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Poland's construction industry – a boom that was not there

Euler Hermes report on Poland's construction industry for the first half of 2017 reveals market growth will be less than hoped for - the cake is not big enough for everyone

WARSAW – 8 August 2017 -- According to the latest official data to the end of June 2017, the total value of the construction industry in Poland had risen 7.6% year-on-year. Over the same period in 2016 it had fallen by 11.9%. The value of the market remains below that of 2015. What are the key drivers?

"Perhaps, in addition to a limited pool of new finance but generally high expectations of the market players, it is the result of reciprocal trade credit, particularly with building material suppliers. Is it enough? The answer may be provided by the insolvency of construction companies and the circulation of receivables for used materials, which have not improved over the previous year," said Tomasz Starus, Member of the Management Board of Euler Hermes, responsible for risk assessment. The key sector findings are:

- A slow increase in the number of new central investments – the companies active in the industry estimate that the effect will be noticeable by 2018, or even in the third quarter of 2018 (according to the Polish Construction Sector Employers' Association, ZPB).
- An increase in the number of insolvencies year-on-year – particularly from January to March 2017 and, more recently, in June. At the end of the first six-months of 2017 there were slightly more insolvencies than the previous year (+3%), despite the inflow of new funds.
- Receivables – As with last year, there is some evidence of a slight improvement for manufacturers. At the same time, there has been an elongation of the average flow of receivables for wholesale distributors (the effect of higher sales in both areas). Every fifth zloty of receivables for manufacturers remains overdue, and for wholesalers – every third zloty.
- The question is how much the industry is driven by inflow of funding from new investments and how much is based on the faith that they exist. Increased lending action for suppliers – the level of potential losses as a result of significantly delayed receivables - is still high and is potentially threatening the viability of many manufacturers and suppliers.
- The growing dominance of the largest players in the construction market works at the expense of local actors.

In the construction industry, an inflow of funds to the market is visible; however it does not appear that the funds come from central investments based on the new EU budgetary perspective. It is rather a revival driven by funds provided by local governments and private investors. The biggest investments, if they have started, are still in the planning phase. In this respect, local governments and regional authorities have better prepared for investments; they have already had their plans ready-to-execute.

However, we should remember that local governments had never completed all planned investments. Thus, announced and market-driving information on their value reaching 40 billion złotys (similar to the funds from the new EU budget) is just a declared amount. This will be reduced to some extent according to Tomasz Starus. However, local governments have joined the action, while central institutions are largely still in the tendering phase, and they do not spend funds in the construction itself. This is evidenced not simply by the lack of viable projects, but also by weak funding which is rarely mentioned but is a fact. Budgets have clearly borne the cost of support of completed investments - the debts from previous years. Therefore all entities, including central institutions, have scarce funds for new investments in relation to needs and the planned scale. For example, according to the information available in June from the National Road Fund (KFD), there are still 2800 km of roads to be built in relation to the remaining financial cap of approximately 11 billion złotys. The ongoing tasks have required more than 95 billion zlotys. A remedy for these shortages may be a cancellation of some tenders, including the highly anticipated bypasses of several cities. Recently, an increase in future funding of 28 billion złotys has been announced. Great emphasis has been put on the word "future" because the funds will be used to finance new projects just in the tendering and planning phase. Thus, the assigned resources will appear in the market 2-3 years from now.

The number of insolvent construction companies increased in the first quarter, decreased in April-May, and then increased again in June. This trend is contrary to previous years when the April-May period was critical and, during the later construction season, the funds available in the market calmed the situation. Unfortunately, this June was surprising with repeated increases in the number of insolvent construction companies.

Tomasz Starus, commented: "The increased number of insolvent construction companies at the beginning of the year was caused by their constantly deteriorating liquidity after the 2016 crisis. This is confirmed by the receivables inflow cycle for construction materials in the first quarter, which is by approximately 10% worse compared to the corresponding value in the fourth quarter of 2016. The positive mood in the market, fuelled by news of the launch of new public tenders, has encouraged many suppliers of building materials to make an intense sales campaign in the market. In March, for example, the turnover of the suppliers of construction materials increased by 32% year-on-year. This was more than ten times higher than the growth of the construction market value at that time. Some suppliers have become aware of the risk that they may incur major cost and, consequently, major risk from financing construction companies. Thus, in June we could not see any increase in turnover relative to the previous year. Growth year-on-year was 2%, both for manufacturers and wholesalers of constructions materials."

This appears to show that the season is growing slowly and is slightly better than last year. Opinions expressed by industry players may be closer to the truth with market growth expectations over the year not at double-digit pace, but rather 7-8%.

Good ongoing financial liquidity is largely an effect of positivity (from the new EU perspective) and a cleaner market (insolvencies) in prior months and not an actual cash inflow. We cannot see any major improvement compared to the previous year, especially if the level of delayed receivables does not fall. The most overdue receivables or ‘difficult debts’ (those not paid within 120 days or more after the payment due date), decreased only for manufacturers. Wholesale distributors paid their liabilities faster in order to gain better terms and bonuses in the fight for the "growing" market – although this trend is still not confirmed – and their construction company clients have not paid their liabilities faster than the previous year, during the market slowdown. In the context of the construction industry, the steel sector is performing relatively well as a result of better control and sales discipline introduced in recent years.

Beneficiaries of the rebound, or revival, as the improvement is limited, are only large companies

While last year saw collapse in the construction market, evident in the financial statements of companies in this sector listed on the Warsaw Stock Exchange (GPW), traces of the crisis are not evident. Indeed, revenues of the largest companies increased by an average of 4%. For example, the industry leader posted the best results in its history with revenues up 8.5% and net profits up 73%. The total value of works and the value of public contracts gained by companies exceed 30%, both in terms of total market value and the value of gained public contracts. Large companies "smooth" the results. By making reserves, they are able to anticipate the market trends, diversify their presence on the market (by choosing the currently profitable niches, e.g. Budimex is currently building the Biedronka markets). These companies do not need to take any contract; they can choose as well as expand exports.

Large companies, by choosing contracts in the local markets and diversifying risk, are taking over the niches of smaller local businesses. They are less competitive in terms of prices, as evidenced by the insolvencies of construction companies in the first half of the year. These were most often not small companies employing a few employees, but companies with the turnover from several to tens of millions of złotys, and even larger companies, reaching over one hundred million zlotys of the annual turnover.

“New contracts are addressed mainly to the biggest players. Any attempts to decrease their dominant position by way of statutory regulation - changing the weight of price parameters in the tenders, regulations for the protection of subcontractors - will probably not help smaller companies. It may even harm them because of the administrative difficulties involved in the acceptance of a subcontractor by an investor. The abolition of the requirement of a contract will give birth to conflicts about the scope and value of work,” commented Tomasz Starus.

“A heavy burden for smaller construction companies, and affecting their liquidity, is reverse VAT tax in the construction industry. Waiting for VAT tax on the materials used for construction for a few months critically affects the finance of smaller construction companies. These amounts usually exceed their profit margins so, before the executed contracts become profitable, they cause a significant, ongoing gap in the finance of these companies. These are not companies with big reserves or cash resources and their local business scale and ownership structure do not allow them to be recapitalised by a larger, foreign entity or parent company as happens with larger players. This is already noticeable with new guidelines from the Ministry of finance for tax authorities to return VAT tax faster, within two weeks rather than two months. However, this is only for very small construction companies with fewer than 10 employees,” added Tomasz Starus.

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