The Bittersweet Taste of the Construction Recovery

Summary from the PMR's annual Construction in Poland Forum

PMR

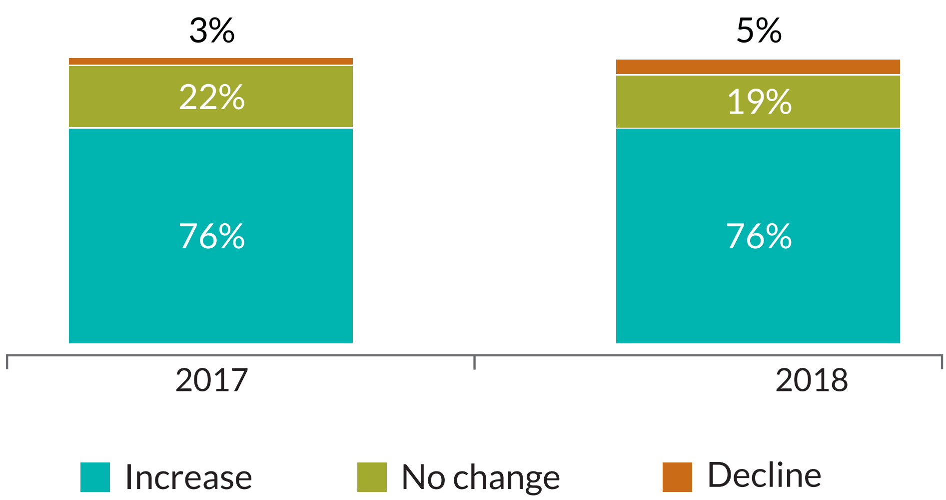
140 executives from leading construction firms converged on the Airport Okecie Hotel in Warsaw on 12 October to take part in the second edition of PMR's annual Construction in Poland Forum. They came to share experiences, exchange views on current trends in the sector, and outline their plans for the immediate future. And it was clear, listening to the panel discussions and to the informal exchanges on the margins, that the market landscape has changed markedly since the previous conference in 2016. One of the Forum's highlights was the unveiling of a new report from PMR, Construction sector in Poland H2 2017. Market analysis and development forecasts for 2017-2022. Bartlomiej Sosna, PMR's Head Construction Market Analyst, took the audience through the latest data on the Polish construction market performance and outlook, while Jaroslaw Frontczak, PMR's Head Retail Market Analyst, and Krystian Gryzlo, a PMR Market Analyst, ran a parallel workshop on DIY and home furnishings e-commerce. .

Polish economy in good shape

Prof. Grzegorz W. Kolodko, the noted economist and former finance minister, was the special guest of this year's Forum, and he talked about the main macroeconomic and political factors shaping the present and future economic situation in Europe and Poland. In his opinion, one of the most important determinants from the point of view of many Polish companies is the exchange rate. Currency risk makes business decision-making and planning harder – that's one of the reasons why adopting the euro would be good for Poland. According to Prof. Kolodko, the zloty is likely to remain volatile but trending upwards in the years ahead. Another important factor is labour productivity, and Poland's productivity has been growing twice as fast as the eurozone's and will keep growing significantly faster in the coming years. This is setting the grounds for the zloty to appreciate. Prof. Kolodko also pointed out that corporate profits have generally outpaced wage growth in the last years, so the reversal of the relationship observed in 2016-2017 – possibly continuing into 2018 – merely represents a redressing of an earlier imbalance, as well as underpinning growth in effective household demand. While he cautioned against over-optimism, Prof. Kolodko said he had no worries about the Polish economy as far as purely economic processes were concerned; what he is worried about are political issues and the 'Polish-Polish war'. The slump in investment is a temporary one and no cause for panic, although the reallocation of spending from investment to consumption might cause the country's budget deficit to climb past 3% of GDP, most probably in 2019. The Polish economy is capable of maintaining an annual growth rate of 4%, according to Prof. Kolodko.

