ALLIANZ RESEARCH

CONSTRUCTION COMPANIES IN EUROPE: SIZE DOES MATTER

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- **Covid-19 is sparking a profitability shock for SMEs in the construction sector.** SMEs represent the lion's share of companies in the construction sector, with about 80% of the sector's turnover in Europe. But unlike large diversified companies, which are resilient and well positioned to weather the Covid-19 crisis, a large number of SMEs could face severe difficulties. In 2020, we expect a 25% decline in revenues for SMEs, which could lead to a 2pp drop in Ebitda margins to 2%, against a 1pp drop to 12-13% for large companies. We further calculate that when assuming a not uncommon 6x net debt to Ebitda ratio, this could leave insufficient funds for debt service.
- **As a result, we expect insolvencies in the construction sector across Europe to increase by 15-24% in 2020, with Spain and France representing the high end of the range and the UK at the low end.** Because of its structural issues, construction already accounts for 20% of all insolvencies. Covid-19 is exacerbating the underlying vulnerabilities of SMEs, reinforcing their fragility, though large companies are not immune. We expect insolvencies to increase by +24% in Spain, +19% in France and the Netherlands and +15% in Italy and the UK.
- **How will construction come out of the crisis?** The most common coping strategies, such as liquidity preservation through dividend cuts and large scale debt issuance as executed by a number of large companies, are not available to SMEs. The same holds for aggressive cost reduction. Rather, SMEs who are often subcontractors to large companies might be at the receiving end of cost reductions by large companies and face additional margin pressure. Self-help for SMEs is largely limited to accessing government schemes, such as furlough and loan support, which according to our estimate is largely tapped. This will create additional cash flow pressure in the future from higher cost of debt.
- **In the world post-Covid-19, SMEs could be left out of opportunities.** We look at the support policies in Germany, Italy, France, Spain and the UK and find that though they may lend some help, they will not fully protect SMEs in the construction sector, even where they comprise the greening of housing-related support. Policy stimulus such as public works, health infrastructure and large-scale climate change projects, and market opportunity will favour large projects and infrastructure, the domain of large companies. We expect those parts of the sector most exposed to energy and infrastructure to outperform in 2020 and 2021, which should compensate for structurally lower office and retail construction demand as far as large companies are concerned. Conversely, traditional areas of SME activity within construction may require substantial stimulus and become less profitable because of costs related to sanitary constraints, or get taken over by larger developers if demand structurally moves towards peripheral new build development. This could occur as we foresee much greater uptake of remote working, and resulting changes in housing preferences.

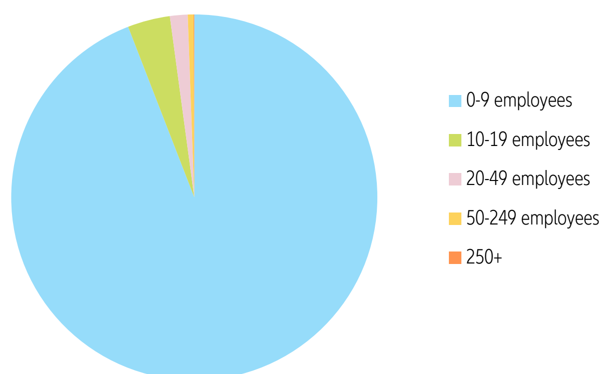
COVID-19 IS SPARKING A MAJOR PROFITABILITY CRISIS FOR SMES IN CONSTRUCTION

Before Covid-19, construction was coming off a cyclical peak but still in expansionary mode, with the largest companies presenting a solid financial outlook. But as a sector dependent on physical activity, construction has seen significant business interruption from the Covid-19 pandemic, despite being classed as essential activity in many countries. We expect Covid-19 to reinforce the already opposing dynamics between large and small companies in the sector.

SMEs represent the lion's share of companies in the construction sector, with about 80% of turnover in Europe. Companies with less than 250 employees make up 99% of the total, while the smallest companies, those with less than 49 employees, account for 98% (See Figure 1 and 2).

This structure is especially pronounced in Italy, where 99% of the construction sector is made up of companies with less than 20 employees. The Netherlands and Poland follow with 98% each, while in Spain and Germany SMEs represent 85% and 75% of turnover, respectively (See Figure 3). European SMEs tend to be concentrated in residential/commercial construction and project development, while in civil engineering, i.e. larger infrastructure, the share of large companies is much higher at 45%.

