Global Construction: Substantial Geographic Differences, High Sensitivity to Economic conditions, Permanent Credit Risk

coface

Contents

The global construction sector is a kaleidoscope of diversity

The global construction sector is a kaleidoscope of diversity with substantial differences between countries and even between the regions of a given country. The sensitivity to changes in economic conditions also varies widely. In general, payment incidents involving actors in the sector are not uncommon. This survey is intended to enable international trade actors to gain an awareness of the risks and opportunities that characterise this market.

Major differences between advanced and emerging countries

The generally moderate or stagnant activity of advanced markets fundamentally distinguishes them from emerging markets where activity is on the contrary often robust. Although advanced countries have been battered by the global economic and financial crisis, some of them still constitute good market outlets in the wake of catastrophes (Japan or New Zealand) or thanks to exploitation of raw materials (Canada, United States or Australia. Emerging countries meanwhile suffered few or no ill effects from the crisis.

Sensitivity to economic conditions differing greatly depending on the sub-sector

Public works are less sensitive to economic conditions despite the trend towards fiscal austerity gaining ground in advanced countries. Business activity has been particularly strong in emerging regions with catching-up necessary in infrastructure development or to facilitate exploitation of raw materials.

Conversely, private non-residential construction (offices, factories, commercial premises, hotels; and leisure areas) is very sensitive to economic conditions. Institutional construction (schools, hospitals, prisons, and the like) is on its part largely subject to fiscal policy. In these two subsectors, the business trend in emerging regions has been relatively stronger than in advanced regions due to the catching up needed in development.

Residential construction characterised by particularly large geographic disparities

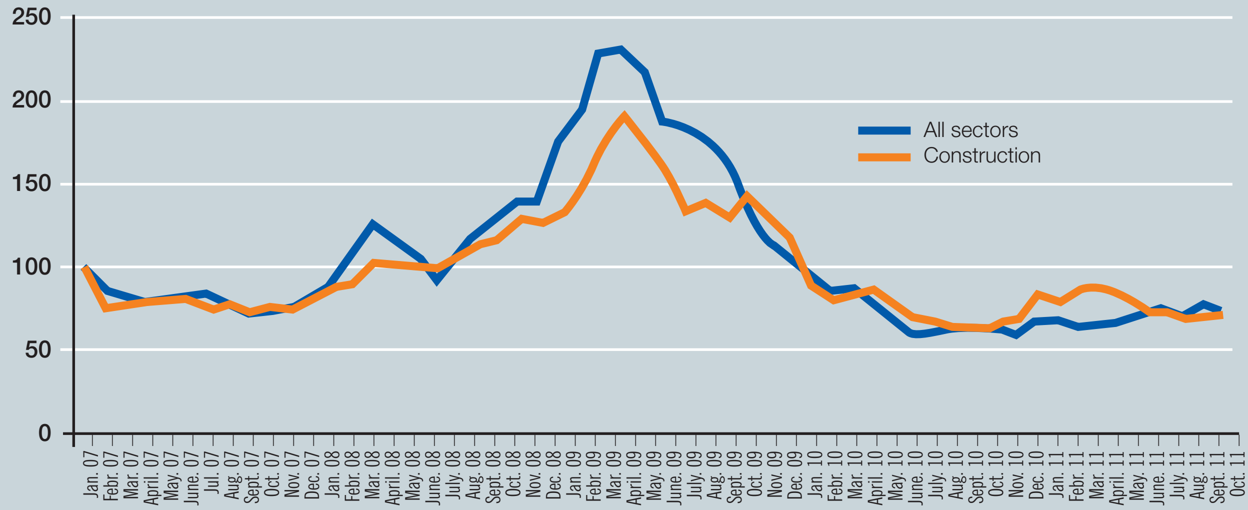
Although this segment has generally enjoyed good growth in emerging countries, its performance has tended to vary widely from one developed country to the next and, in the largest among them, even between regions. The disparities are attributable to differences in demographics, economic environment (employment, incomes), lending practices, taxation, vacant housing stocks, and prices (not only in new homes but also in existing housing, which represents the majority of the market). The psychological significance of housing, the choice between buying and renting also come into play. Among advanced countries, the construction markets in Ireland, Iceland, Spain, Portugal, Denmark, the Netherlands, Greece, Central European nations, and the United States were thus the scene of great excesses in pricing and supply. Severely battered by the crisis, they will need several years to stabilise. Prices continue to fall with no end in sight amid considerable stocks of vacant housing. But at this juncture some markets in Europe have only been moderately affected by the crisis: France, United Kingdom, Belgium, and Italy. Despite skyrocketing prices, supply shortages have moderated crisis effects. Nonetheless, economic uncertainties, tightening credit conditions, stagnating incomes, and tight fiscal conditions have begun to affect these markets. And a third group of countries comprises markets where the global crisis has had only a limited impact and which have been holding well thanks mainly to the better economic conditions they enjoy. That has been the case for Australia, Canada, and a few European countries (Germany, Austria, Switzerland, Norway, Sweden, Finland, and Poland).

Relatively large payment incidents

Even outside periods of economic crisis, payment incidents are not rare occurrences in this sector. Companies are constantly faced with changes — sometimes sudden — in orders from the public sector, in the regulatory framework, the taxes applicable to the sector, the cost of materials and land, and demand from households and companies. Small-size actors — numerous in housing maintenance and renovation and generally lacking in geographic or sectorial diversification, have been the most exposed to fluctuations in local markets. Conversely, the major international players with diversified activities are generally solid enough to cope with the unexpected.

World payment-incident index

(100 = January 2007)



Source : Coface

Europe: very disparate, high-risk markets

Markets almost stabilised in 2011, ending a three-year decline

The European construction sector suffered three years of decline (2008-2009-2010) before almost stabilising in 2011. Its activity was down 17% as a result of the decline, falling back to its level of 1998. The downturn was even sharper (-20%) in both residential construction, a segment generating 29% of total sector business, and non-residential (25% of the sector). The number of new homes delivered fell 45% between 2007 and 2011. However, in the public works segment (46% of the sector) the decline was more moderate.

The near stabilisation achieved in the sector in 2011 reflects the net impact of a upturn in residential, particularly public housing and old-housing renovation, and a decline in non-residential and public works. The upturn in housing is the logical consequence of the volume of building permits issued through 2010. In non-residential construction, the private segment has been undermined by the economic uncertainties and the public segment by fiscal austerity measures. Public works have been in decline. The budget-cutting has had a negative effect despite the resilience of spending on transport infrastructure.

Very modest growth likely for the markets in 2012 subject, however, to the impact of austerity plans

In 2012, construction activity overall could finally begin to grow again albeit very moderately provided the upturn in housing remains on track. The construction of new housing will also remain substantially below its early 2008 peak. Non-residential and public works meanwhile are expected to decline again in a very uncertain economic context marked by the tight fiscal policies adopted in many countries. The construction of premises for commercial, industrial, and tertiary activities will remain affected by the economic uncertainties. Institutional construction, meanwhile, will be hobbled by strengthened fiscal austerity measures. Energy-related construction projects are on the contrary to benefit from the new energy policy adopted by Germany. The outlook will not be as bright, however, in the transport infrastructure segment. Renovation, not only in housing but also in commercial, industrial, and institutional non-residential premises, will continue to surge as a result of the tightening of security standards and the search for energy savings.