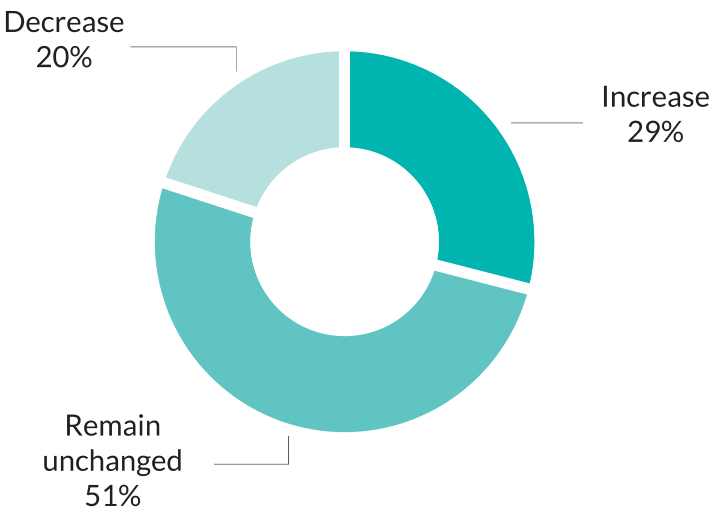
Conditions in the construction sector have improved sharply during the past year – this is the message emerging both from the survey we conducted for the Construction sector in Poland H2 2017 report and from our poll of Forum participants. As many as 76% of Forum attendees expect their companies to report an increase in construction or real estate revenue in 2017, with just 3% predicting a decline. A very similar pattern of responses was found when participants were asked about their projected revenue in 2018. They were somewhat less optimistic about their return on sales, however. More than 50% expect their operating profit margin to remain unchanged in the next 12 months, with 29% predicting it will increase and 20% that it will decrease.

How do you expect your company's construction or real estate revenue to change in 2017 and 2018, compared to the year before??



Source: PMR Forum, 2017

How do you expect your company's operating profit margin to change in the next 12 months?



