INTUITION
9 AUGUST 2024

Global construction set for an upward cycle

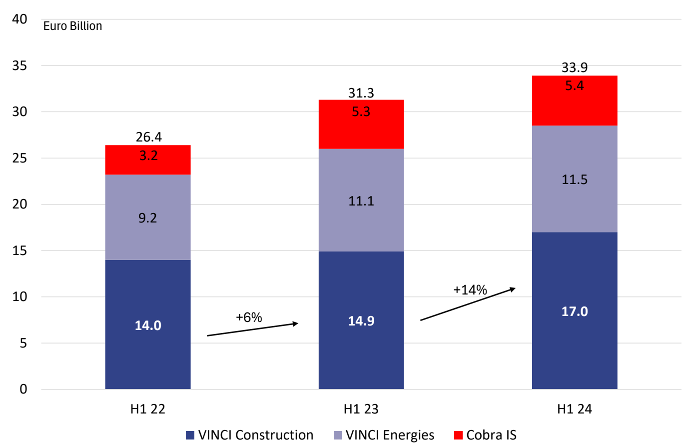
An international company that we have introduced into our global portfolios has seen an acceleration in their construction activity. Is the global construction market ready for a positive reset? Based on their results we look at the sector and what could influence a new growth phase over the next few years. Research suggests that the global construction market is set to become a $20 trillion industry by 2027.

Willie Pelser

VINCI, a French company with a global footprint, reported results two weeks ago. We first wrote about the company a few months ago – refer to the 1st March issue of Intuition if you would like to refresh your memory.

One of their major divisions is VINCI Construction – which focuses on large construction and infrastructure projects. During the presentation they referred to an acceleration of new orders in the first half of 2024. A continuation of this trend bodes well for VINCI's revenue and profit in years to come as projects are completed. The chart below breaks down the orders by business segment. (The energy segment and the standalone energy component, Cobra IS, also have construction associated with some of the projects.

VINCI: NEW ORDER INTAKE



VINCI's new order intake has grown by 14% over the same period last year, underpinning its future revenues.

Vinci's update made me wonder about the state of the global construction industry. Below is a summarised conclusion of my investigation.

SPEED READ

- **VINCI Construction has seen an acceleration in its new order book over the past two years, which underpinned revenue, cashflow and consequently, dividends to investors when they reported their H1 2024 earnings last month.**
- **The global construction market is expected to deliver 6% compound annual growth over the next few years, driven in part by secular trends.**
- **Slower inflation, reduced input costs and potential interest rate cuts bode well for the industry.**
- **Artificial Intelligence trends and ESG factors (now that we really understand what it is all about) will have a positive impact on the industry.**

- The global construction market is expected to have reached $15.5 trillion in 2023, which implies growth of 6.9% over 2022.
- Whilst growth of almost 7% in 2023 is impressive, it is worth digging a little deeper to understand the source of this growth. According to real GDP data, it is important to note that much of the topline growth in construction was more likely being driven by price inflation rather than an increase in the volume of work. In addition to grappling with ongoing inflation, the industry is facing volatility in material prices and increasing labour costs. Another significant challenge is the ongoing shortage of skilled labour, which continues to impact the sector. Moreover, high interest rates and tighter lending standards are also impacting construction activity.

