Euler Hermes Economic Research

Euler Hermes Germany

Industry Report

Construction in Germany: *Betongold* at a turning point?

August 08, 2014

Didier Moizo (Sector Advisor)
✉ didier.moizo@eulerhermes.com

Lukas Boeckelmann (Junior Economist)
✉ Lukas.Boeckelmann.ext@eulerhermes.com

Ludovic Subran (Chief Economist)
✉ ludovic.subran@eulerhermes.com

Executive summary

- In the last few years we have seen robust growth in the German construction sector (+2.8% in 2012 and +4.4% in 2013), driven by residential housing. This positive trend in the German construction industry is based on a positive economic environment coupled with a demographic boost.

- We expect this positive trend to continue though more moderately in 2014 with +3.5% to EUR 285bn in gross output, due to increased house prices, regulation of rents and low public investments. In 2015, more GDP growth and an increase of public investment in construction should push growth output to +5.3%.

- As for companies in the sector, because of elevated input costs, margins of companies are low (estimated at 6% in 2014-15) and risk of non-payment remains high as DSO (36 days on average) are above those of other sectors. However insolvencies in the sector should further decrease this and next year: -3% in 2014 and -5% in 2015, a slower pace compared to 2013.

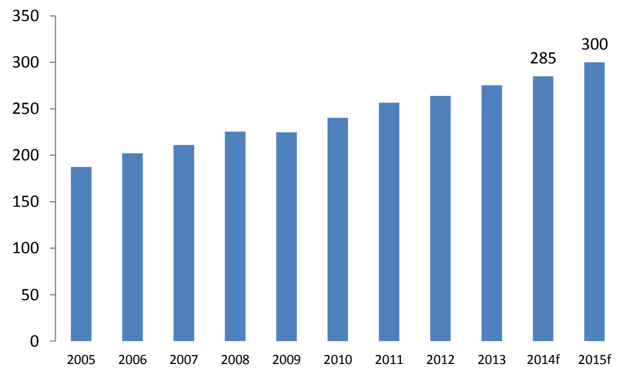
Good times for the German construction sector: +2.8% in activity in 2012 and +4.4% in 2013

The German construction sector has been on an upward trend since 2005, registering an average growth in gross output of +4.9% per year in nominal terms. Although the 2009 crisis marked a decisive moment (output contracted by -0.3%), the gross output went back on track and increased by +6.8% in 2011, +2.8% in 2012 and +4.4% in 2013 (Chart1).

Similarly, permits granted for dwellings increased by +21.7% in 2011, +5.6% in 2012 and finally +12.1% in 2013. This positive trend continued in the first quarter of 2014, where permits granted for dwellings increased by 15.3% compared to the previous year, equivalent to an additional 8,500 permits. Although the 2014 numbers are partially due to both the adverse weather conditions in the first quarter of 2013 and the particular mild conditions in the winter of 2014, the yearly growth rates show that we are experiencing a general positive development.

Behind this upward trend, there is a boost in residential construction. Since 2010, under the

Chart 1: Construction, Gross output, nominal in €bn



Sources: Oxford, Euler Hermes

influence of the ongoing adjutments of national and regional budgets, growth in incoming orders from residential construction greatly outperformed incoming orders from public construction. So far, Germany holds the second-to-last place in house ownerships in Europe. Only 53.4% of Germans own their own dwelling, compared to an average of 70.6% in Europe. This could mean a slight increase of house ownership in Germany.

The reasons are structural: More purchasing power and lower interest rates have been combined with positive demographics

The construction sector is supported by a strong demand in a stable economic context: (i) record low mortgage rates (1.43% vs its peak rate of 4.87%); (ii) a low and decreasing household deposit rate - at its lowest level in 10 years (0.7% vs 4.47%); (iii) low and decreasing unemployment numbers; and (iv) an increasing disposable income (increasing by 2.2% p.a. since 2005). Such factors make real estate very attractive as an investment (the so called *Betongold*), especially as equity is structurally considered high-risk in Germany.