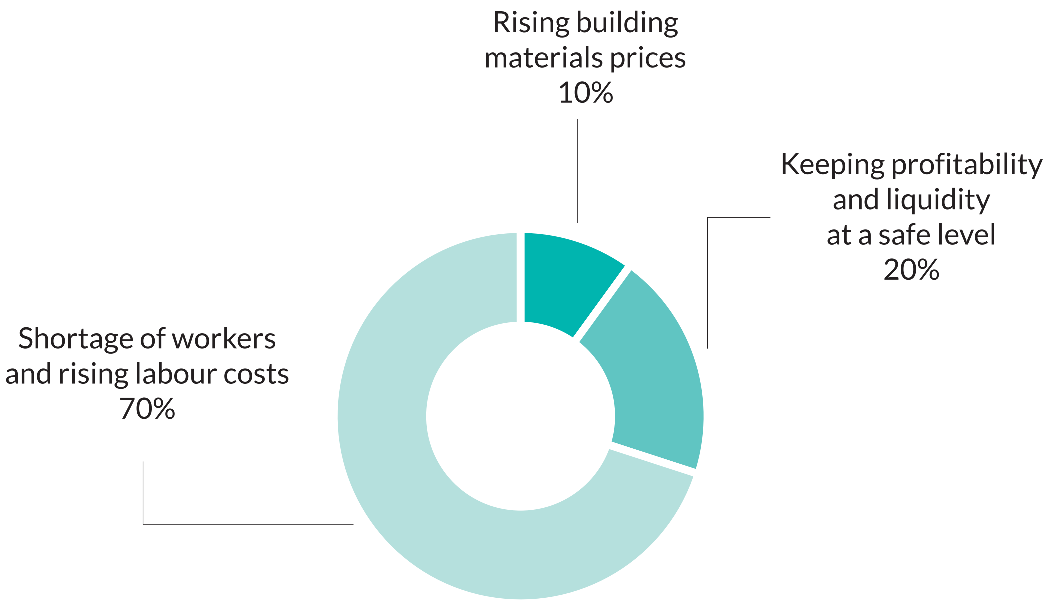
Source: PMR Forum, 2017

More projects, fewer workers

The top concerns voiced by construction sector executives during the 2016 Forum were a significant slowdown in public tenders and a slump in investment activity, but things were different this year: while some contractors again complained about slow EU funds utilisation on the part of the GDDKiA and local governments, it is worker shortages, with their attendant rise in labour costs – as well as rising building materials and transport prices – that seem to be the industry's principal worry at the moment. Although the concurrence of many new projects was always going to create staffing issues, the speed at which the problem has been estalating has caught many in the sector by surprise. In the opinion of Adam Zubelewicz, Board Member at Erbud, one reason why labour shortages became a major problem earlier than expected is the recovery in Western Europe, where wages for construction workers are still much higher than in Poland. Hiring foreign workers has now become a necessity for Erbud, although the company is aiming to work with foreign partners as subcontractors. Warbud, too, is using foreign workers to cope with shortages. As Board Member Miroslaw Jozefczuk said, the company is doing its utmost to retain its workforce, and is recruiting foreign workers mainly from Ukraine and Belarus, however this strategy is reaching its limits because the Ukrainian labour market is getting tight too. Leszek Marek Golabiecki, CEO of Unibep, also expressed the view that given the project pipeline predicted for the next few years, the ability to recruit and retain enough workers will be a key source of competitive advantage.

In the opinion of Jaroslaw Szczupak, CEO of Alstal, under these circumstances it is advisable to form partnerships with subcontractors, even if it means overpaying a bit at times. Renaud Roussel, CEO of Colas, noted how dynamic the situation in the Polish construction market was. It is not just the rising prices of building materials that are worrying – transport is also becoming a problem, he said. Just like other construction firms, Colas is finding it hard to recruit workers in Poland, and is turning to Ukraine and Romania.

What do you think will be the main challenge for the construction sector in 2018?



Source: PMR Forum, 2017

The labour shortage is putting an upward pressure on wages. Kamil Simka, Executive Vice President at Skanska, believes however that construction companies should also be paying attention to non-wage motivators. Skanska is trying to make construction a more attractive sector for employees, for example by implementing innovative solutions on its construction sites.

Participants in the contractors' panel also noted how the employment structure in the sector was a cause for concern, and that Poland's system of vocational education was in need of reform. Efficiency and innovation were other debated topics. Several executives expressed the view that pre-fabrication could be part of the solution to the labour shortage and rising building materials costs, for example in public buildings construction. The cost factor was also the subject of lively debate. Andrzej Golawski, CEO of Mostostal Warszawa, warned that the continued increases in input costs meant we could face a repeat of the wave of bankruptcies that swept the sector during the previous investment boom. In his opinion, it will not get any cheaper with time, and the only thing that can save the industry from a liquidity crisis is using realistic calculations that take proper account of all the costs and risks.

According to the Erbud representative, while the upward trend in building materials prices could be temporary, labour costs are unlikely to ease.

In the opinion of Artur Popko, Board Member and Director of Infrastructure Projects at Budimex, a repeat of the 2011 scenario – with many companies declaring bankruptcy – is in fact unavoidable; Vistal Gdynia's descent into financial trouble is an early sign of that. He pointed out that despite the large number of public tenders being announced in the road and railway sectors, bids are still very low in many cases, suggesting that a lot of companies are not taking account of all the risks. (Part of that could reflect new players trying to break into the market.)

In the opinion of Mostostal's Mr Golawski, given the mounting problems that construction firms are either already facing or will have to contend with soon, their optimism is unfounded. Mr Simka of Skanska also stressed how his company was approaching the recovery with caution, mindful of past experience.

According to Mr Golabiecki, the Unibep CEO, the market is beset by imbalances, and the recovery is therefore set to have a bittersweet taste for the sector.

Banks are also noticing liquidity glitches, especially among subcontractors. However, some positives can also be observed when looking at the behaviour of contractors, said Anna Glanowska-Szpor, Managing Director for the Construction Industry at ING. In her opinion, contractors have become more rigorous about risk management and are thinking ahead more. Their portfolios are becoming more diversified each year, and they are also becoming bolder in expanding their business abroad.

