Higher materials and energy prices, supply-chain disruption strain construction company margins

Scope Ratings

The construction industry has faced significant challenges in the last few years. Skyrocketing building materials prices driven by delivery bottlenecks and a scarcity of raw materials have squeezed the profit margins of most companies in the sector.

A further rise in energy prices as a consequence of Russia`s invasion of Ukraine has added fuel to an existing trend. The production of many construction materials such as steel, bitumen, and cement is energy-intensive and will suffer if energy prices remain high. Energy price increases will just push up building materials prices that were already at record highs before the pandemic.

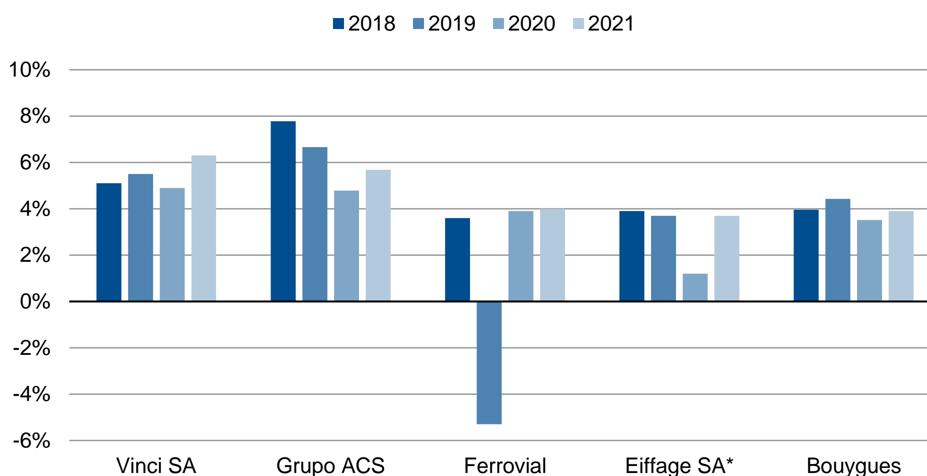
However, it is not just the shortage of construction materials, resulting in input cost inflation, that is pressuring margins in European construction markets. Other risks include a shortage of labour and supply-chain disruptions, which remain material for most companies and are straining margins.

The impact of higher energy prices on the construction sector is twofold. Beyond soaring building materials prices, Russia is an important producer of a number of key metals and this is exacerbating a shortage in building materials. See Ukraine crisis underpins metal price rally, 3 March 2022.

While all construction companies need to mitigate the potential effects of the energy price crisis, the extent varies across firms. Larger construction companies are in general more diversified across different segments and have stronger bargaining positions. Smaller companies could face more difficulties sourcing essential materials, endangering their ability to complete projects, weighing on their business and financial risk profile and ultimately impacting their credit quality.

The average profit margins of the construction activities of Europe's largest contractors stood at a modest 4% between 2018 and 2021. See Figure 1.

Figure 1: Top European contractors – reported EBITDA margin of construction activities



* Operating profit
Source: public information, Scope Ratings

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Higher materials and energy prices, supply-chain disruption strain construction company margins

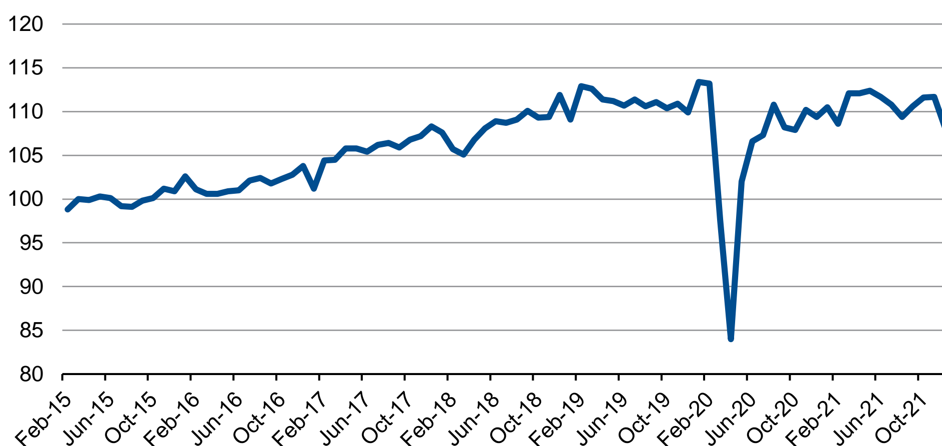
Large construction companies such as Vinci, Ferrovial and ACS[1] benefit from a diversified business profile, including civil engineering works, industrial construction and concessions. As profit margins in their core segment – construction – shrink, those companies have focused their strategies in expanding the concessions segment of their businesses, expecting to benefit from recurring income and higher margins through infrastructure management. For motorway concessions, average EBITDA margins are between 50% and 80%, for example.

