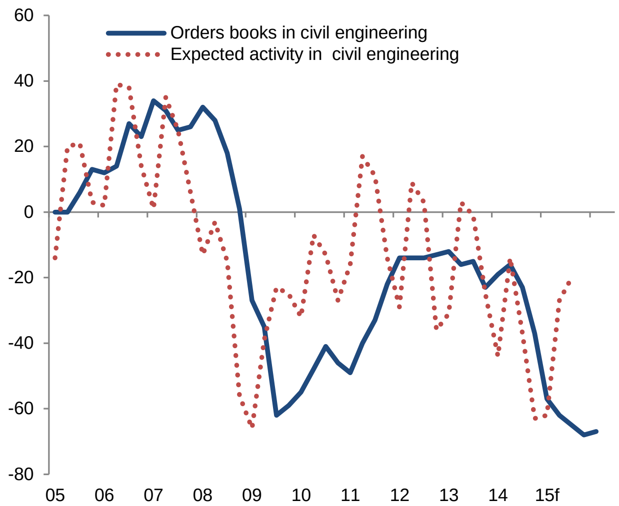
Sources: Oxford Economics, Euler Hermes

Chart 3: Building permits and housing started (in thousands)



Sources: INSEE, Euler Hermes

Chart 4: Household investment and unemployment rate (in %)



Sources: INSEE, Euler Hermes

The down cycle in non-residential construction also seems to be ending since March 2015, when the year-on-year contraction observed at the end of that month began to fall from 16% to 11% at the end of July. Although the activity index for this segment has been rising for the past few months and was up +0.5% at the start of August, it is still 11% below its January 2005 level (see chart 5) and has dropped -24% since February 2012. With non-residential construction in decline over the past three years and at its lowest point in the past decade, a turn-around in this segment is quite likely.

Signs of improvement are harder to find however in the Civil engineering segment, where orders are at an historic low and the activity index fell to -67 in January 2015, its lowest point since 2005. Yet the outlook does seem to be improving, since although still negative the index has been rising and reached -36 in July 2015 (see chart 6).
Civil engineering will benefit in 2016 from the **French government's plan to provide EUR1bn** in investment funding to local authorities, of which 500 million is to be used for the government's priority projects and the remainder for local projects in small and medium-size urban areas. Hundreds of millions of euros are still needed to maintain and upgrade roads and railways.

The recovery will need funding however and 60% of this is currently short-term

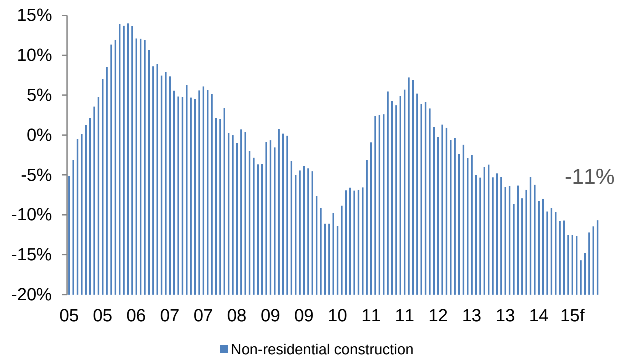
In mid-2011, construction prices stopped rising and over the past year have been declining (by -0.6% from April 2014 to April 2015), even though inflation was 1.2% in France over this period (see chart 7). The construction sector is feeling the squeeze of the lack of demand which has intensified competition between the large number of construction firms.

As activity recovers, firms will need funds for investment, for their operating expenses and for recruitment. Yet **their short-term debt and liabilities are already equivalent to 60% of assets** (see chart 8).

Although builders have relatively little long-term debt, the construction sector has one of the lowest levels of equity funding. In addition to this, the various funding sources are clouded with uncertainty — public funding is hampered by budgetary constraints, high public debt and shifting political priorities, while borrowing depends on the availability of credit and interest rates. As a result, funding for investment is limited in terms of both amount and duration.

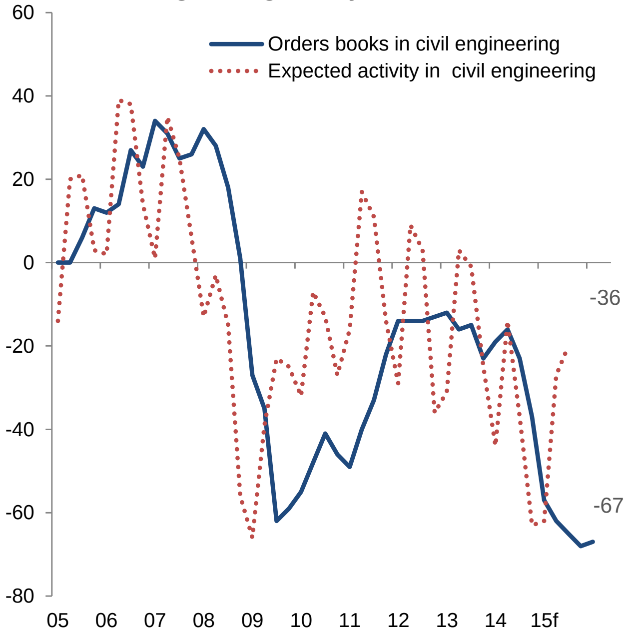
The construction sector has one of the lowest levels of equity funding of any industry, with only 24.6% equity vs. an average of 32.4%. The sector has somewhat less long-term debt than others however, at 9.6% vs. an average of 12.0%.