Growing geographic disparities

The repercussions of the global crisis accentuated the disparities in construction between the various European countries and even within national markets.
Three groups can be distinguished:

1. **A first group comprises European countries where construction has been affected to a degree reflecting the extent of past excesses. The shake-out and consolidation process will take time.**

Payment incident trend
The sector's many actors (builders, developers, finishing work specialists, material suppliers, and equipment suppliers) are involved in a large number of incidents.

In Spain, where the property bubble burst in summer 2007, sector activity fell back to the level prevailing in 2000. One-third of Spanish companies that fail are in construction. Home prices have dropped over 25%. This downward trend will likely continue for several years more with prices still high, stocks of vacant homes estimated at over one million units, and household confidence undermined by a national unemployment rate exceeding 20%. No improvement will thus be likely in this segment in 2012. That also applies to non-residential construction, which experienced an even more severe adjustment, and public works, which will continue to suffer from the effects of fiscal austerity.

In Portugal, residential construction has been in decline since 2004 with the global crisis only accentuating the trend. And the climate of austerity has been affecting demand for housing. With supply slow to adjust, prices have begun to fall. Public works have been affected by fiscal austerity.

In Ireland, sector activity will contract again in 2011, the fifth consecutive annual decline. This negative trend is attributable to the large number of vacant buildings, the steady decline of prices and incomes, the tightening of credit, and the weakness of the economy. The start of the slide in new housing starts dates back to 2006. And there is no end in sight even with prices already down by half. And the trend in commercial construction has also been negative. Public works and institutional construction have been held back by fiscal belt tightening. In 2012, business activity may finally stabilise thanks to improvement in the national economy.

In Denmark, the crisis has dragged down investment in construction, residential or not. Housing prices are already down 30% with the stock of vacancies still high. The entire sector is expected to stabilize in 2012. Sector actors remain weak.

In the Netherlands construction has been in decline since 2009. As a result of past excesses the housing segment has suffered most.

In Iceland, Greece, and many Central European countries (Romania, Bulgaria, Hungary, the Czech Republic, Slovenia, Slovakia), the construction sector is still mired in the crisis. And public works in the latter group of countries have suffered from the stagnation of subsidies at both the national and European levels. The excesses in commercial and tertiary construction have yet to be completely eliminated. But, considering the sector's capital spending backlog, a recovery could develop by 2012.

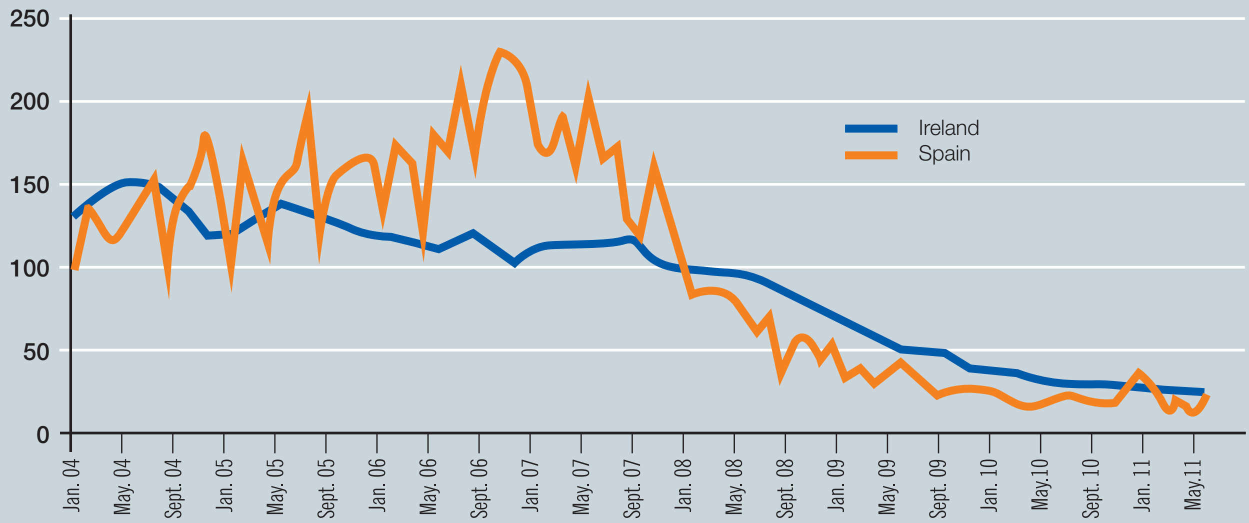
2. A second group comprises European countries where housing construction suffered relatively less from the crisis and in some cases even rebounded in 2010. A new downturn is either getting underway (or could develop) due especially to the persistence of excessively high prices in a context of weak growth.

Payment incidents have been relatively commonplace with sector companies weakened by the crisis

In the United Kingdom *, construction rebounded strongly in 2010 from the sharp decline suffered in 2008-2009. But business conditions deteriorated again in 2011. Construction has been the sector recording the most corporate bankruptcies, especially among small regional actors. The situation will be unlikely to improve in 2012. Demand from the public sector, which generated 40% of sector business has been squeezed by austerity measures. Orders associated with the Olympic Games are coming to an end. The credit crunch and wage stagnation have tended to discourage first-time home buyers. Especially with housing still apparently 30% overvalued relative to current rent and wage levels — a 10% decline in prices notwithstanding.

* *Please read also vantage point - Coface UK, page 15*

Spain : Housing starts
Ireland : Planning permission - new dwellings
(Base 100 = 2002)



source : DataStream

Construction in Europe

Regional disparities are, however, still large. The London area has fared substantially better than the rest of the country particularly compared to the northern region and Ulster. Demand has remained strong there, while supply in both the residential and non-residential segments has been choked off by the complexity of zoning rules and the limited availability of public land. This imbalance alone will likely suffice to stave off further deterioration in the property market. Various measures taken by the Conservative/Liberal Democratic coalition government intended to spur construction of public housing and the purchase of new homes by first-time buyers, and also to make public land more available, could even beef up activity.

In France *, the 2008/2009 downturn in new home building was short-lived and limited in scale with good demographics, insufficient supply in relation to demand, and moderate household debt all providing support for the market. But the upward spiral of prices, especially in Ile de France (Paris and surrounding suburbs), the reduction of tax breaks for rental property investment have tended to cool off buyers with stocks of new housing thus reaching eight months of sales by end June 2011. In case of a credit crunch, income stagnation, and increased unemployment, demand for new housing could fall and sector activity slump even more. And craftsmen
in the sector, very active in maintenance and renovation, could suffer from a possible decline in sales of second homes resulting from a stiffening of the tax on capital gains. A further increase in VAT (already hiked from 5.5 to 7%) would have a negative impact as would a reduction in tax incentives for sustainable development. Non-residential construction whether commercial, tertiary, or industrial, relatively more affected and still convalescent, could suffer from a new economic downturn that might cause companies to become radically more cautious. Public works are apt to be affected by possible austerity measures.

