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UK outlook: Construction

Drag on residential from higher interest rates to weigh on the global construction sector but resilient non-residential segment.

The construction industry worldwide is experiencing challenges as the economic momentum is fading and interest rates are rising fast. Nevertheless, the strong uptick in non-residential and infrastructure, especially in the US along the clearing of existing back-logs means that the global construction is poised to increase by +1.9% y/y in 2023 and growth should remain around 2-3% in 2024. In 2023, the average earnings before interest and taxes (EBIT) margin for the industry (including all segments) is expected to grow by about 3%, but there is heterogeneity across regions and segments. Regarding specific segments, infrastructure is expected to see notable growth, driven by increased global public investment in infrastructure projects, particularly those related to the green transition and the development of emerging economies. On the other hand, the residential construction sector might encounter difficulties, largely due to rising interest rates and high property market valuations.

Figure 1. Global construction output (%y/y)

Sources: Oxford Economics, Allianz Research.

Despite profitability on the strong side, smaller firms in the sector grapple with liquidity issues as cash flow is crucial in construction since companies often have to pay for materials and labour upfront while being paid in instalments. Unsurprisingly, construction firms make up for about 30% of insolvencies in most countries.

From a longer-term perspective, the sector should continue to grow steadily: there is an increasing demand fuelled by urbanization, demographic shifts, and larger investment in infrastructure. By 2030, the industry's global output is projected to reach USD 15.5 trillion, with China, the United States, and India being the primary contributors, accounting for around 60% of this growth.

Looking forward, we see a number of key trends and challenges that will shape the industry:

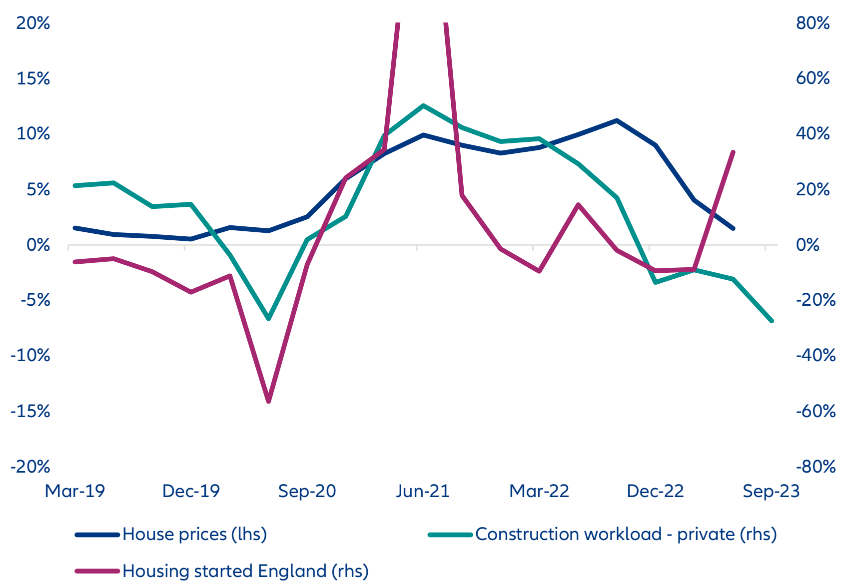
1. **Rising interest rates:** Mortgage rates for households and financing costs for corporates and governments mean less support for the construction business.
2. **Housing market price correction:** House prices have decreased in most regions of the world, although some correction could better align prices with potential home buyers, a strong decline could hit new build in the residential segment
3. **Green regulation:** Heat/power savings are high on the policy agenda for green motives but also in Europe because of the on-going energy crisis. There is a balancing act for policy makers as green regulation could boost construction via renovations but it also hurt the sector by increasing costs.
4. **Public policies on infrastructure:** Many countries around the world have pledged large amounts to build new infrastructure, this is a tailwind for the construction sector. However, firms must remain cautious about the red-tapes and processes to actually get the cash from these subsidies.