The demand is also under the new and positive influence of demographics: Germany experienced a net immigration of 1.2m over the last 4 years and the urban proportion in major cities increased to 9.4% (Chart 2-4).

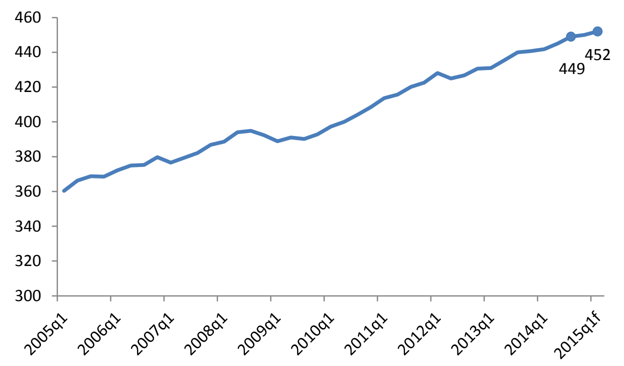
These positive drivers are there to stay; this explains in part our forecast of +3.5% in 2014 and +5.3% in 2015

Strong demand of housing should continue as the favorable macro environment remains. The German macroeconomic situation should continue to improve: we expect a GDP growth of +1.5% in 2014, and then +2% in 2015, lower unemployment rates and a higher purchasing power. We forecast disposable income to reach EUR452bn by 2015.

Likewise, the Eurozone's monetary policy is not expected to change in the short term, such that both the deposit and mortgage rates should remain at their low levels. In our forecasts, we assume 1.23% for the average mortgage rate by 2015, and 0.72% for the houshold deposit rate. Equally, immigration rates should be high as Germany increasingly competes on the world market for high skilled workers: we forecast net immigration to reach 475000 people in 2015.

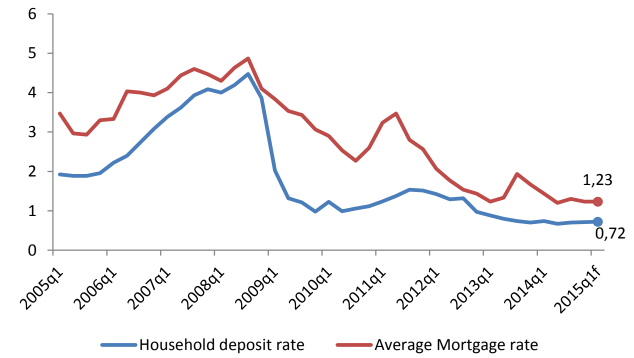
In 2014, we expect the positive trend to continue with +3.5% increase for gross output (to EUR 285bn). One of the reasons for this slight moderation is summarized below in the risk section: increased house prices, low levels of public investments and generally high input costs.
In 2015, we expect more and better growth,

Chart 2: Disposable income €bn



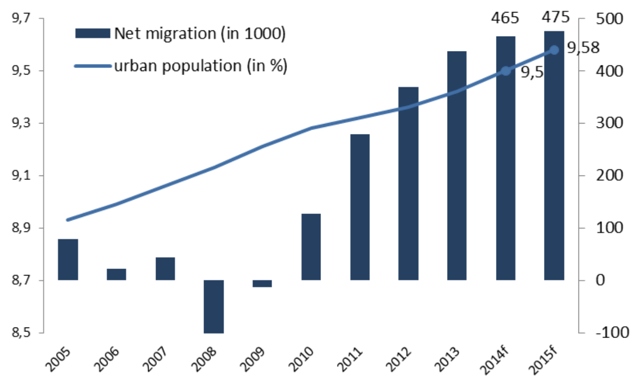
Sources: Global Insight, Euler Hermes

Chart 3: Household deposit rate, Average Mortgage rate



Sources: Global Insight, Bloomberg, Euler Hermes

Chart 4: Net migration (right axis) and urban populayion (cities > 1mn, left axis)



Sources: Eurostat, WorldBank, Euler Hermes combined with increased public investments into infrastructures as agreed upon by the Coalition Government and more supportive microeconomic fundamentals (companies' financials) should push gross output growth to +5.3%.