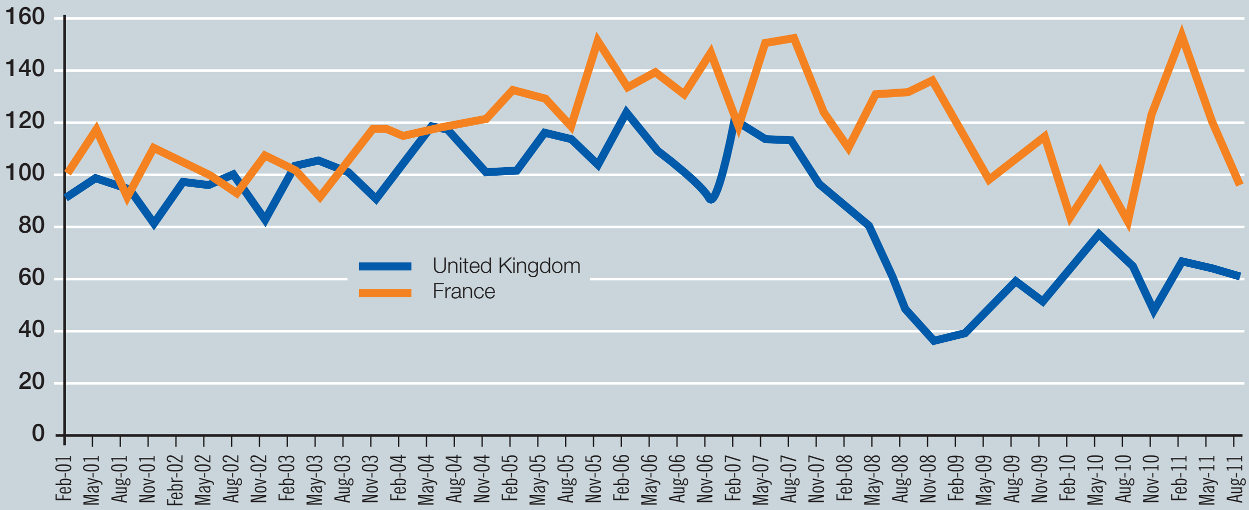
In Belgium, the downturn in 2008-2009 was also relatively limited in scale. Although the business activity rebounded quickly it has been in decline again since last spring.

In Italy, the business downturn was also limited. Households have moderate debt burdens. Housing needs are substantial with limited stocks. Conversely, prices have increased at a much slower pace than they did in France or Belgium, which tends to mitigate the risks of forming a speculative bubble and pushing the market into a downturn.

* *Please read also vantage point - Coface France, page 18*

France - United Kingdom : Housing starts

(Base 100 = 2002)



source : DataStream

3. The third and last group includes European countries where the construction sector was not affected by the crisis.

Payment incident trend

Here as elsewhere payment incidents have been proportionally more numerous than in many other sectors. Besides difficulties resulting from current economic conditions, sector companies are structurally weak. They are generally medium or small in size with operations in a single region. Few have diversified nation-wide or international operations in the residential, non-residential, and public works segments. Caution is still called for with a slowdown in construction activity already perceptible in most country markets, a trend that in some cases could even ultimately result in stagnation in 2012.

In Germany, construction recorded no excesses before the crisis with business activity and prices remaining stable. And since 2010, the sector has recorded a slight acceleration. Large cities like Frankfort, Munich, Hamburg, Düsseldorf, and Berlin constitute the most dynamic markets characterised by strong demand for rental premises for both housing and offices. Commercial property has benefited from the conversion of department stores and the development of shopping centres. A slowdown could develop late 2011, however, before stability returns in 2012.

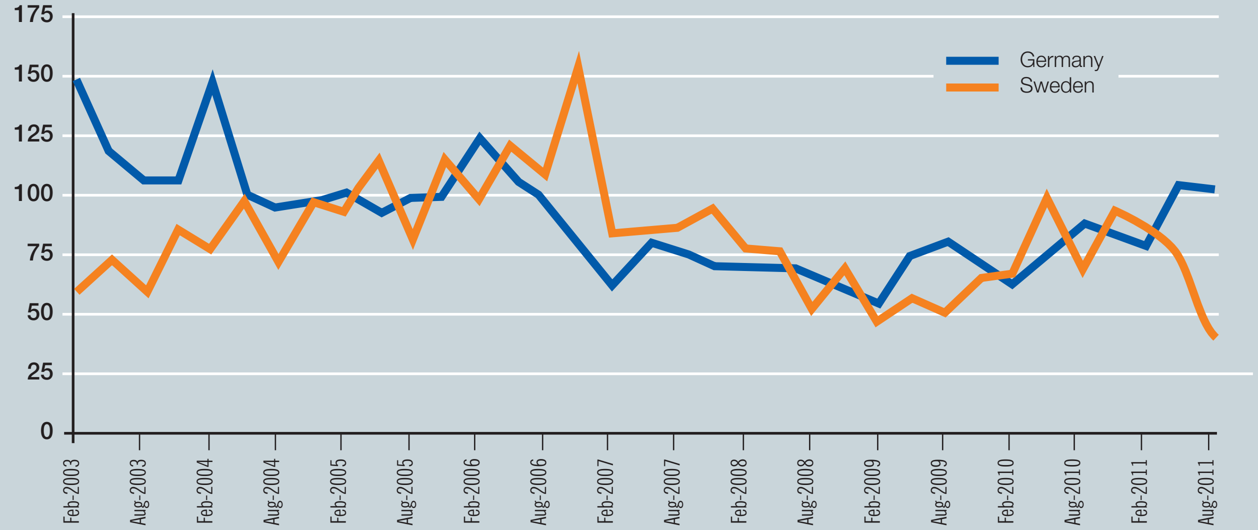
Although the housing and private non-residential segments (sales and office premises) could still grow slightly, institutional construction and public works will be affected by the fiscal austerity. A comparable situation exists in Austria.

In Norway, as in Switzerland, construction activity has been dynamic. The market is tight. In the housing segment, prices have been rising rapidly albeit in phase with incomes, a trend likely to continue.

In Sweden and Finland, the sector has also been growing, a perceptible slowdown notwithstanding. Home prices have increased sharply but remain aligned with incomes. Office construction is expected to remain strong in view of the relatively good local economic context. In northern Europe, modernisation of old buildings has been particularly dynamic.

In Poland, sector activity was only briefly affected in 2009. The need for modern buildings is considerable. Although many property loans were contracted in Swiss francs and franc's counterparty in zloty have increased twofold since 2008, the number of payment incidents and thus homes repossessed has been limited. The commercial and tertiary property segments have also been trending up even if temporary supply excesses coupled with brief downturns in activity remain possible. Meanwhile, the pace of road and rail remediation projects has remained excellent.

Germany : Building permits - new buildings
Sweden : Residential building starts
(Base 100 = 2005)



source : DataStream

North America: marked differences between the United States and Canada and even between regions within each of the two countries

United States: a gloomy situation

Investment in construction declined again, down 2% in the first eleven months of 2011. The decline was greater (down 4%) in the non residential building segment (35% of the sector) than in residential building and public works (30 and 35% of the sector), respectively stable and down 2%. New home construction has been in decline since 2006.

Payment incident trend

The sector companies most involved in housing construction remain in a shaky position. Builders have suffered all the more to the extent that they had to cut sales prices with their costs continuing to rise. Companies operating in the do-it-yourself segment have been the least affected due to the relatively good performance in the renovation segment and home-improvement projects undertaken by owners.

