FOCUS

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Insolvencies in the construction industry in France: interest rates are key

Since the low of 2014, glimmers of recovery have been seen in the construction industry. Corporate insolvencies are declining. French households are increasingly attracted by bricks and mortar as their purchasing power is at its strongest since 2003, particularly due to interest rates also being at historic lows. However, interest rates, which have been rising since the beginning of the year, could ultimately put a damper on household spending should this trend continue. So, if corporate insolvencies in the construction industry continue to decline from now to the end of the year (-7.7% on average in 2017 according to Coface), the power of households to purchase new property will begin to fall by 9 m² in 2017. Coface expects to see a 18m² decline in purchasing power between 2016 and 2018. This means that we will be back to 2012 levels in only two years. The current recovery may indeed be short lived.

The industry finally recovers on the back of low interest rates

With an average increase in corporate insolvencies of 4.2% per year, 137,520 companies went bankrupt between 2008 and 2014, effectively one third of all French bankruptcies (415,000).
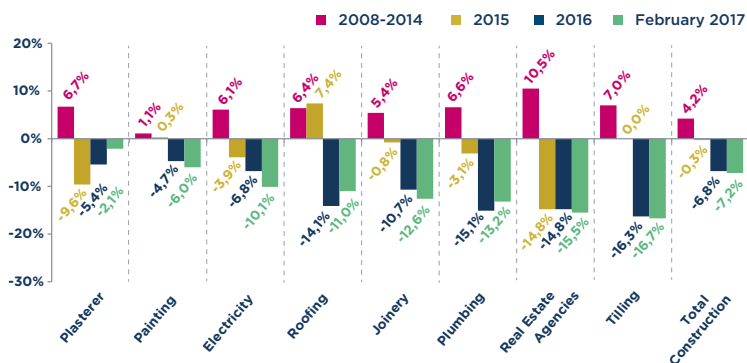
This trend was significantly reversed in 2016 with a decline in insolvencies of 6.8%, particularly in crafts *(cf. chart 1)*. The greatest improvements came in the areas of plumbing (-15.1%) and tiling (-16.3%) which respectively account for 7% and 3.6% of all insolvencies in what is a fragmented industry. Real-estate agencies (4% of insolvencies in the industry) also benefited from this recovery (-14.8%). Specifically, the sales market for pre-owned housing is less dynamic (+5.6% in 2016) than that for new-build housing (+20.6%) according to the Ministry of the Environment, Energy and Sea. Craft trades workers (floor coverings, joinery, roofing) directly involved in building new housing are, generally speaking, experiencing the worst downturns.

At the same time, the gross margin of[1] companies in this industry increased by 5.3% over one year at the end of the third quarter of 2016. The margin rate was 23% at the end of 2015 according to the Fédération française du bâtiment (French Building Federation)[2]. This recovery has also led to an increase in capacity utilisation rates in the sector: 86.1% on average in 2016 compared with 84.3% in 2015 (but far from the average of 92.5% recorded between 2001 and 2008). This situation has therefore improved somewhat, giving players in the construction industry an average of 6.8 months' work. At the end of February 2017, housing starts and permits authorised increased respectively by 13% and 14.4% over 12 months. This good performance led Coface, in March 2017, to revise its credit risk assessment of the construction sector[3] to average risk[4].

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CHART 1

Trends in insolvencies in the building industry.

Sources : Ellisphère, Coface

It can be seen that activity in the sector is growing, helped by a resurgence in household confidence and a fall in the average interest rate for housing loans (Banque de France) of 173 base points between January 2014 and January 2017, particularly due to a fall in inflation of, on average, 0.2% in 2016, which has led the European Central Bank to step up its measures to encourage banks to finance the real economy. Effectively, in addition to no-cost refinance rates, the rate on the deposit facility from the ECB has declined by 0.4% since March 2016.

However, not every signal is positive. In particular, the construction industry continues to destroy jobs (as it has done every year since 2008). In 2016, 10,800 jobs were cut. Furthermore, the number of new companies entering the sector continued to decline in 2015 (-16.6%) and in 2016 (-3.5%) according to INSEE. On average, every new company entering the sector creates 2.7 jobs.

2017: a decline in defaults, yet some signs foreshadowing a downturn

In 2017, mortgage loans remained interest free. This, and the fact that they applied to pre-owned property once more, is what boosted the sector in 2016. The Pinel legislation is also still in force.

CHART 2

The sector will continue to recover in 2017.
Annual default rates

Sources : Ellisphère, Coface

Another important factor supporting the market in 2017 is the fact that interest rates are slated to remain relatively low despite recent increases, insofar as the European Central Bank is unlikely to increase its official interest rates between now and the end of the year despite rising inflation. It should be said that heightened concerns following the presidential and legislative elections (should, for example, M. Le Pen or J-L. Mélenchon win the first round) are very likely to lead to a sharp increase in interest rates[5].