Our forecasts for incoming orders (Chart 5) also show the relative dynamics of private and public construction and their upward trends by 2015.

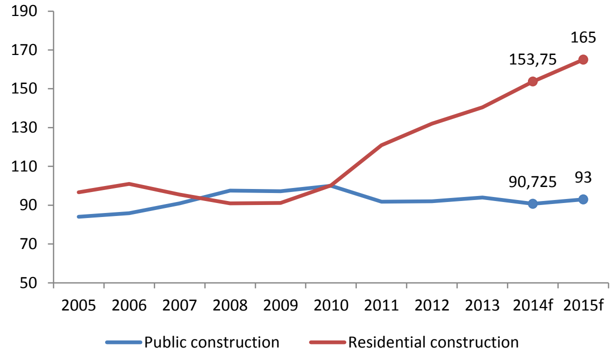
The slight deceleration in 2014 is due to remaining risks to address: high house and rent prices and subdued public construction sector

As the supply of housing cannot satisfy the new demand, rent and house prices have strongly increased over the past years, especially in urban areas (such as Berlin, Munich, Hamburg or Frankfurt). From 06/07 to 06/2014, house prices for new and existing real estate increased on average by +4.7% and +3% respectively. Since 06/2011 this trend has accelerated to +6.6% and +6.4%. Concerning rents, they grew by +2.6% each year, but accelerated to +3.2% from 06/2011 to 06/2014. Regarding the gap between the trend for house prices and the trend in disposable income (+2.2%), there is a short term risk that could discourage households from buying houses, which would be a setback for construction companies. In our forecasts (Chart 6), we expect these appreciating trends to continue.

Note that the Coalition between CDU/SPD negotiated a regulation of housing rents: in areas with a tensed housing market, should the regulation be implemented as planned, existing rental contracts can only be increased to a regional rental index (*Mietspiegel*) and new rental contracts may exceed the index by a maximum of 10%. In effect, regulated rents are likely to disincentivize potential interested parties to buy a house instead of renting it. Similarly, lower rents translate into lower returns for investors, therefore the policy is likely to cause a softening of the demand for housing construction.
In France for example, the regulation of rents caused a substantial drop in the construction industry: in the second quarter of 2014 the number of new construction projects decreased by -19% compared to the previous year. Also building permits plunged by -13%.

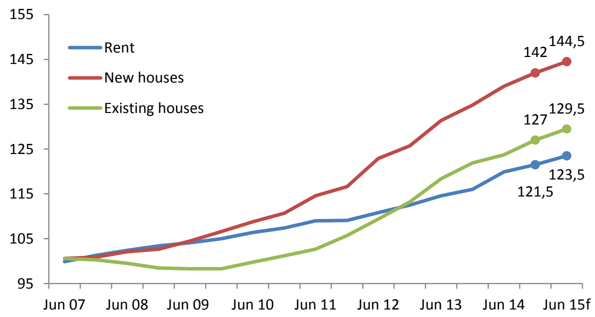
Public construction is still lagging, due to an investment backlog caused by ongoing federal and state budget consolidation. A potential risk therefore is a continuation of subdued public investments. In the first 4 months of 2014, the index for incoming orders decreased by -3.4% in comparison to its value for the same period in 2013. In April 2014, it stands ~10% under its long term average. In the short term, the outlook could be supported by underground and infrastructure construction. The SPD/CDU

Chart 5: Incoming orders for the construction sector, value index



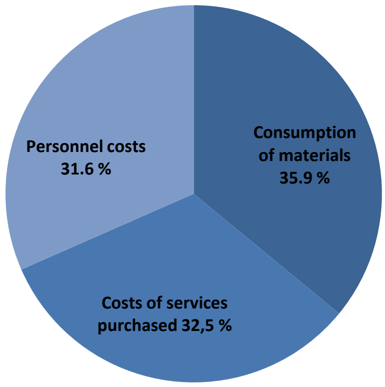
Sources: DeStatis, Euler Hermes

Chart 6: Development of German rents and house prices



Sources: IMX Immobilienscout24, Euler Hermes

Chart 7: Cost structure for the construction sector



Sources: DeStatis, Euler Hermes

Coalition recently agreed on additional investments in infrastructure of EUR5bn. Should there be an agreement on a German toll system, of which implementation is currently being discussed, we would expect another surge in public investments in infrastructure.