New home sales are now far below what they were during any down cycle since 1945 with deliveries 40% below the historic average. Demand for new homes has been decimated by the considerable stock of existing houses for sale. While the number of new homes on the market has fallen from 550,000 to 160,000 since 2008 (historic average: 300,000), the volume of existing housing units up for sale remains high (3.3 million compared to the normal 2 million), inflated by the still rising volume of repossessions and forced sales attributable not only to a still sombre employment picture but also to the high proportion of households — one in four — with mortgage loans to pay off that still owe more than the value of the underlying asset.
A vicious circle exists between the decline in prices for existing housing, sales of repossessed homes, and the massive stock of vacancies. End June 2011, 13% of property loans were affected by payment delays exceeding 30 days and among those in distress one-third had already resulted in repossession. At that juncture, a third of existing houses sales was court-ordered.

Substantial disparities between regions

The sombre overall economic picture is nuanced by great regional disparities. The situation remains delicate in Florida, Arizona, Nevada, Idaho, Utah, California, Georgia, and States in the Great Lakes area, which had been affected by the most extreme excesses and/or suffered greatly from the global crisis.
But some sub-markets in these states have already become stable again with coastal Orange County, San Francisco, and Silicon Valley in California and with Florida's Miami benefiting from purchases by foreigners or strong recovery in the technology industry. Suspended programmes have resumed. The urban areas that host the automotive industry will benefit from the brighter outlook in the sector. The property crisis has had little effect on the Midwest, Texas, or the Northeast. Here again, some sub-markets like Boston, Washington, Raleigh, Nashville, and Dallas have already recovered their dynamism.

New construction has hit bottom

Although the market is still in difficulty overall, new construction seems to have bottomed out. And while prices continue to decline for assets that are the subject of forced sales, they have levelled off for new construction. The annual formation of 750,000 new families (for which the accession to property has become more difficult due to a more limited access to credit and the mood of great caution engendered by a dispiriting job market) tends to spur the rise of rental prices and demand for multi-family housing (investment in this segment up 17% in the first eleven months of 2011). Although construction of single family homes was down 3% in the first eleven months of 2011, it levelled off in the closing months of the period. The decline in prices for existing housing (down 35% on average so far but plummeting 60% in Las Vegas since the 2005 peak) has facilitated access for prospective buyers and improved profitability for investors. Pension funds, universities, and investment companies are now interested in single family homes even if they require more delicate management than mass housing.

Construction in North America

The sustained decline in prices and the fact that loans granted since 2009 are of much higher quality will likely help reduce the number of foreclosures and thus the stock of vacant housing. But considering the size of the stock and the very low level of business activity in general, a return to normal will likely take several years. The time required would be shortened, however, if the Obama Administration follows through with measures under consideration to rent the innumerable assets repossessed (over half the total stock) but still unsold by the Federal Housing Administration and the para-public agencies Fannie Mae and Freddie Mac or else to facilitate access to low-cost refinancing for households.

Non-residential construction still struggling

Non-residential construction also continues to suffer. That has notably been the case in the institutional segment (school and government buildings, for example) affected by the financial difficulties of the States, counties, and towns. The consolidation of public sector finances expected in 2013 does not suffice to augur improvement ahead. In the office and sales area segments, excepted in the downtown areas in large metropolises like Washington and New York, there is still a large stock of vacant buildings. The sombre economic outlook tends to have a dissuasive effect on the launch of new construction programmes.ment de nouveaux programmes.

Disparate development trends in public works

In considering public works, it is useful to distinguish between transport infrastructure that depends on federal and local government (roads, bridges, ports, dikes, waterways, canals, airports) and infrastructure dependent on private initiative (gas-fired power plants, aeolian fields, electric power lines, hydrocarbon mains, most railway, and so on). Transport infrastructure is aging and thus requires major works projects financed in large part by federal funds. But the replenishment of these funds has not yet been approved by Congress. Private infrastructure spending, meanwhile, is supported by the development of hydrocarbon exploitation, the good financial health of rail freight, and the growth of electricity demand.

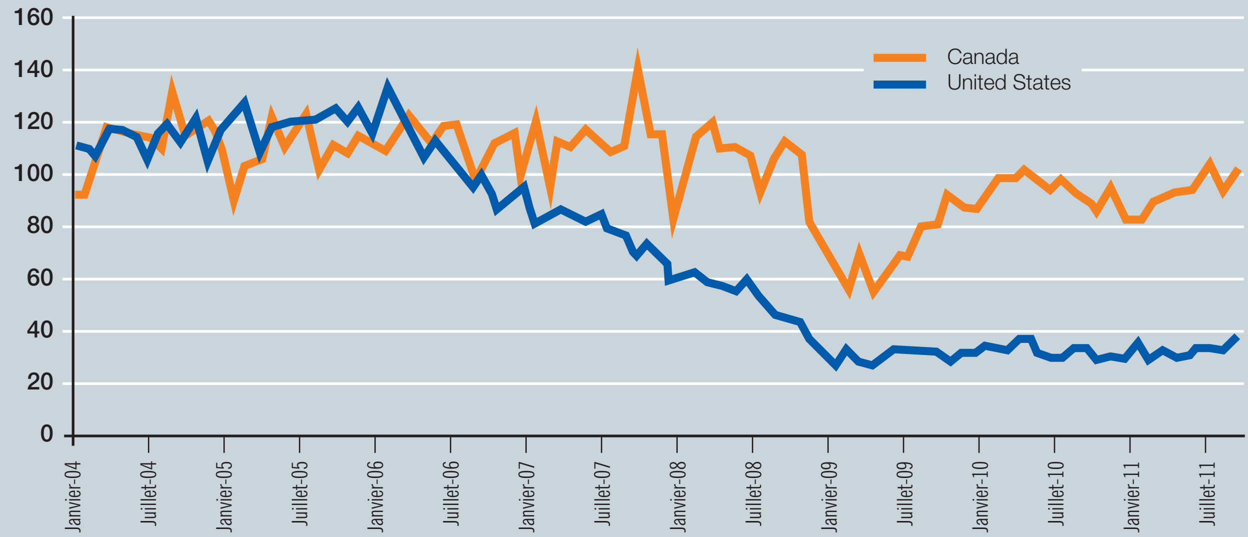
Canada: a possible decline in the sector in 2012

Unlike the United States, Canada's housing market only suffered a brief downturn late 2008 early 2009. A recovery got started by early 2010. Stocks are at normal levels (six months of sales) with prices trending up and payment incidents remaining uncommon. But the high level of household debt, tightening credit conditions, the rise of prices outstripping the growth of incomes, and the correction of excesses in Vancouver and Toronto are already accompanied by a marked slowdown in housing construction that will ultimately result in a decline in 2012. The sector will thus return to a level in phase with demographic development (180,000 new families per year due partly to the annual arrival of 300,000 new immigrants). Alberta (hydrocarbons), New Brunswick and Nova Scotia (naval construction) will prove more resilient than the other provinces.

Reasonable stock levels in conjunction with demographic pressure will likely check the downturn's severity.

Non-residential construction, whether commercial or tertiary, is expected to hardly suffer from the general economic slowdown with vacant premises in short supply. Public works will continue to benefit from the needs for infrastructure linked to raw material exploitation.

