Euler Hermes Economic Research

Euler Hermes Germany

Industry Report

Construction in Germany: Slower growth ahead

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Executive summary

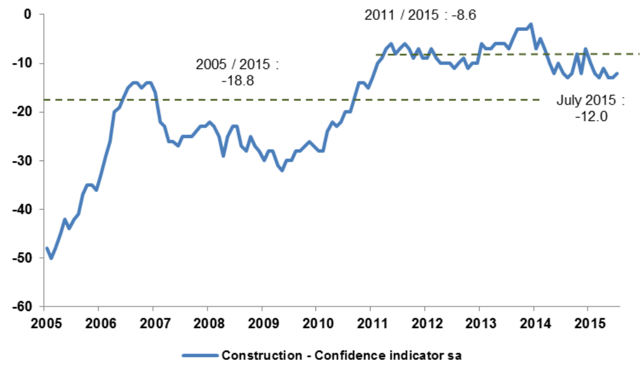
- Euler Hermes forecasts a +2% growth rate for the German construction sector in 2015, after a +3% growth in 2014. This positive trend is set to continue thanks to robust demand in the residential and private housing segments, supported by net migration inflows and a rising rate of urbanization.
- The slight deceleration is explained by: (i) uncertainty about the level of public spending; (ii) potential deceleration of housing prices - in the wake of modest growth of disposable income; and (iii) a more limited effect of low interest rates.
- Profitability (EBITDA over net sales) of companies in the construction sector is expected to remain stable at 5.9% in 2015. The positive effect of lower energy prices is entirely offset by higher personnel costs. Insolvencies will continue to decrease but less rapidly (-3% in 2015) totalling 3,850 cases in 2015.

According to companies, confidence is down 3.5 points compared to 2011-2015 average

The construction sector suffers from noticeable cracks in confidence, reflected in a deterioration of the sector's confidence index. It dropped to -12 in July 2015 from its recent peak 18 months ago (-2 in December 2013). The index is below -8.6, its average value for the last five years but still above -18.8, its average for the last decade 2005-2015 (Chart 1).

While the index was close to positive territory in December 2013 (-2), pointing to a marked recovery after years in disarray, the recent decline in the index indicates points to a slight deceleration in the construction sector in 2015-16. Several mitigators can explain this loss of momentum.

Chart 1: Business tendency survey, confidence indicator in the German construction sector

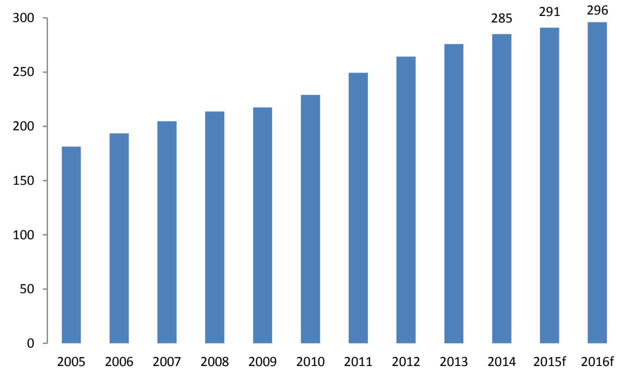


Sources: OECD, Euler Hermes

Less favorable times for the German construction sector: +2% in 2015

After a significant boom from 2010 to 2013, the German construction sector continues to grow but more slowly. Gross output increased by +5% on average from 2010 to 2013, before moderating to +3% in 2014.
For 2015 and 2016, we expect a consolidation of growth at around +2%. While slightly lower than previous forecasts, performance is still good, considering the persistent difficulties facing other European countries like Spain and, to a lesser extent, France. In value, the gross output might rise to EUR296bn in 2016, after EUR291bn in 2015 (Chart 2).