Figure 1: Share of SMEs in the European construction sector (number of companies)

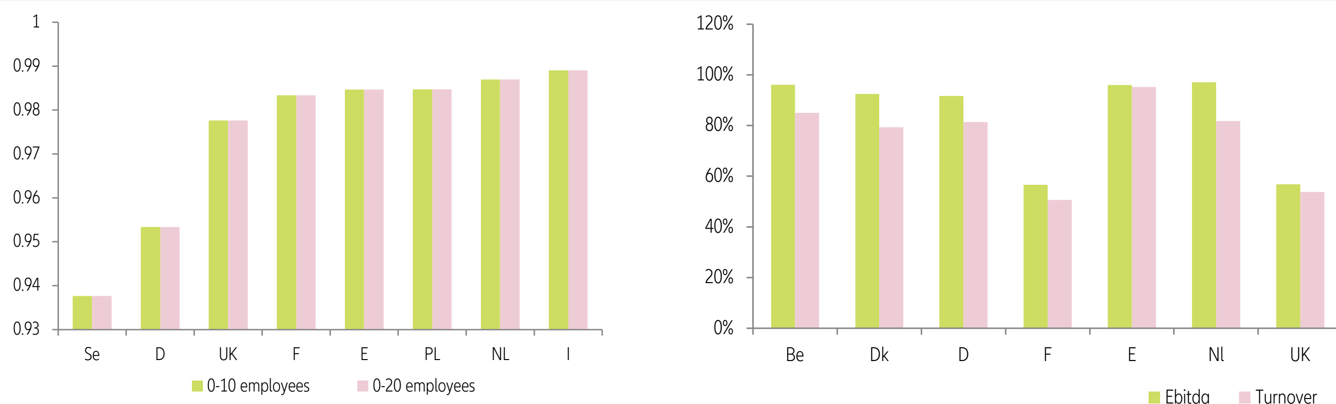


Sources: Eurostat, Euler Hermes, Allianz Research

Figure 2: Importance of SMEs in the European construction sector

Sources: Eurostat, Euler Hermes, Allianz Research

Figure 3: Weight of SMEs by type of company and country - construction of buildings



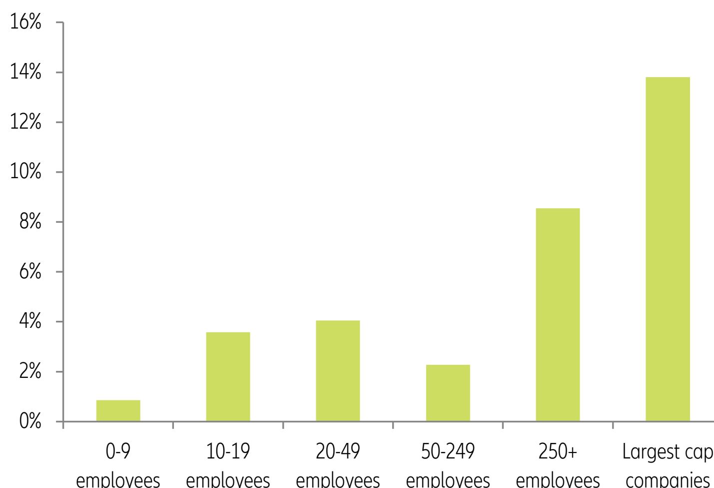
Sources: Eurostat, Euler Hermes, Allianz Research

SMEs are structurally less profitable than their large counterparts, as evidenced by Ebitda margins ranging from below 1% to 4%, depending on company size, compared to 10-14% for large companies. The reasons for the profitability differential are plentiful but most importantly we can attribute it to lack of negotiating power, project size and scale. SMEs often operate as subcontractors to larger companies, thus the bulk of profits is captured by the latter. We note that at the extreme ends, German SMEs are materially more profitable than French ones with an av erage Ebitda margin that is 800bps higher. We attribute this to the lower cost of labor from access to a cheaper domestic as well as foreign workforce, French SMEs being much less profitable in civil engineering (a very logical consequence of the prevalence of very large companies reaping most of the benefit of public contracts), Germans being more active in profitable project development and, to a minor degree, lower raw material prices.