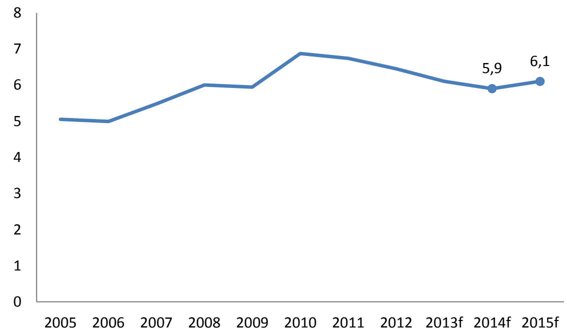
In the end, profitability of companies in the sector is indented by elevated input costs but insolvencies should continue to decrease

The profitability of firms in the sector has increased since 2000, while the improvement in EBIDTA over net sales really took off beginning in 2006, especially for for large firms with a turnover of over EUR50mn.

However, input materials make up for 35.9% of total costs in the sector (Chart 7). Meanwhile, the production of crucial input materials for the sector, such as cement and steel, are in the hands of oligopolies. Energy costs, which are not only an important factor for the sector itself but also for its suppliers (e.g. cement is very energy-intensive in its production) are already on a high plateau and could be threatened by ongoing tension with Russia. German energy prices are 8 – 14% higher than in France and are due to structurally increase in the long term.
As a result we expect the profitability in the sector to stabilize around 6% in 2015 (Chart 8). It is important to note a steady decline in DSOs (Days Sales Outstanding) since 2000, reaching a record low of 36 days in 2012 and showing a structural decrease in 2007. It is still 16 days above Germany's record low DSO across sectors for Europe (20 days, compared to 60 in France e.g.).

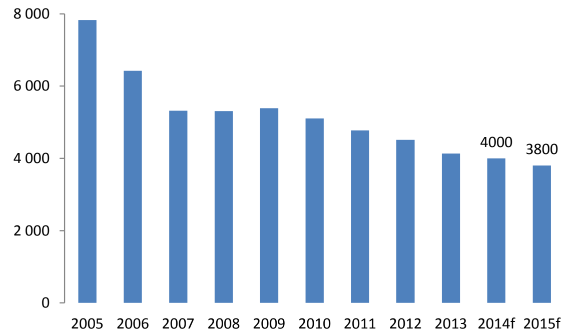
The construction sector still registers the second highest numbers in insolvencies (with 4131 insolvencies in 2013) among all sectors in Germany. However, the sector is also in second place in terms of improvement since 2009: insolvencies were reduced by -23% (only beaten by the agricultural sector with -24%). Since 2005, insolvencies in the sector decreased by -7.7% each year. Between January and the end of April 2014, insolvencies were stable in the construction sector compared to the same period in 2013. We expect insolvencies to decrease more moderately by -3% in 2014. In 2015, based on the more positive environment, the decline in insolvencies should accelerate again to 5% (Chart 9).

Chart 8: EBIDTA over net sales (in%)



Sources: Banque de France - Base Bach, Euler Hermes

Chart 9: Insolvencies in the construction sector



Source: DeStatis, Euler Hermes

View all Euler Hermes Economic Research online
http://www.eulerhermes.com/economic-research

Contact Euler Hermes Economic Research Team
research@eulerhermes.com

Publication Director
Ludovic Subran, Chief Economist
ludovic.subran@eulerhermes.com