United States / Canada
Housing starts
(Base 100 = 2002)



source : DataStream

A better situation overall in Asia/Pacific than in Europe or in North America

The catastrophes in Japan and New Zealand will ultimately « benefit » their respective construction sectors

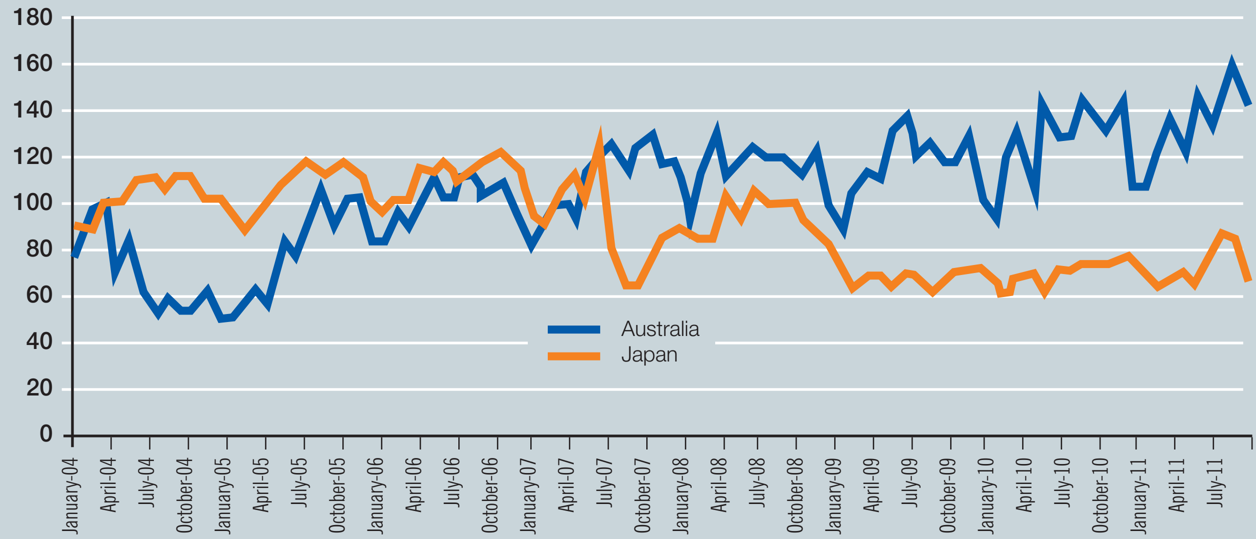
In Japan, a construction sector that has been lifeless for years will ultimately derive "benefit" from the massive destruction caused not only by the earthquake and tsunami but also by the contamination and subsequent evacuation of large swaths of land. Construction should thus rebound in 2012, a trend likely to continue in 2013 before a gradual slowdown begins to develop. Public construction (40% of sector investment) notably responsible for roads, bridges, ports, and airports, will be the main beneficiary thanks to extensive central and local government involvement in reconstruction efforts. Private residential construction (30% of sector investment) will benefit less but doubtless for a longer time. Private non-residential construction (18% of investment), affected less by the catastrophe, will continue the moderate recovery it initiated in 2009.

In New Zealand, the earthquake will ultimately benefit residential construction, which declined sharply in 2008 in the wake of an extended boom. Construction activity has remained weak, which has made it possible to partially correct for past excesses in terms of prices and household debt, a trend facilitated by the sharp decline in immigration recorded during the period. Construction needs in housing, but also in infrastructures, offices and commercial buildings, after the earthquake that struck Christchurch in February 2011 are immense. But reconstruction will not start as long as Christchurch remains hit by aftershocks. It could even be postponed if the authorities decided to abandon too instable locations and look for safer ones.

Australia: overheating cooled off by the global crisis but with the outlook remaining bright

In Australia, after a very strong surge in activity, the global crisis cut short the boom in non-residential construction. And a slight recovery has left the segment far below its prior level of activity. Economic uncertainties notably concerning raw material prices will not improve the situation in the short term. Housing construction also suffered from the global crisis late 2008/early 2009. But it rebounded quickly, spurred by the expiration looming end 2009 of subsidies to first home buyers, before

Australia : Building approvals - new houses
Japan : New housing construction started
(Base 100 = 2002)



source : DataStream

slipping into a decline early 2010 likely to persist until at least end 2011. Even the state of Victoria housing market, which came out of the crisis largely unscathed, has suffered a decline. After several boom years, fuelled notably by strong immigration and a housing shortage, a lull is not surprising. In the medium term, construction activity is expected to benefit from good demographics. Public works are expected meanwhile to benefit from the launch of several transport infrastructure projects (TGV, fibre optics) intended to remediate Australia's underdeveloped status in that regard. The pace of implementation will depend on the joint commitment of the federal government and the federated states. And the development of raw material exploitation will moreover require additional infrastructure (ports, railway).

In China: difficult policy balance between overheating in property and slowing GDP growth

Construction contributes about 18% to the formation of China's gross domestic product compared to 12% of global GDP. If steel, cement, other materials, appliances and furniture are added, the proportion is even higher (25%). Residential construction alone represents 12% of GDP. This segment has developed rapidly since the opening of housing to the private sector in 1998 and with the acceleration of the rural exodus. The subsequent strong growth of urban demand and the rapid rise of prices have spurred construction activity. But fear of formation of a speculative bubble coupled with the rise of discontent among a high and growing proportion of the population unable to finance a home prompted the authorities to take measures to cool off the market. In view of the sector's weight in the economy, however, that policy has had its ups and downs. But the measures have been stiffened since 2010 and have already been implemented in over 40 tight markets including Beijing, Shanghai, Shenzhen, Chongqing, Guangzhou, Nanjing, and Hangzhou. They are aimed particularly at speculators that often buy dwellings solely to hold them for investment purposes (capital gains) and not to rent them out. Granting loans for the purchase of a third home is now prohibited. To purchase a second home, rates were increased and downpayment in cash revised to 60%. Purchases by non-residents are restricted. On instructions from the authorities, bank loans to the sector (20% of the total outstanding) declined sharply in the second quarter 2011. Access to loans from "trusts" — instrument of corporate funds or private parties looking for investment opportunities — and to offshore bonds, used frequently by developers and largely picking up the slack for banks, will doubtless be restricted. And the effects of the measures taken are already palpable. Sales have declined — very sharply in Beijing and Shanghai — since 2010. The adjustment of prices has been slow to materialise due to the sector's oligopolistic character and the owners' reluctance to sell their properties in bad times.

The decline in sales and prices in conjunction with the growth of stocks and the rise of construction costs is expected to moderately reduce activity in the private residential segment. That will be partly offset by the start of a public-housing construction programme intended for low income households. The programme starts in 2011 with 10 million units planned for the first year and a total of 36 million by 2015. But its immediate impact will be limited for several reasons: It is small in size in relation to the market. The necessary land has to be given up by local governments that naturally give preference to private construction, which provides them with more fiscal revenues. And just 8% of the resulting housing units will be under the central governments direct control with the rest managed by local governments and public companies. And compounding these negative factors are concerns over the quality of the construction, which could delay its execution. The central government seems ready, however, to put pressure on local authorities and public companies to meet programme objectives.