Chart 2: Construction, Gross output, nominal in EUR bn

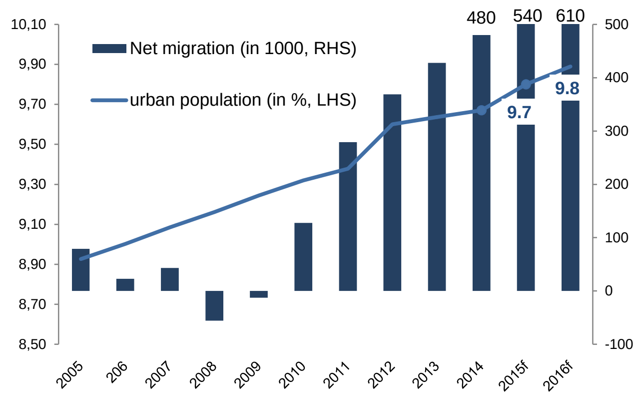


Sources: Oxford, Euler Hermes

Boosters #1 and #2: Demand for dwellings continues to be sustained by demographics: positive net migration (1.7 million in 5 years) and a rise in urban population rates (nearing 10% in the big cities)

In 2014, net migration grew by +12%, slowing down after +16% in 2013. At the same time, the urban population rate increased to 9.7%. These two drivers will keep contributing positively to the strength of the construction sector in Germany for the next couple of years. Indeed, rapid extrapolation points to +13% p.a. for net migration to 600,000 in 2016, and 9.8% for the urbanization rate (Chart 3). However, several factors will dampen sector prospects.

Chart 3: Net migration (right axis) and urban population (cities > 1mn, left axis)



Sources: Worldbank, DeStatis, Euler Hermes

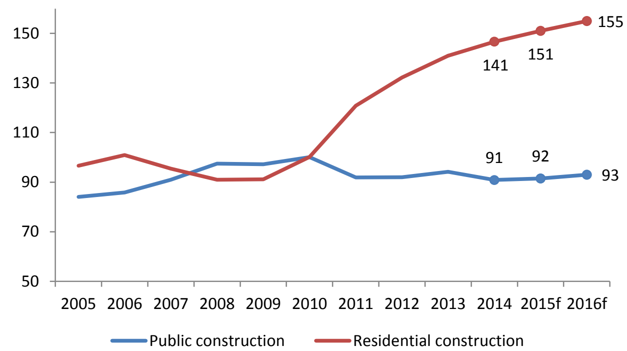
Mitigator #1: Public construction remains a weak contributor to the sector's growth

The residential segment is the most dynamic component of the construction industry with recorded growth of +4% in 2014 vs. +6% in 2013. In 2015, its growth, forecast at +3%, should again be higher than the other segments of the construction industry.

We expect that public construction will continue to lag behind and only increase by +1% due to modest German infrastructure investment programs. These Government plans remain uncertain since indexed on a budget surplus.

Looking at incoming orders, there is now a growing gap of over 60 percentage points between residential and public construction indices which were equal back in 2010 (Chart 4). Civil engineering represents 17% of the German construction sector. If there is no increase in public investments, residential construction will continue to surge ahead but the losses in the public segment will start indenting total construction output.

Chart 4: Incoming orders for the construction sector, value index base 100 in 2010



Sources: Destatis, Euler Hermes

Mitigator #2: Growth in household disposable income (+1.5% in 2015) remains below the rise in housing prices (+4.9% in 2015)

Disposable income has increased by +2% per year from 2007 to 2014 in spite of a plateau in 2007-2009.

Housing prices have risen by +4.9% from 2007 to 2014 annually due to unsatisfied market demand. The trend is apparent for new buildings as well as for existing ones (+3.4% annually).

This gap between the tempo of the buildings' prices and the disposable income is expected to continue in 2015 and 2016. All in all new buildings' prices will register a 1.5 time growth from 2007 to end of 2016, against a 1.2 time growth for the disposable income.

In 2016, however, we expect housing prices to start decelerating slightly to +4.1% owing to the remaining moderate rise in disposable income (+1.8% for the 2015-2016 average compared to +2.7% for the 2013-2014 average) (Chart 5).

Mitigator #3: The positive impact of low interest rates may be behind us

After peaking at around 4.5% in 2008, household deposit rate and average mortgage rate have experienced a dizzying decline. A rise is not expected in the short-term as the European Central Bank's forward guidance should keep interest rates at record low for the next year. However, the bulk of the positive effect of cheaper borrowing costs and lower savings earnings might have already happened (Chart 6).