In our central scenario, we expect the two months of lockdown to be followed a U-shaped recovery, with a return to 85% of normal activity levels thereafter. As a result, construction revenues are likely to decline by 25% in Europe in 2020. Given that the largest companies are likely to see revenue declines in the order of 5-10% (source: Company announcements, Factset consensus), we must conclude the impact for SME's will be materially worse.

SMEs are likely to see greater margin compression than large companies. We compare margins of a sample of large companies to those of the Eurostat universe of SMEs. In 2020, large company Ebitda margins are likely to decline by 40-100bps on the above revenue expectations (source: Company guidances, consensus). On the basis of historic margin compression in times of revenue decline, namely 2009, we expect SMEs could see a 200bps margin compression, twice the rate of large companies. This could eliminate almost 50% of an average small company's Ebitda. The table below shows that when assuming an average SME Ebitda margin and debt levels in the order of 6x Ebitda, which is not uncommon, this leaves insufficient funds for debt service.

Figure 4: Weight of SMEs by type of company and country - construction of buildings



Sources: Eurostat, Bloomberg, Euler Hermes, Allianz Research

Figure 3: Impact of 200bps margin compression on debt service capacity for a template construction SME

	Pre-crisis	Crisis impact low	Crisis impact high
Revenues	100	80	75
Ebitda margin	4%	3%	2%
Ebitda	4	2.4	1.5
Depreciation	1.6	1.6	1.6
Ebit	2.4	0.8	-0.1
Interest expenses	0.6	0.6	0.6
Net debt/Ebitda	6	6	6
Debt/total assets	75%	75%	75%
Interest cost	2.5%	2.5%	2.5%
Debt service	1.6	1.6	1.6
Working capital requirement	1.5	1.44	1.35
Operating cash flow	2.5	0.96	0.15
Cash interest cover	4.2	1.6	0.25
Cash available for debt service	1.9	0.36	-0.45

Sources: Eurostat, Bloomberg, Euler Hermes, Allianz Research

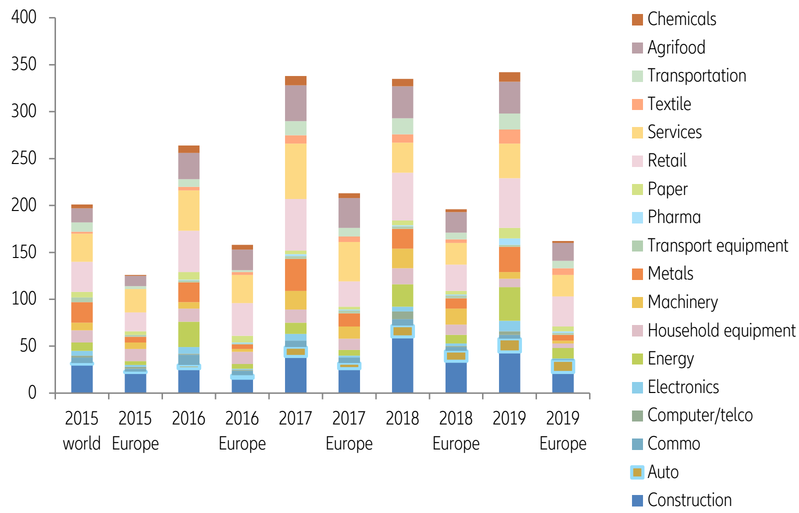
Insolvencies to increase across Europe by 15-24%

Construction is one of the most exposed sectors when it comes to insolvencies. It has on average represented 20% of insolvencies across all sectors in the major European countries, the highest share in a number of countries, followed by retail, hospitality and support services, which are similarly fragmented sectors.

In our risk rating framework, construction has the highest share of high risk ratings (See Figure 9), reflecting high levels of risk with regard to payment behaviour and insolvencies. In Spain, construction is rated high risk, with the subcomponents demand and liquidity rated weak and distressed, respectively. Italy is rated sensitive, with all subcomponents rated as minor threats. The Netherlands has a sensitive rating, with liquidity rated weak and sensitive, and in the UK profitability and liquidity are rated weak. All these subcomponents highlight sensitivity to orders and economic activity.