Payment incident trend

The trends and developments discussed here could undermine the financial position of some sector companies especially since some of them are burdened by heavy debt. The degree of concentration of the sector is moreover very limited. Of the over 50,000 contractors operating in the country, the 20 largest represent just 13% of the market. Some could thus disappear.

The medium-term outlook remains bright, however, thanks to growing urbanisation, the lack of alternatives for investing available funds, and the rise of incomes. Furthermore, promising new markets have been opening in average-size cities and in western China. Activity in public works has been dynamic driven notably by the rapid development of transport and energy infrastructure. A slowdown is looming, however, in reaction to the quality of public works projects (cf. recent high-speed train accident and weaknesses in some dams). Sector activity could moreover be affected by the priority given by central government authorities to reducing the massive debt contracted by local government to finance a good many of the projects.

China's construction boom has resulted in the emergence of Chinese actors of international stature in specialities ranging from shell construction to building materials and heavy equipment. These newcomers are increasingly present in emerging regions, particularly Africa and the Near East.

Many emerging countries are in the same situation as China

Major residential construction programmes

There is a glaring shortage of affordable housing, in, for example, the Middle East (Saudi Arabia, Emirates, Israel, Egypt, etc.), Brazil, Indonesia, the Philippines, Turkey, South Africa, and the Maghreb, at least in major urban centers. Demand is generally kept high by strong demographic pressure, growing urbanisation, increasing number of households with younger people moving out of the parental home. The concomitant growth of the middle class looking for modern homes and the dilapidated state of some of the old properties also push up demand.
The shortage of supply, often linked to a lack of available land, is driving prices up sharply and excluding a large part of the population from the market. Private developers, who are very active, prefer to focus on high-end construction projects, for which there is a small but wealthy clientele.

In Saudi Arabia, 70% of homes built can be afforded by only 10% of households. Less than a third of houses are owner occupied. As in China, to try and address the lack of affordable housing for middle class and low-income families, the authorities have launched a social housing scheme to build 500 000 homes (it is estimated that two million such homes are needed). However, the shortage and high cost of land, coupled with inexperienced local contractors responsible for construction could increase costs and add to delays.

In Algeria too, there is a social or assisted housing scheme to build over two million homes by 2014. As in Saudi Arabia, the shortage of local skilled labour could add to delays even if foreign companies are used.

In Brazil, the "Minha casa, Minha Vida" social housing scheme, launched in March 2009 under the Programa de Aceleração do Crescimento (PAC), is a state-subsidised programme for building one million homes for middle class and low-income families by 2012 and an extra two million by 2014. However, the authorities' intention to increase the primary fiscal surplus in order to give themselves more room for manoeuvre and to rely less on monetary policy to counter inflation could reduce available subsidies and slow the pace of construction.

In South Africa, the post-apartheid boom in residential construction ended with the advent of the financial crisis but there was a brief surge in 2010 in anticipation of the World Cup, before declining again in 2011. Banks are reluctant to grant credit to households with debt above 70% of their available income. Social housing construction is well below the needs of the many lower income households. 2012 will not be any different.

Boom in non-residential construction

Private non-residential construction (offices, retail outlets, factories, warehouses, hotels, leisure facilities…) is also buoyant. Urbanisation and growing wealth, along with the resulting development of supermarkets and shopping centres, as well as the booming industrial, financial and tourism sectors provide incentives for investment. The exploitation of raw materials deposits and subsequent transformation create demand for construction.

In these countries: strong activity in infrastructure construction, particularly where this favours raw materials production

In Brazil, new building sites keep appearing in anticipation of the Football World Cup in 2012 and the Olympic Games in 2016. The construction of transport facilities, too, is intended to reduce the severe lack of the means for the exploitation, transport and despatch of raw materials.

In the Middle East, construction of roads, railways, trade ports or marinas, power plants, desalination plants is in full swing, driven by substantial oil revenues.

In many African countries, rich in natural and under-exploited resources, building sites and projects linked to energy and transport are not uncommon.

Nevertheless, one must stress that activity in South Africa is weak, after the completion of building work connected with the organisation of the Football World Cup in 2010. Despite the (Eskom/electricity, Transnet/rail freight, and Sanral/roads) have been slow to launch new projects. The public procurement procedure is time consuming.

Construction in other emerging countries

Public investment seems below requirement. African states are increasingly relying on the involvement of foreign companies, alone or as a private/public partnership.

Payment incident trend
Despite the dynamism of construction in the emerging regions, there is a risk of payment incidents, even if less significant than in the advanced economies.

Although demand is generally higher than supply and prices are on a long-term rising trend, temporary, but sudden and far-reaching imbalances occur. The speculation accompanying the soaring prices and the high returns can lead to spiralling supply and the development of high indebtedness among developers and construction firms. If demand cannot or will not follow, the balance is upset and the whole sector weakened. The private market, sometimes limited to a few large cities, offices and luxury homes, is so narrow that any fluctuations are amplified.

Huge influx of foreign and local capital

The massive influx of foreign or local capital, as in Brazil, Singapore, Hong Kong, Abu Dhabi or Dubai, can encourage too much risk to be taken in return for modest returns.

With many empty offices and homes, and to prevent a property bubble forming and then bursting, as in Dubai, the Abu Dhabi authorities have decided to slow or even postpone the construction of commercial or tourism complexes. The Abu Dhabi museums projects (Guggenheim Abu Dhabi museum…) will bear the brunt of the delays. Only infrastructure projects or schemes to modernise oil and gas installations will remain unscathed. However, this will only benefit specialist, generally international, companies.

In Marrakech, it is uncertainties over security as well as prices which have cooled the interest of European buyers and created difficulties for companies.

In Singapore and Hong Kong authorities have taken similar steps to those of China to cool their markets.

In the Baltic countries, the bubble and its bursting was caused by a classic case of a runaway economy and soaring credit.

In India, builders and developers, already contending with rising material costs, have had to face, since spring 2011, a net decline in demand for offices and homes. Personal mortgage rates have hit 16% with inflation at 8%. Interest from business clients has also been cooled by high prices and the cost of borrowing. To revive demand, market players are squeezing prices, which is reducing margins. At the same time, banks and other investors are turning away from a heavily indebted sector. While the big players are expected to weather the storm, smaller players are very vulnerable.

Company size: a key factor for withstanding the crisis

Aside from financial factors specific to each player, size is the key factor determining a company's ability to withstand market fluctuations. Generally, it enables diversification of operations, both geographic and sectorial. In large countries, this diversification can be regional. The strength of American, European, Japanese and Korean international construction companies, often responsible for engineering and the structural works on large contracts, comes from their sectorial and geographic diversification. The same applies to global suppliers of materials, structural components, electrical installations and building and construction equipment.

Just behind them are their newer counterparts based in China, India, Brazil, Turkey, Saudi Arabia or the Emirates, the markets of which are less diversified.

Risk is concentrated in finishing companies, builder's merchants, equipment leasing companies and even developers, which are smaller in size, especially if they are regional.

Dominique Fruchter,
Coface Country Risk
& Economic Research Department

For **Chris Coppin**, the main issue for the construction industry in the UK over the coming months is how long it will take for the private sector to compensate for the slackening of the public sector.

UK construction battered by austerity

➔ How has the UK construction industry been doing since the country moved out of recession?