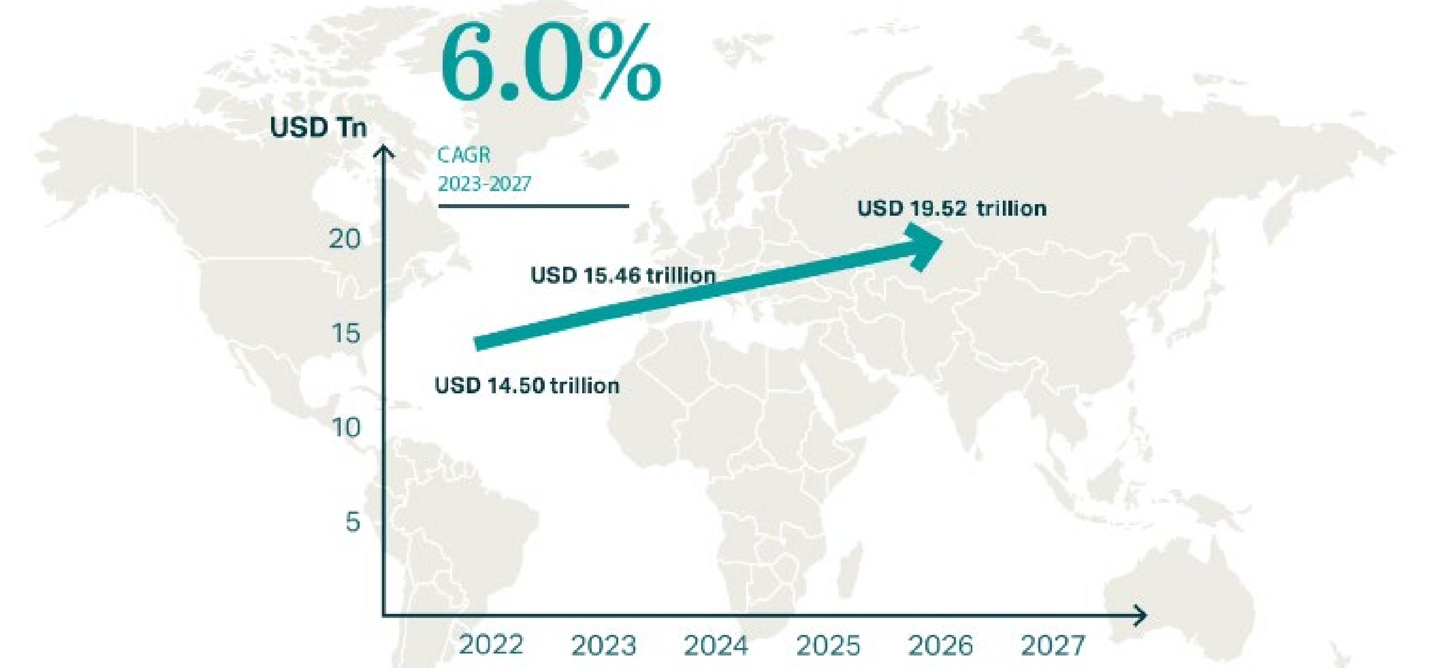
However, looking into 2024, there is expected to be a large boost to construction associated with manufacturing, transportation infrastructure, and clean energy infrastructure, as funding from three key pieces of US legislation passed in 2021 and 2022 - the Infrastructure Investment and Jobs

Act (IIJA), the Inflation Reduction Act (IRA), and the Creating Helpful Incentives to Produce Semiconductors (CHIPS) Act - are expected to flow into the industry. As such, construction confidence remains high, with the Association of Builders and Contractors (ABC) identifying expectations for an increase in profit margins and staffing levels, particularly in the first half of 2024, but which is nonetheless expected to continue for several years.

Based on research and analysis from various sources, it is estimated that the construction market could reach almost $20 trillion in 2027 – which implies growth of more than 6% per annum.

In addition to balancing sustainability with efficiency, the increasing occurrence of severe weather events such as hurricanes, floods, and wildfires have raised the focus on resilient design. With such new demands on both sustainability and resilience, the industry is poised to take advantage of an increase in the development of advanced and emerging materials such as self-healing or high-performance eco-friendly concrete, electrical steel, graphene, and carbon fibre composites. Many old buildings will not be fit for purpose in a more environmentally sensitive future, which requires either demolition and rebuilding, or extensive refurbishment.

GLOBAL CONSTRUCTION MARKET GROWTH PATH



The global construction market is set to reach $20 trillion by 2027 – which implies a compound annual growth rate of more than 6%."

There are numerous drivers behind this forecast growth, but the key influences can be summarised as follows:

1. **Sustainability.** When the ESG buzzword first hit financial markets a few years ago, there was a mad scramble to figure out what ESG meant. Numerous ESG exchange traded funds were established to try and capitalise on this new fad. Now that the dust has settled and the 'green' has emerged, there is more clarity as to what ESG really means and how investors can benefit therefrom.

   For example, the International Energy Agency (IEA) states that buildings account for 30% of global energy consumption and 26% of global energy-related emissions. In its "Net Zero Emissions by 2050" Scenario, the IEA requires all new buildings and 20% of existing structures to be zero-carbon-ready by 2030.

2. **The unfolding economic cycle.** After two years of high interest rates and high inflation, all indications are that a global rate cutting cycle is imminent. Broader economics, monetary policy, and overall market uncertainty have had varied impacts across different segments, but broadly residential construction has lagged worldwide due to higher interest rates. Non-residential construction has held up better, and this should continue, driven by various secular trends.