Roads and railways offer biggest growth prospects and risksi

Most of the contractors who took part in the panel discussions believe that the segment with the best near-term growth prospects – theoretically anyway – is infrastructure construction, and especially road and railway construction. Many also think that residential construction retains considerable potential. There are differences between the participants, though, as to areas they are planning to focus on in the next few years and the strategies they want to pursue. Mostostal Warszawa is still pinning substantial hopes on the industrial-energy segment, which is its biggest market. According to Mr Golawski, the CEO, the country's plants will have to bring their emissions performance into line with EU standards sooner or later, so Mostostal intends to maintain its position in this segment.

According to Erbud's Mr Zubelewicz, the years 2018-2019 will see a major increase in road construction activity, and probably in railway construction as well. He stressed that given the existing imbalances, it was crucial that new road and railway construction tenders were carefully designed and contained cost adjustment clauses. The energy sector, by contrast, has disappointed, and whether it has good prospects is open to doubt, Mr Zubelewicz said.

Mr Szczupak, the Alstal CEO, said his company was now pursuing a specialisation strategy due to very intense competition on the market, focusing chiefly on building construction. Warbud, meanwhile, is still trying to maintain a diversified, balanced approach, and is active e.g. in buildings, roads and railways. Unibep, while recognising the positive trend in railway and road tenders, is continuing to diversify its operations and developing export. According to its CEO Mr Golabecki, the rapid growth in railway and road construction means these segments have very good prospects, but are also highly risky ones.

This view was echoed by the infrastructure panel chairman, the economist and columnist Kazimierz Krupa, who represented the Polish Association of Construction Industry Employers (PZPB). In the words of Mr Krupa, after the stagnation of the last few years the PLN 200bn to be poured into infrastructure investments represents both an amazing opportunity and a serious danger for the sector.

Artur Popko, the CEO of Budimex, said that a certain slowdown in road tenders could be observed at the moment, with some contract award processes being suspended, and with some of the already awarded contracts still awaiting finalisation. Under these circumstances, contractors are starting to wonder whether it is safe to put pen to paper on these contracts at all, considering the rapid price increases.

Przemyslaw Wrobel, Adviser to the Director of the Centre for EU Transport Projects (CUPT), is not perturbed by the slowdown in contract award by the GDDKiA. In his opinion, it is the pace of project execution and funds utilisation that are more important. Mr Wrobel is worried however about the likely cumulation of investment projects especially in railway construction in 2018-2019, and is therefore less optimistic about this latter segment. Because numerous railway projects failed to get off the ground in 2015-2017, the pressure is mounting to meet contract award targets, and the volume of work may prove impossible to execute.

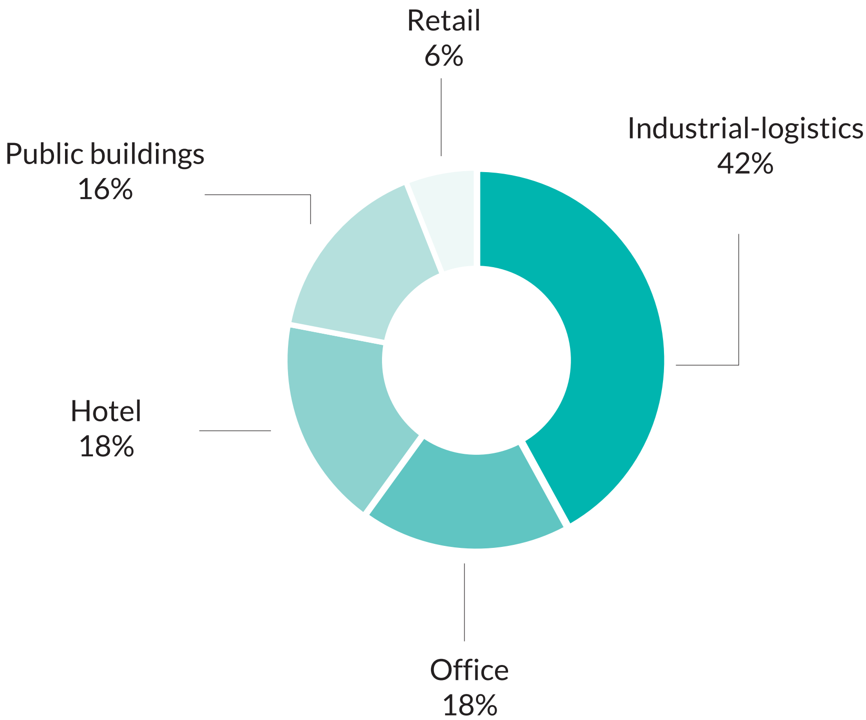
Lukasz Marcinkiewicz, Managing Director of LH Engineering, who also represented Lafarge, noted that no sector would react well to fluctuations of this kind, caused by sudden inflows of money into the market. Unfortunately, the lessons from the previous EU budget perspective have not been fully learned, in terms of spreading investments more evenly over time.