➔ **Chris Coppin (CC) :** As the UK moved out of recession during the first half of 2010, Q2 and Q3 of that year evidenced a much improved recovery in the sector and effectively 'kick-started' the UK economy. However, while the usual year-end slow-down played its part, Q4 experienced a down-turn in business activity due principally to adverse weather across the UK but also the initial impact of the government's austerity measures. The traditional year-end cash drain on construction businesses was evident earlier in the Q4 cycle.

➔ How do you explain the strong impact of public sector spending?

➔ **CC :** Experts estimate that public sector spending on construction represents about 40% of the industry turnover. For an industry so heavily reliant on publicly funded work, the new coalition government's decision to drastically reduce spending as part of the drive to reduce UK debt, it was widely recognised that once these measures started to bite, the construction sector would suffer a period of deceleration.

➔ Did 2011 first half confirm the downturn for the sector?

➔ **CC :** Not totally. Moving into 2011, despite a traditional slow start to the year that was not helped by continued poor weather, construction activity in February and March was unexpectedly better than forecast. There are varied opinions for this although it was clear that rising costs of materials (like steel and aggregates) was a factor and there was evidence that businesses 'brought forward' to avoid rising prices.
Q2 has been more stagnant as more work was undertaken during Q1. This is illustrated by figures released by the Office for National Statistics stating that the sector has only grown by 0.5% compared with the previous quarter. Activity is traditionally far stronger in Q2.

➔ What do you expect for UK construction industry in 2011 second half and 2012?

➔ **CC :** Q3 2011 evidenced a further slow-down in activity and a steady flow of insolvencies at sub-contractor level resulted. Steel structures, coatings, claddings and frames fabricators in particular were badly affected. The slow-down is widely expected to have continued to run into Q4. The main question is how quickly private sector construction work will be able to pick up the slack left by the public sector. The government is committed to halving its construction spending, with more than £90bn of capital spending cut by 2014. The housing sector, a key driver for the sector as a whole, has continued to show fragile recovery with mortgage acceptances remaining low, particularly for the first-time buyer market. Private non residential market, the sector's third pillar, is expected to show some support given the relative dynamism expected in corporate investment.

➔ How are businesses coping with this unfavourable trend?

➔ **CC :** Early evidence of the difficulties the sector faced was the failure of two large publicly quoted businesses; Connaught Plc in August 2010 and ROK in November 2010. Both were similar business models being heavily reliant on public funded work to include social housing maintenance. Fortunately at the timing of these failures there was no notable increase in sub-contractor failures, although many businesses continue to face challenging conditions.

➔ Can we expect deterioration in the near future?

➔ **CC :** We don't yet know how the second half of 2011 ended, but reduced public spending is beginning to bite deeper. We expect this to impact further as Local Authorities deliver more expenditure cuts with the new financial year starting in 2012 Q2. A growing number of public contracts are being down-sized, delayed or simply cancelled. Following the completion of the Olympic Park, with the odd exception such as Crossrail, there is little by way of major publicly funded work on the horizon. As a result the market will be chasing lower volumes resulting in further pressure on margins throughout the chain and the inevitable cash squeeze. Problems with the availability of credit will continue. Add to this mix the fact that many construction businesses operate on a high cost base e.g. labour, plant and equipment, we can expect to see an increasing number of company's chasing low or no margin work purely to service their cost bases and resultant failures can be expected. A number of major UK groups including Travis Perkins (builder's merchants); Balfour Beatty (contractor); Severfield Rowen (structural steel) and Bellway (house-building) have all publicly commented of tough market conditions.

➔ Do you see some good points that could to some extent protect the businesses?

➔ **CC :** Yes. Despite the difficulties faced there will be more outsourcing opportunities as work e.g. public maintenance programs are taken-over by the private sector. Increasing refurbishment work to replace cancelled new build contracts will also provide opportunities. This is largely expected to be to the benefit of the major tier 1 contractors.

➔ Does it mean businesses are unequal in front of adversity?

➔ **CC :** Indeed. Construction sector activity is regionalised. It has been the very buoyant activity in the South East and London area which has, and continues, to underpin UK construction activity performance. While the majority of the major contractors have diverse business activities which are regionally, and in many cases internationally spread, we can still expect to see winners and losers.

➔ Logically, the most at risk should be medium and small businesses?

➔ **CC :** Yes. Smaller regional players based outside London and the South East are struggling to survive. Coface UK main concern remains at 2nd and 3rd tier contractor and sub-contractor levels. We anticipate a rising trend in failures as margins are eroded, cash flow pressures increase, finance becomes less available and major contractors moving into the smaller value contract chain as they look to keep cash flow liquid. We are already experiencing an increase in late payment notification traffic. A number of 2nd tier contractors are also highly leveraged which remains of concern. Medium / smaller businesses also face the winding-down of the Government's 'Time to Pay' scheme for taxes The risk assessment of these businesses is challenging as we frequently only have historic abbreviated accounts to base a decision.

➔ How does this concern translate into your risk underwriting approach?

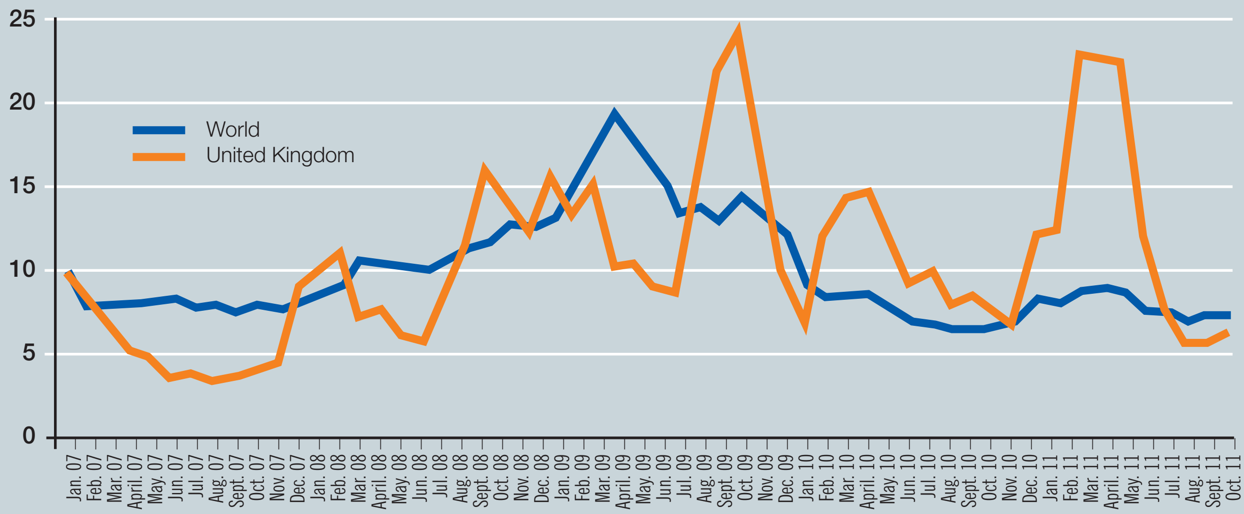
➔ **CC :** In such a challenging sector, we adopt a balanced view and take a measured approach in our risk underwriting attitude. For a number of the more sensitive buyer risks we will consider the relationship with our Insured as well as the one between the latter and its buyer. Since the last crisis, our risk assessment has certainly been more focused on cash flow, debt profile and the ability of a business to comfortably service its debt. The looming refinancing issues for a number of highly leveraged businesses during the next 12/18-months are subject to close monitoring.