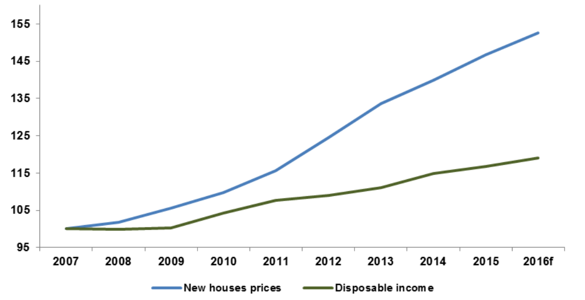
Certainly low interest rates will continue to boost demand for housing but to a lesser extent as rates have been below 2% for close to three years already.

In 2015, the profitability (EBITDA over net sales) of companies in the sector will be stable at 5.9%

The positive development in energy prices (-60% since mid 2014 in oil prices) will not be translated into additional profits as personel costs are increasing (introduction of minimum wage). This mechanical offset can be explained by the cost structure of the sector: labor costs, consumption of materials and costs of services purchased each represent a third of the overall costs.

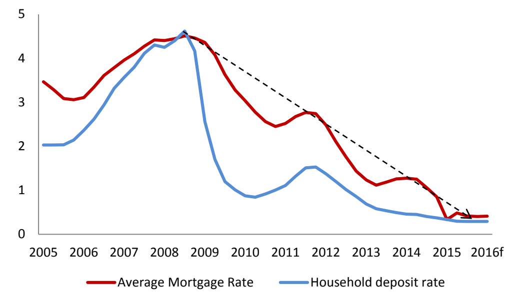
The EBITDA (over net sales) has stabilized at around 5.9%, which is in line with its long term average, but 0.8 percentage point below its 2010 peak (Chart 7).

Chart 5: Disposable income vs. New houses prices



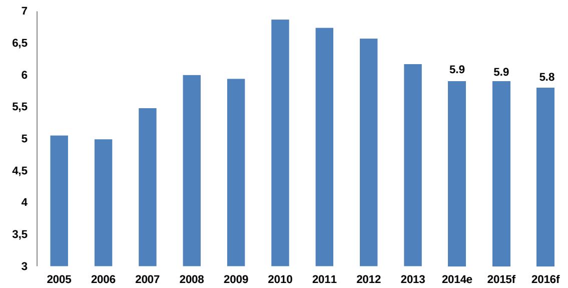
Sources: IMX Immobilienscout24, Deutsche Bundesbank, Euler Hermes

Chart 6: Household deposit rate, average mortgage rate



Sources: IHS, Deutsche Bundesbank, Euler Hermes

Chart 7: EBITDA over net sales (in%)



Sources: Base BACH - Banque de France, Euler Hermes

The slowdown in the sector will not help reduce significantly the number of insolvencies: 3,850 cases expected in 2015 and 3,750 in 2016

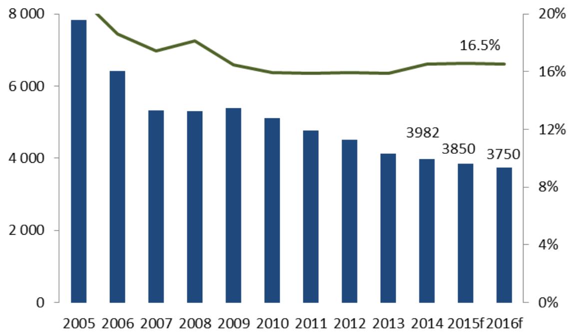
Insolvencies in the construction sector decreased by -4% in 2014 to 3,982. A noticeable decrease for a sector where most companies struggle with working capital requirements and profitability. However, in 2013, the fall was even more impressive: -8% year-on-year. The limited indebtedness (9.3% of the total balance sheet) of German construction companies can explain this positive trend, when compared to construction companies in other European countries.

Having said that, the number of insolvencies in the sector was second only to that of wholesale and retail trade (4,545) in 2014.

In spite of the slight deceleration of the sector, and with stable profitability and financing conditions, we expect this declining trend to continue in 2015 and 2016, maybe less vividly so.

For 2015, the fall should be close to -3% (Chart 8). Construction will still account for 16.5% of all insolvencies. For comparision purposes, in France, it represents 25% of all cases.

Chart 8: Insolvencies in the construction sector in number (left axis) and share of total insolvencies (right axis)



Sources: Destatis, Euler Hermes

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