Factoring the impact of the Covid-19 crisis, we estimate insolvencies in 2020 by country on the basis of our judgement on companies' ability to survive as a function of size. Because of the dynamics of lower profitability, subcontracting and resilience, we assume the highest share of casualties will be amongst the smallest companies. With this approach, we estimate that insolvencies could increase by +24% in Spain, +19% in France and the Netherlands, and +15% in Italy and the UK in 2020. We estimate this on the basis of our judgement for each country on which percentage of companies within each size cluster is most likely to survive.

Figure 6: Major insolvencies by sector



Sources: Euler Hermes, Allianz Research

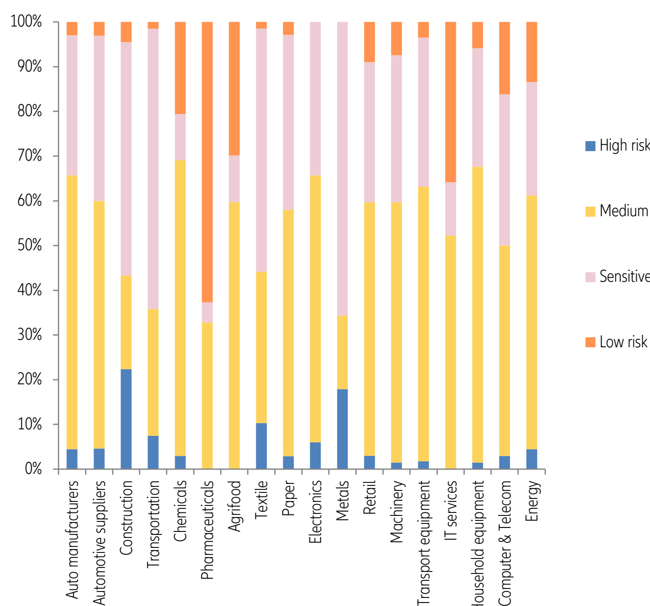
Figure 7: Number (lhs) and share of insolvencies major European countries: France (left), Germany (right)

Sources: Euler Hermes, Allianz Research

Figure 8: Number (lhs) and share of insolvencies major European countries: Italy (left), UK (right)

Sources: Euler Hermes, Allianz Research

Figure 9: Construction within the context of EH global sector ratings



Sources: Euler Hermes, Allianz Research

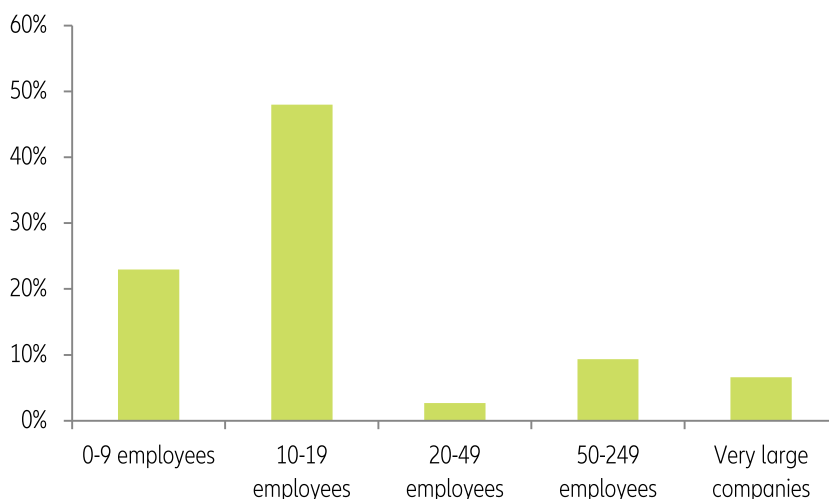
HOW WILL CONSTRUCTION EMERGE FROM THE CRISIS?

Emerging from the crisis will also be more complicated for smaller companies than for large ones considering the specific and prevailing issue of labor. Labor intensity measured as employees/revenues, is significantly higher for SMEs: The average 250+ employee company generates almost 60% higher revenues per employee than the average 0-50 employee company. Consequently, new additional labor-related costs stemming from the Covid-19 crisis are particularly onerous. The incremental cost of Personal protective equipment (PPE) alone could amount to almost 50% of Ebitda for the average smallest companies (source: Eurostat, Euler Hermes).