3. **Secular trends driving global construction include the emergence of AI, which is driving demand for data centres and associated infrastructure.** We have commented before on the impact that AI is having on creaking electricity infrastructure, resulting in significant demand for additional and strengthened grid capacity across many developed countries. We are all too aware of failing infrastructure in SA, but a lack of maintenance

and investment in key infrastructure is popping up across developed countries as well – Thames Water in the UK being a prime example. The IIJA Act (passed in November 2021, see above) authorised spending of $1.2 trillion for transportation and related infrastructure, of which $550 billion was for new investment. The balance was earmarked for rehabilitation. The last time that the US released data on the condition of its road network was in 2020, when it noted that 30% of the nation's roads were in an unsatisfactory condition. So far, only $70 billion has been spent, indicating some of the potential in the US market alone over the next few years. But the problem is not limited to the US. It applies to many western countries.

> "Companies indicated that labour workaround strategies include firstly embracing the "gig economy" where staff can work as contract employees for multiple employers rather than committing to a single employer. "

4. **The impact of digitalization and generative AI.** Although construction companies have adopted digital technologies for some time, through the rise of generative AI and other disruptive technologies these companies are now poised to realise improvements in project design, cost controls, site inspections, safety and quality assurance. The aim will be efficiency improvements to mitigate other pressures such as rising labour costs and supply chain challenges. Emerging AI technologies and their applications can improve profit margins, foster stronger partnerships, help relationships between different stakeholders and functional departments, and improve integrated project delivery through transparent and trusted data-sharing.

5. **New work and workforce norms.** Since Covid, construction companies have faced a significant labour gap. More than 68% of construction firms surveyed are struggling to fill open positions. To meet the incoming demand for work, 70% of surveyed firms expect to increase headcount in the next year. The rise of remote work and greater career flexibility have contributed to retention issues. Furthermore, over one-fifth of construction workers are older than 55 years of age and often represent the most skilled workers on a job site. In hiring, firms struggle to find younger workers with comparable skills. Companies indicated that labour workaround strategies include firstly embracing the "gig economy" where staff can work as contract employees for multiple employers rather than committing to a single employer. Secondly, substantial investment (more than $1.5 billion) has been earmarked for upskilling and cross skilling programs. The net effect of this trend is that capacity across the construction industry is far lower than in the past. That is allowing larger, more robust competitors to tender for work at better margins.

Whilst there is no doubt that deteriorating growth is cause for concern, many of the drivers for the construction industry are secular in nature and driven by need and environmental demands rather than speculative demand. This points to a more stable outlook rather than the boom/bust cycles that have occurred before. Even in SA, the GNU's desire to "turn SA into a construction site" bodes well for the sector, as we focus on infrastructure renewal. That in turn will drive higher private sector construction activity, hopefully the start of a virtuous cycle. So, while the near-term outlook may remain challenging, opportunities abound both locally and abroad. We believe companies such as Caterpillar, Ashtead, Deere & Co, Afrimat, and Raubex, (amongst others) should deliver solid earnings and dividend growth.

Caterpillar, the big construction machinary firm, is set to benefit from the construction revival.

Our next seminar will be held in September. The topic will be advertised in due course.

[Harvard House is on Facebook]

[Harvard House is on YouTube]

CONTACT DETAILS:

For more information on the range of products and services offered by Harvard House Investment Management and its associated companies (including Harvard House, Chartered Accountants), or for any financial advice, please contact the Company at:

Topic: TBC

Natal Midlands	
Date:	12 September, 2024
Venue:	Christ Church Howick, 23 Mare Street, Howick
Morning Time:	10am for 10.30am
Evening Time:	5.30pm for 6pm

Johannesburg	
Date:	10 September, 2024
Venue:	Rosebank Union Church, Cnr Winne Mandela Drive and St Andrews Road, Hurlingham
Time:	7am for 7.30am

Cape Town	
Date:	n/a
Venue:	SSISA Conference Centre, Boundary Road, Newlands, Classroom 1, 3rd Floor
Time:	7.30am
Venue:	ABRU Motor Studio, Lourensford Wine Estate, Somerset West
Time:	5.30pm for 6pm

HARVARD HOUSE GROUP

3 Harvard Street, Howick, 3290, South Africa
P.O. Box 235, Howick, 3290, South Africa
+27 (0) 33 330 2164
+27 (0) 33 330 2617
@ admin@hhgroup.co.za
W www.hhgroup.co.za