Strengths	Weaknesses
High demand due to urbanization and population growth	Highly cyclical
Increased investment in infrastructure development	Cost control and schedule management challenges
Growing focus on sustainable and green construction	Skill shortages in the industry
Emergence of smart cities pushing advancements in construction	Regulatory and environmental challenges

Market focus – UK

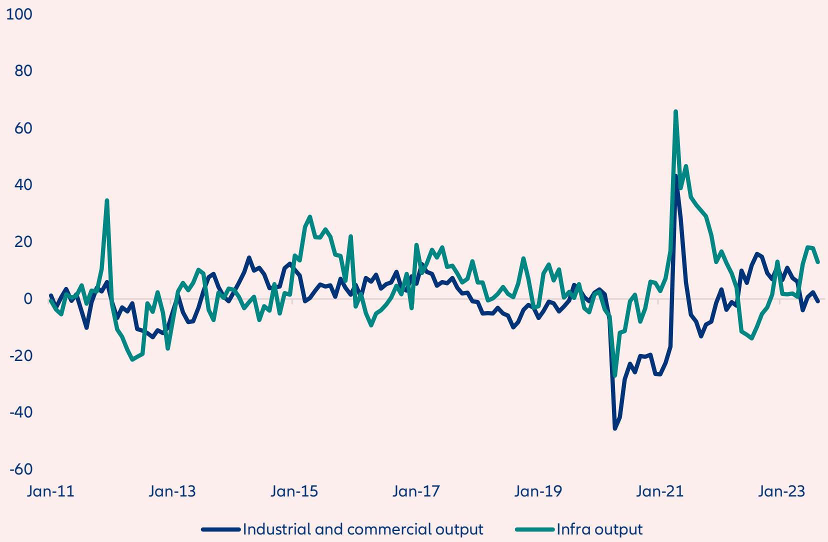
Residential new build is still strong…thanks to backlogs. As interest rates have been rising fast in the UK, mortgagers have been on a downward trend and house prices have decelerated sharply. House prices only grew by 1%y/y in Q2 2023 while they grew by about 9% in 2021-2022. Housing starts in England have increased strongly (+33% as of Q2 2023), however construction firms have been reporting decreasing workload from private clients which points out that firms are clearing their backlogs and that the slowdown in new build is yet to come.

Figure 2. Residential construction indicators (%y/y)



Sources: OECD, RICS, CLG, Allianz Research

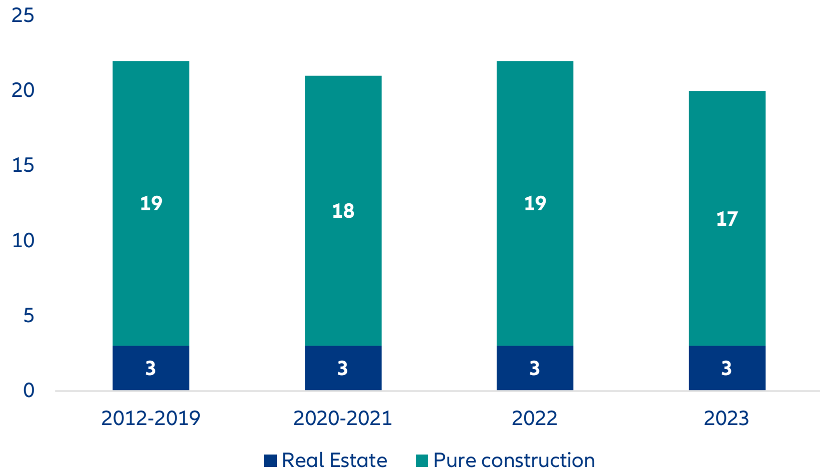
Figure 3. Non-residential indicators (%y/y)



Sources: ONS, Allianz Research

Non-residential construction down while infra is strong. Growth of non-residential construction in the UK has been on a downward trend since Q3 2022. Industrial and commercial output declined by about -1% as of August 2023 while infrastructure output grew by about +13%. Economic uncertainty, rising rates and the legacy of Brexit are probably the main factors driving slow non-residential build. Going forward, both segments segment should slowdown.

Figure 4. Share of construction in insolvencies (%)



Sources: ONS, Allianz Research

Liquidity remains an issue as interest rates rises and inflationary pressures remain. Although the sector benefits from solid profitability it is mainly composed by SMEs that often work as subcontractors for large firms. As a matter of fact, they have lower pricing power, higher exposure to the business cycle, and a longer cash conversion cycle (i.e. they have to pay most of the inputs and their labour force months before getting paid by their clients). As a consequence, these smaller players tend to go bust as soon as their cash is mis-managed. In the UK, construction firms account for about a fifth of the country's insolvencies.

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