➔ How do you view the situation in two years?

➔ **CC :** 2012 and 2013 are forecast to be challenging periods although we still have to differentiate between regions and subsectors. We expect London and the South East to outperform. Rail, utilities and energy are positives. Housing will be stable. Commercial, industrial and civil engineering will generally be negative.

Chris Coppin,
Risk Manager
Coface UK

Payment incidents index - Construction
(100 = January 2007)



source : Coface

For **Eric Joffin**, underwriter in charge of the construction sector for Coface France: « The decline in new home sales augurs a construction downturn in France in 2012 ».

Rather alarming figures

The French new home market has shown signs of weakness. The latest figures from the Federation of Property Developers are rather alarming with sales down another 16% in the third quarter 2011 compared to the same period a year earlier. This is consistent with the trend recorded in the second quarter (down 15.5%) but is not as severe as the 22% fall in the first three months of the year. The Union of French Homes similarly reported late October that sales of single family homes at end September were down 7% in the preceding twelve months.

For homes, the shortage of land and the problems with financing (stiffening terms of access to credit) have hurt sales. The "roadmap" for durable development in France, known as the Grenelle de l'environnement also makes it more difficult to obtain land for single-family homes. There is thus a shortage.

The drop in sales of flats is attributable to the reduction in the tax break available under the Scellier programme effective since 1 January 2011 (phased reduction in the tax break from 25% down to 13% of the price of the property asset intended to be rented out by end 2011). The sales decline will accelerate moreover as a result of the cancellation of the tax deduction applicable to capital gains on property and, end 2012, of the Scellier programme itself. Sales benefiting from the Scellier programme currently represent 52% of the total recorded by developers, down from 61% in 2010. And they fell 22% year-on-year in the third quarter 2011, a decline nonetheless less severe than the 32% drop suffered in the first half.

Although new housing starts were up 10% in the third quarter, that upward blip largely reflects sales from last year since there is on average a six to eight-month time lag between a sale and the start of construction. Monthly fluctuations notwithstanding, the sales trend is clearly downwards, auguring a decline in new housing starts from end 2011 through the 2012 first half. And unless sales recover soon, the downward trend will continue into the second half.

Deterioration in a context of a marked slowdown in prices and the rise of interest rates

Prices have been in a marked slowdown for several months. But their net rise in the preceding twelve months in conjunction with the rise in interest rates nonetheless led to the collapse of property purchasing power. The twenty-year average interest rate on property loans rose from 3.7% to 4.3% in the twelve-month period ending June 2011. How will interest rates behave in coming months? If the problems with sovereign debt remain unresolved, banks could tighten credit terms for private individuals. And property sector professionals are troubled. Buyers are approaching their solvency limits: for several months notaries have noticed that with rise of interest rates, banks have been increasingly reluctant to grant loans.

Public works squeezed by budget-cutting at the local community level

After three years of crisis and a 15% decline in activity in 2010, public works are expected to have grown again in 2011, up 2.5% forecast. But this good performance masks a highly varied mix of situations and consequences in the wake of the crisis that can only be evaluated now. All public works customers have not increased their orders. Analysis of the skeleton budgets of 73 départements (counties) attests to a decline in public works spending in 2011. Direct investment will decline 8.1% on average; subsidies will decline 1.7%, and maintenance spending 1.9%. These averages thus obscure marked disparities with a quarter of the counties, for example, approving a cut in direct investment exceeding 15%. Deprived of dynamic sources of revenue, local communities are forced to focus on their mandatory duties to be able to hold the line on spending.

Sector companies: vulnerability closely related to their size

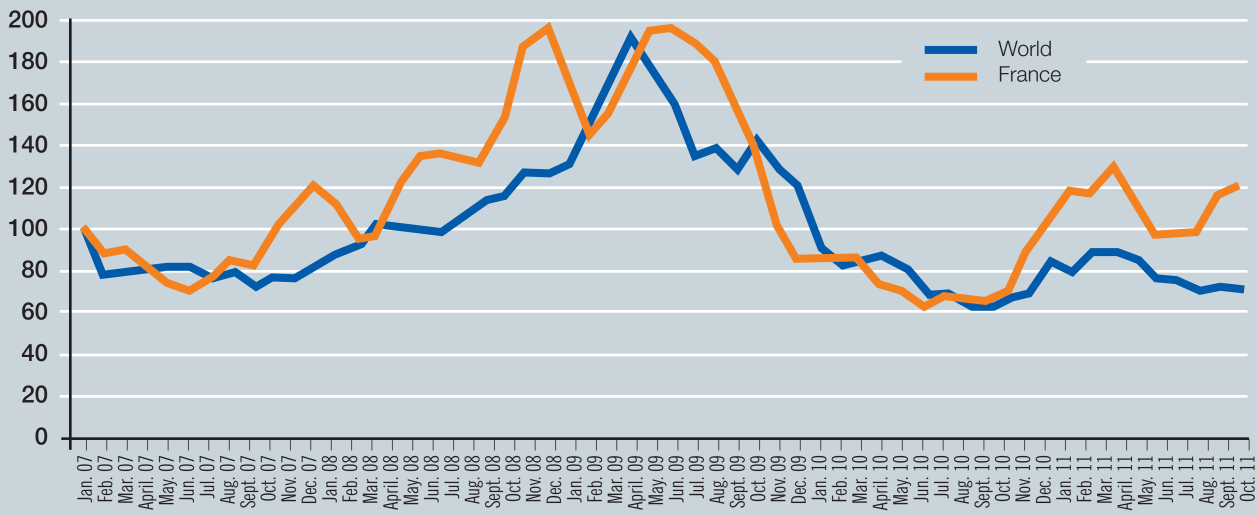
Under considerable pressure, sector companies are engaged in fierce competition to win new business by cutting their margins to the bone. They also have to cope with high prices for raw materials, especially oil whose derivatives figure among the ingredients of many PW materials, notably asphalt for roads. Sector companies could suffer the consequences of weakness they accumulated during the crisis years. According to the banks, contractors have experienced difficulties getting out their 2010 financial statements on time. The bankruptcy rate in the sector, meanwhile, remains far higher than it was before the onset of the crisis, albeit easing year-on-year in the 2011 first half.

Very small public works companies generally find it difficult to compete for public contracts. That handicap is now compounded by the drop in public tenders, reduction in the financial resources available to local communities, impact of weather conditions on public works schedules, withdrawal of the central government direct responsibility from project management. Small PW companies have suffered in consequence from a sharp deterioration in their cash positions and future prospects. These actors also have to meet competition from major PW players, which have been compensating for the scarcity of large projects not only by competing for smaller jobs but also by drastically cutting their prices.

Eric Joffin,
underwriter in charge
of the construction sector
Coface France

Payment incidents index - Construction

(100 = January 2007)



source : Coface

Coface

12, cours Michelet
La défense 10
92800 Puteaux
France

Postal address: 92 065 Paris-La Défense Cedex
Fax: 33 (0) 1 49 02 27 41
www.coface.com