Homes, warehouses and offices remain most attractive areas of building construction

The building construction segment is perceived as less risky by construction companies and by financial institutions alike, due to its more market-based nature and lack of dependence on government or EU grants. As pointed out by Roman Nagler, Director of Corporate Loans at Bank Zachodni WBK, 10% of companies active in building construction are loss-making at the moment, compared to as many as 25% in infrastructure construction. And building construction still offers higher margins, although Michal Sternicki, General Manager of Areal Bank Polska, said that some building construction projects were also becoming unattractive in terms of profitability. Mr Sternicki also noted how the operating environment for developers was undergoing dynamic changes (e.g. the introduction of a reverse charge mechanism in the VAT system, the prospect of Sunday trade restrictions, or a new tax on commercial real estate).

According to bank representatives who participated in the Forum, housing, industrial & warehouse, and office buildings will remain the most attractive parts of building construction in 2018. In the opinion of Piotr Okonski, Director of the Strategic Clients Department at PKO BP, the logistics segment in Poland remains structurally underestimated and has many advantages that have already caught the eye of foreign investors. The residential construction segment remains very strong, Mr Okonski said, and he noted how the supply of homes was structurally constrained and also how home prices were still about 10% lower than during the previous housing boom even despite the upward trend in the last years. The office segment will continue to grow, especially in cities like Warsaw, Wroclaw, Krakow or Gdansk, according to Mr Okonski.

Which segment of non-residential building construction do you expect to exhibit the strongest growth in 2018?



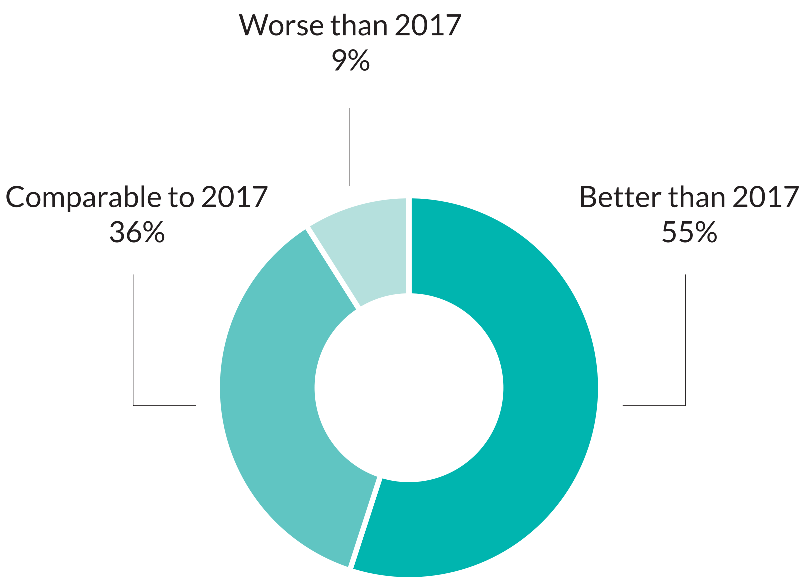
Source: PMR Forum, 2017

Some panelists, however, expressed the view that office projects were becoming more and more risky. Marcin Panek, Capital Resources Director at Golub Gethouse, revealed that having completed the Mennica Legacy Tower office building in Warsaw his company intended to concentrate exclusively on the construction of homes for rent and of student dormitories, in part because these are the asset classes that are presently drawing heightened interest from foreign investment funds, who are even prepared to buy "holes in the ground". According to Rafal Trusiewicz, CEO of Katharsis Development, office projects and also retail projects are losing their attractiveness in the eyes of developers, and there are two main reasons for this, namely rising costs of land acquisition and construction, and a downward pressure on rents. Under these circumstances, Katharsis Development plans to branch out into the construction of homes for rent in the future, as a parallel business line to retail parks.