Several reasons for building cost inflation

Construction output returned to pre-Covid levels by the second half of 2020

Construction was relatively resilient during the pandemic. After some strong negative impacts in the second quarter of 2020 as the first Covid lockdowns hit, construction output in Europe had already returned to pre-Covid levels by the second half of 2020. Rapid recovery also translated into continuous demand for building materials. This led to a global shortage of raw materials, stemming from demand for timber and steel. Strong demand – not only from construction but from other industries like automobile production – combined with transportation issues (capacity constraints, delays and higher costs) and resulted in steep prices hikes.

Figure 2: Production in the construction sector, February 2015=100, seasonally adjusted series



Source: Eurostat, Scope Ratings

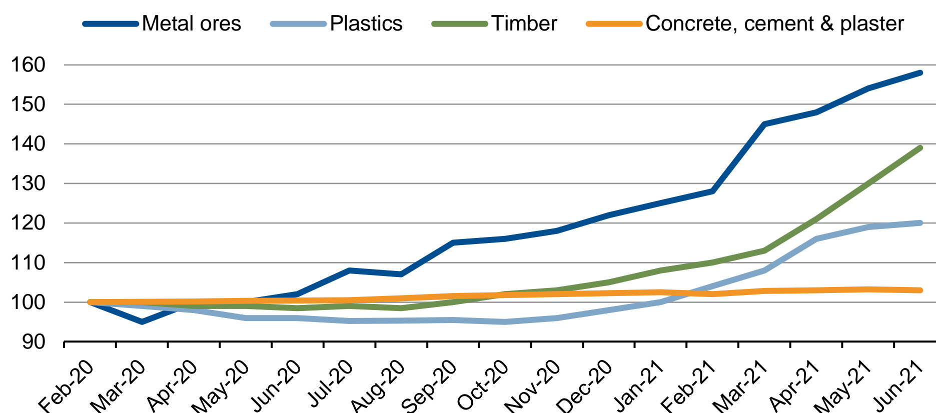
Higher energy prices have a price-driving effect in energy-intensive industries, among them various building materials

Concrete, steel, and cement are energy-intensive industries

The shortage in construction materials has been easing since the end of 2021 but rising energy prices leading to reduced sales and rising materials costs will put pressure on construction firms as the production of many of their main cost items – including steel, bitumen, and cement – are energy-intensive industries and will suffer if energy prices remain high.

[1] ACS and Ferrovial's credit rating is available on our investor platform ScopeOne: app.scope-one.com

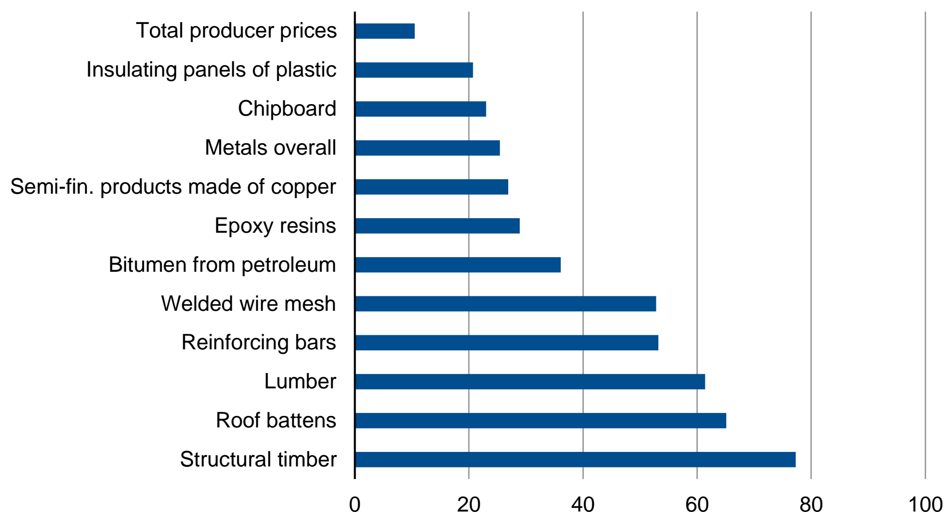
Figure 3: Producer Price Index in the European Union, February 2020=100