Chart 5: Non-residential construction index (in annual growth - volume)



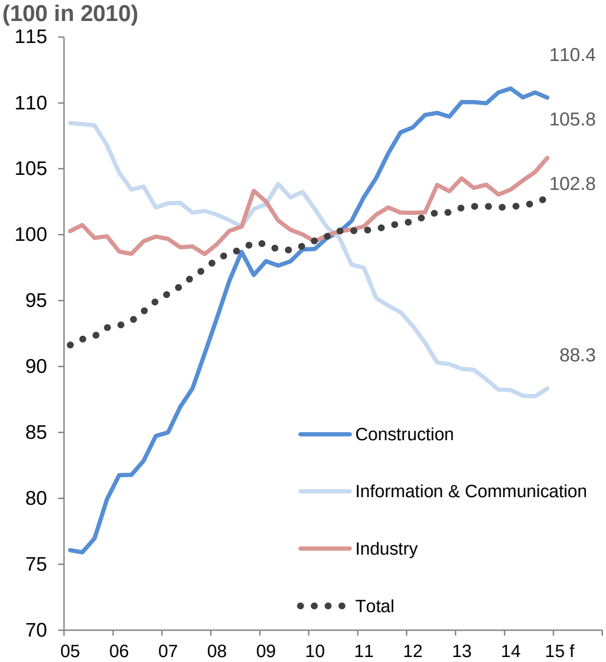
Sources: INSEE, Euler Hermes

Chart 6: Civil engineering activity index



Sources: INSEE, Euler Hermes

Chart 7: Construction price index (100 in 2010)



Sources: INSEE, Euler Hermes

The recovery will also increase the need to finance and secure trade receivables, which account for 31% of assets. This is over twice the average of other industries and a third more than in Germany.

The decrease in the number of business insolvencies and the improvement in employment will take time, with 30,000 insolvencies and 79,000 fewer jobs still expected in 2015 and 2016.

The number of business insolvencies is particularly high in the construction sector, mainly due to the large number of companies. The gradual pick-up in activity will not have an immediate impact on the number of insolvencies, which will continue to be substantial in 2015 and 2016. Currently at an historic high, the number of companies that fail is expected to total 30,000 over the two years (see chart 9). After reaching an historic peak of 26% in 2010, construction still accounts for 25% of business failures in France, which is nine percentage points more than in Germany.

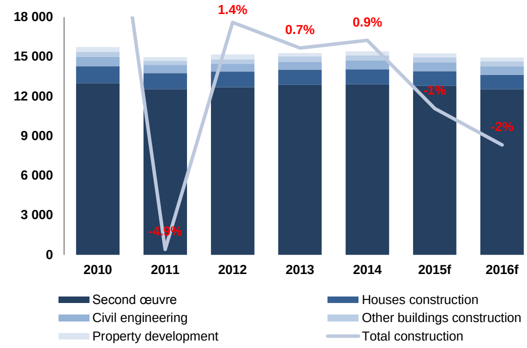
The sector continues to destroy jobs, with employment down -3.4% year-on-year at the end of June 2015 (see chart 10). **The recovery will only reduce the extent of job destruction. A total of 79,000 jobs** are still at risk in 2015 and 2016.

Chart 8: Balance sheet structure of construction sector companies (in % of assets)

Assets	in % of total balance sheet	Liabilities	in % of total balance sheet
Fixed asstes	23,0	Capital and reserves	24,6
stocks	12,2	Provisions	4,2
Trade debtors	31,0	Debenture loans	9,7
Other debtors	16,7	Other creditors	25,1
Other assets	5,2	Trade creditors	28,0
Cash	11,8	Deffered debt	8,4
Total assets	100,0	Total assets	100,0

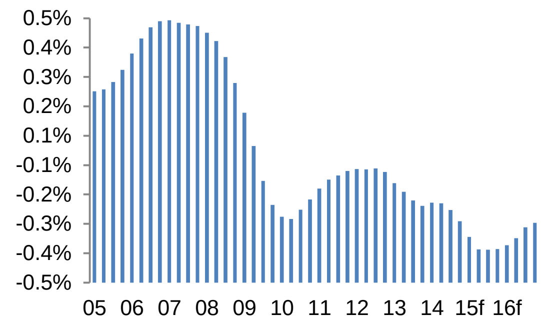
Sources : base Bach, Euler Hermes

Chart 9: Business insolvencies by segment (in number and annual change)



Sources: OCDE, Euler Hermes

Chart 10: Net job creation rate (annual change)



Sources: INSEE, Euler Hermes

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