Mariusz Frackiewicz, Country Manager at Avestus Real Estate, brought up another aspect that he said was serving as an impediment to new office projects for the BPO/SSC sector in some areas, namely increasing problems in recruiting staff. But the view was also expressed by some panelists that the tight labour market might have a positive effect by contributing to the emergence of new office hubs in Poland, e.g. in Lodz or Lublin. And George Fereira, Senior Project Manager at Grupa GSE, is hopeful that the deepening labour shortages in the Polish economy will drive increasing demand for the kind of automated logistics centres that his company builds.

The participating developers were agreed that the profitability of new commercial real estate projects in Poland will hinge on the right choice of location and on maintaining rigorous cost control.

What do you think 2018 will be like for residential developers in terms of sales performance?



Source: PMR Forum, 2017

Distributors of building materials worried about falling profitability

Contractors are deeply concerned about the increases in materials prices that have occurred this year, but executives from the building materials manufacture and distribution sectors who took part in the Forum offered a reassuring message, saying there would be no repeat of 2007 because the market circumstances were different now. According to Jaroslaw Komorowski, CEO of Grupa PHMB, there is a lot more competition and capacity in the building materials sector today – indeed, some segments are grappling with overcapacity – helping keep prices in check. But this is also the reason why the mood among distributors of building materials is less than buoyant. In the words of Piotr Kozina, head of store network at Grupa PSB, the sector's main gripe are drastically shrinking operating margins and eroding profitability. (Some family-owned players are additionally experiencing succession problems.) Grupa PHMB's Mr Komorowski also mentioned margins as a problem. Katarzyna Stefanide, General Manager of MGI Polska (Bricomarche), said she did not observe margins being lowered yet but that her company was already seeing its bottom line being adversely affected by rising labour costs and transport costs. Pawel Kisiel, Vice President for Sales and Marketing at Atlas, said another cause for concern was expansion of the informal market, which he attributed among other things to the abolition of the building materials tax break. The upcoming introduction of a split payment mechanism for VAT – due to come into effect on 1 April 2018 – could become another barrier, according to Mr Kisiel.

In debating the outlook for the building materials market, industry representatives also touched on the subject of e-commerce and its likely impact. According to PSB's Mr Kozina, e-commerce will play a growing role, but principally in the home & garden segment; in the case of bulky building materials, by contrast, logistics and warehouse location will remain vital. Grupa PSB therefore plans to pursue an omnichannel strategy to maximise sales.

Ms. Stefanide of MGI Polska also believes the market will evolve towards an integrated multichannel model. In the opinion of Mr Kisiel of Atlas, offering professional, added-value services (consulting, logistics etc.) is another tactic that market players are likely to employ to build competitive advantage.

Construction in Poland is an annual conference that brings together key decision-makers (CEOs and Executive Directors) from all sections of the industry, including contractors, property developers, distributors of building materials, and financial institutions. It has earned the accolade of "the industry event of the year" for being the occasion where key market data are unveiled for the first time and for the way it influences industry opinion. This year's Forum featured Prof. Grzegorz W. Kolodko, the noted economist and former finance minister, as the special guest speaker, and the roster of panelists included top executives from Mostostal, Erbud, Warbud, Unibep, Alstal, Colas, LH Engineering, Atlas, Avestus, Katharsis Development, Bricomarche, Grupa PSB, Skanska, or Budimex, among others. Andrzej Golawski, CEO of Mostostal Warszawa, said of the Forum: "This gathering of leading industry representatives is an opportunity to take stock of the latest developments, diagnose the sector's condition, and above all to gain access to the most up-to-date market data, allowing players to develop a big picture view and make informed predictions about the future."

Hope to see you at next year's Forum in October 2018!

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More info about the PMR Forum **http://www.forum-budownictwo.com/**

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