Source: Eurostat, Scope Ratings

Higher energy prices could impact cement production in particular, since more than half the cost of cement is directly or indirectly linked to crude oil prices. According to information from Germany's Federal Statistical Office (Destatis), the average price of reinforced steel bars grew by 53.2% YoY in 2021; and the price of bitumen (used in road construction, buildings and foundations), by 36.1%. Producer prices for insulating boards made of plastics such as polystyrene were 20.7% higher, while prices of chemical products – widely used in the construction sector – also increased.

Figure 4: Producer Price Index from selected construction materials, 2021 (YoY)



Source: Destatis, Scope Ratings

Russia-Ukraine conflict has twofold impact

Russia's invasion of Ukraine has exacerbated the trend to higher energy prices and is impacting the construction sector by contributing to further soaring building materials prices, and because Russia is an important producer of a number of key metals, including copper, aluminium, palladium, platinum and nickel, which are used in the manufacture of stainless steel.

Little room to adjust pricing to face increasing material prices

Inflationary pressures challenge construction companies' profit margins, as there is typically little room to adjust pricing for existing contracts. Higher energy prices will

particularly impact construction companies working to fixed-price contracts. Prices can be fixed months or even years ahead of completing a project, rendering companies vulnerable to price shocks for projects that start later.

Customers – among them government institutions – are also concerned about the sharp rise in the price of materials that has caused delays in the completion of public works, led to stoppages or even on occasions caused cancellations of contracts. Higher materials prices have also led to a growing wave of deserted tenders. Lack of ability to revise contract prices triggers tenders without offers, putting at risk the execution of projects linked to European funds. In recent months, the escalation of costs has caused hundreds of public works tenders to remain deserted[2].

Uneven impact in construction companies credit profiles

Shortages of materials and staff combined with higher construction materials prices may lead to delayed decisions on contract awards. Companies will seek to avoid being trapped in non-feasible projects due to cost overruns when picking up new contracts and prioritise the presence of clauses dealing with risks associated with delays, increased costs and future supply-chain risk.

Larger companies exposed to long-lasting projects thus timing mismatch risk

As mentioned above, while all construction companies need to mitigate the potential effects of the energy price crisis on contracts, the impact varies across firms. Larger construction companies are in general more diversified across segments and geographies. Large size can also create stronger bargaining positions and better access to raw materials, as bigger companies can buy supplies in bulk. On the other hand, larger companies tend to be tied to larger long-lasting projects thus increasing risk if they are working to fixed-price contracts, with potential negative consequences for their profitability.

Smaller companies could face problems in source essential materials

Smaller and geographically concentrated companies might face more difficulties in managing rising construction material prices, not only from the cost side but due to problems in sourcing essential materials. This might endanger their ability to complete projects. The latter will result in less predictable and more volatile cash flows and profitability, weighing on their business and financial risk profile and ultimately impacting their credit quality.

A potential economic slowdown might also put the brakes on the recovery of the construction sector, which is highly vulnerable to potential changes in fiscal policy. However, in the medium term, war in Ukraine may lead to a more intensive use of EU funds, especially to secure energy supplies.

Construction companies could benefit from those resources, particularly those focused on net-zero construction projects could well find themselves best placed to win future tenders.

[2] For example, more than 500 projects worth EUR 230m have been deserted due to rising prices in Spain, as highlighted in a recent report by the National Confederation of Construction of Spain (CNC).

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