Large companies have adopted a range of coping strategies that is helping them absorb the impact. First and foremost, these comprise action to preserve liquidity in the form of large-scale debt issuance and cutbacks to dividends. This is significant: New debt issuance accounts for as much as 20% of last reported balance sheet debt in some cases, and dividends absorb between 12% and 37% of cash flows for some of our large sample companies. Small companies have not had the same access to debt markets, even more so as low-grade issuance ground to a halt, and in many cases, they do not pay dividends, i.e. they do not have this lever.

Furlough schemes and government loan guarantees are, however, equally accessible and being used by all companies. On average, the construction sector has furloughed 75-80% of workforces in the UK, while 37% of companies have made use of the scheme in Germany and 95% in France. Note, however, that access to loan schemes will mean greater pressure on cash flows as a result of higher debt levels in the future. Cost cuts and capex reductions are possible avenues, but again bear much greater leverage at large companies. The fact that many SMEs operate as subcontractors to large companies reinforces the dynamic. Large companies may cut subcontractors and exercise significant pressure on tender prices, which can result in lower levels of activity and margins for SMEs. Lastly, in view of generally lower capacity utilisation, large companies are likely to more aggressively pursue smaller projects that otherwise would have been left to smaller companies.

Figure 10: Covid-19 induced incremental PPE cost as % of Ebitda by company size



Sources: Eurostat, Euler Hermes, Allianz Research

Figure 11: Overview of Covid-19 crisis coping strategies

	Strategies:					
Examples:	Shift to online	Debt issuance	Dividend cut	Cost/capex cut	Furlough	Gvt support schemes
Company 1	Point of sales online	Eur 2.5bn	suspended	"significant" cost cut; Eur 500m y/y capex cut	yes	ECB PEPP
Company 2	--	Eur 3.5bn	suspended	--	--	--
Company 3	--	Eur 4bn	--	reduce opex, defer investments	--	--
Company 4	--	--	halved	--	initial 3 months for all bar essential	--
Company 5	Online marketing, reservations	--	interim cancelled	suspend land acquisitions; postpone all non-essential capex	85%	confirmed availability
Availability to SMEs:	☑	☑	--	☑☑	☑☑☑☑	☑☑☑☑

Sources: Eurostat, Euler Hermes, Allianz Research

Photo by Ashkan Forouzani on Unsplash

IN A WORLD POST COVID-19, SMES COULD BE LEFT OUT OF OPPORTUNITIES

Despite the crisis, there will be opportunity and beyond that, the sector will likely see structural change. A current average P/E market multiple declining to just 10x 2021e from 26x 2020e (source: Factset, Euler Hermes) implies significant earnings recovery. Current consensus implying average Ebitda growth of 24% for our sample of large companies confirms this. We interpret this as large companies being able to benefit from solid book-to-bill ratios, which currently stand at around 1x, but more importantly, their ability to capture growth from infrastructure. While this means that that large companies may overshoot the economy, below we outline why we do not see the same ability to capture opportunity for SMEs.

- Residential – Besides enabling larger commuting distances, an increased uptake of remote working might lead to demand for houses with larger square footage. As peripheral and remote locations offer greater space and affordability, this could cause demand to shift away from city centres, leading to softening house prices in the latter. As city centres are typically characterised by renovation as opposed to new build activity, this segment could take a dent, though there may be a positive resulting outlook for new build activity outside of metropolitan centres. There may also be positive impact on infrastructure construction demand. SMEs might benefit from non-city centre peripheral activity, but they will also be hit by the dip in renovation. If such a trend became very pronounced, we could see large developers reaping most of the benefit of new build activity. Large companies would also be the prime beneficiaries of infrastructure build.

- Office – The increase in remote working could be reinforced by ESG considerations, notably reducing the usage of transport, as well as the real estate carbon footprint through less office space and well-being concerns. Of all structural trends, reduced office demand might turn out to be the strongest one. This would mostly affect large companies. In some cases, there could be reconversion to living space, but again, large developers would be best placed to benefit.
- Commercial/retail – The crisis has potential to further accelerate e-commerce penetration. This would affect small shop space but also shopping centres through likely rising vacancy rates. Shopping centres may see reduced foot fall as a result of regulation for some time. This could all lead to much reduced new build but also reduced retrofit activity. The scope for reconversion to living space is limited.
- Hospitality – While the hotel and hospitality sector is hit hard, it will ultimately see a rebound in activity. There may be a minor impact in terms of structural reduction in travel, also as a result of climate change concerns.
- Infrastructure and public works – Infrastructure is arguably a sector that will benefit, first and foremost through public stimulus programmes but also through longer term structural trends. This has been visible throughout the crisis, for example through companies seeing sustained demand in energy infrastructure. This segment will continue to see buoyant activity and the next level of climate policies will support that. Greening the economy will move to scale, favouring large projects. Furthermore, there is scope for increased public demand in the health sector as governments look to future proof against pandemics. Transport infrastructure demand could originate from the above mentioned office and housing trends. All of these are the domains of the largest operators in the sector. SMEs might receive subcontracted work but will not achieve the same profitability.

We have considered support policies for the major countries in Europe in order to see if this could materially alter the outlook. Our view is that while such policies may lend some help, they will not fully protect SMEs in the construction sector. Some countries are looking to speed up public tender processes in order to hand out public contracts. A number of countries have published green and energy policies that are helpful for the construction sector, and most have put lending support schemes in place. Germany stands out positively, while support is scarcest in France and the UK, as shown below. In the case of Germany, it is particularly because of the federal investment aid for states as the most important potential lever for spending.

- In Germany, measures are very broad-based, and targeted towards consumption as opposed to construction specific. We rationalize this with the sector showing strength going into the crisis. The VAT reductions are illustrative. Rates will revert to normal at the end of 2020, which according to some industry participants leads to additional cost of bureaucracy. the acceleration, easing and advancing of public tenders should be positive for the sector, albeit depending on execution. This concerns mainly federal tenders and should therefore mostly benefit larger companies. State and communal projects are more impactful for SMEs. Those could come forward through the broad EUR5.9bn federal support to states for investment spend, which we see at the core of the program. Capping social security contributions at 40% will also have a positive bearing for SMEs. There are also positive energy related measures: Over the near term these are principally made up of the removal of the solar build cap and support for energy efficiency related renovation measures through a EUR 1bn 2020/2021 increase in the CO2 building renovation program to EUR2.5bn. There is furthermore an unspecified increase in support for energy performance enhancement for communal buildings. All of these should bear immediate positive impact. An increase to the 2030 offshore wind build out target by 5GW is very long term and much depends on a number of other issues, such as planning, support schemes, power prices and electricity system constraints. We see an impact from the mid 2020s at best. All in all, the package is positive, but unlikely to alter the outlook very materially for 2020.

- Italy has also put in place support for energy transition-related construction: Increase of tax relief for energy optimization retrofits such as isolation, heating and water systems change. Alongside, there is an increased bonus for seismic protection reinforcement. The tax relief amounts to 110% of costs incurred, which we see as a strong incentive. This should benefit residential and the SME sector even if, on average, this type of work represents comparatively small projects.

- In France, companies across all sectors have access to public loan guaranties (PGE), which have seen a very wide uptake. This helps with liquidity bridging but will also bring about greater financial strain in later years as a result of higher debt. The "solidarity fund", which compensates very small businesses for revenue loss, is a silver lining but won't change the overall picture given eligibility and caps. The same holds for the postponement of social security and tax payments as it is on a case-by-case grant basis. The overall stimulus plan focuses on sectors likely seen as more strategic, i.e. automotive and airlines. France's already low carbon footprint resulting from the prevalence of nuclear power is a likely explanation.

- The UK already had a sizeable program in place since 2019. It announced a cross-cutting GBP 330bn loan guarantee scheme in the last budget in March. Because it is a small business and large company scheme, there is a risk that some companies may not be captured at all. VAT payment deferral until June helped with liquidity but is not a stimulus measure.

- While Spain is supporting companies across sectors through the government loan scheme ICO, this is reserved for medium and large companies. At the same time, government bidding activity is down 50% as of Q2 2020.

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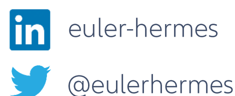
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