Our forecasting model for defaults in the construction sector takes account not only of the confidence of players in the industry but also of trends in interest rates. In terms of trends, this VAR model[6] shows a time lag of one quarter between defaults and confidence. It lags four months behind interest rates. This is hardly surprising because, on average, builders' order books have been full for 6.2 months ahead since 2001 and the average time to housing starts has been 5.2 months. We believe that the confidence of the players in the sector should continue to grow in 2017 (99.4 in March) to reach 105 in December 2017. From 2001, over the long term, this confidence has been 102 on average. Similarly, we foresee a gradual rise in average interest rates to 2% in August 2017 (a level comparable with May 2016). These conservative assumptions lead us to believe that defaults in the sector will drop to 7.7% in 2017. Ultimately, overall French defaults should fall by 3.2%[7]in 2017 to 56,250 in total. Outside construction, this downward adjustment will be 1.2%.

MODEL 1

Model forecasting defaults in the building industry.

This VAR model compares default rates with past rates, trends in interest rates and in the confidence of actors in the sector.

$$DEF = a * DEF_{t-1} + b * DEF_{t-2} + c * TAUX_{t-4} + d * CONFCONS_{t-3} + \varepsilon$$

WHERE

	Cœfficient	Prob.
a	-0,898523	0,0000
b	-0,53289	0,0000
c	0,918639	0,0232
d	-1,191249	0,1183
ε	0,015994	0,0940

1 - The gross margin covers the gross operating surplus and added value.
2 - 2016 Overview and 2017 Outlook, Fédération française du bâtiment, December 2016.
3 - Coface Barometer, Recovery in global growth: more than a flash in the pan? March 2017.
4 - Each quarter, Coface reviews all assessments for 12 sectors in 6 major regions and 17 countries in the world. Its assessment scale includes 4 risk categories (low, average, high, very high).

In 2018, an increase in rates will have a dampening effect on the purchasing power of households to acquire real estate

The fall in rates has created a wealth effect. Since 2012, the surface area that average households can purchase has increased year on year. At that time, this area was 54 m² according to Coface[8]. By the first quarter of 2017, the same household could buy 79 m². This average capacity can be measured by four factors: rates, maturities, household income and property prices. Table 1 shows the major impact of rates on purchasing power. Effectively, on average, a variation of 0.1 percentage point (p%) in average mortgage interest rates has increased the household purchasing power by 1.25 m² (all other variables remaining equal to their Q12015-Q12017 average). Similarly, between 2015 and 2017, a 1% increase in the price of new-build reduced by 0.7 m², on average, the floor area that could be purchased. Between the first quarter of 2012 and the first quarter of 2017, household income and the prices of new housing increased by 8.8%, while maturities only increased by one month. Over the same period, rates fell by 2.5 p%. In the final analysis, interest-rate trends can fully explain the increase in purchasing power over this period. Effectively, trends in all the remaining variables have had virtually zero effect on this purchasing power.

As a result of this increase in rates, household purchasing power will possibly be impacted from the second quarter of 2017. While it seems fair to say that there will be growth in the sector in 2017, 2018 will be an uncertain year because a new plan may be introduced to promote development in the housing sector. The main candidates running for the presidential election disagree over how the system should be reformed (cf. insert 1). Leaving aside the effectiveness of whichever plan is put forward, there are several factors which could put the brakes on recovery in the sector.

Firstly, housing in France is still overvalued by 27% according to the OECD. This institution ranks France as the fifth-most expensive country in terms of the long-term average for property prices. French household debt is moderate, but continues to grow (56% of GDP according to the Banque de France). Strong growth in mortgage loans, with amounts outstanding increasing by 4.8% over one year to January 2017, suggests that buyers have taken advantage of historically low rates to go into debt.

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TABLE 1

Impact on purchasing power of a variation in one of the factors of housing demand.
Calculation based on the period from the first quarter of 2015 to the first quarter of 2017.

	DIFFERENCES	SQUARE METERS EFFECTS
Mortgage Rates	+0,1 p %	-1,25
New Housing Prices	+1 %	-0,7
Income	+1 %	+0,7
Maturity	+1 month	+0,2

Sources : ACPR, Observatoire Crédit Logement, calculs Coface

INSERT 1

The housing-related proposals of the main candidates running for the Presidency of the Republic

François FILLON
- Abolition of rent controls
- Fiscal stability for five years in relation to the taxation of real-estate investment
- Simplification of standards and the shortening of legal proceedings
- Creation of an approved lease giving owners tax advantages in proportion to the modest nature of the rents charged

Emmanuel MACRON
- Supply shock to bring down prices, particularly in areas under stress, where the status of "Operation of National Interest" will allow jurisdiction over urban planning, particularly in granting planning permission, to be transferred from municipal level to the State
- Promotion of mobility, particularly for young people, by creating a professional mobility lease and 80,000 homes for young people and students
- Exemption from paying council tax for 80% of households that currently pay it
- Maintaining stable standards: no new standards in the construction industry for the entire five-year term

Benoît HAMON
- Construction of 150,000 social housing units per year
- Construction of 60,000 homes for young people and students over 5 years
- A charge on transactions and upscale properties
- Strengthening of rent controls
- Mobilisation of land stock held by local authorities to reach objectives in building new homes

Marine LE PEN
- Strengthening of subsidised loan programmes
- Revaluation of young people's housing entitlements
- Reduction in council tax
- Active policy of selling social housing to its lessees (as is the case with François Fillon), setting a sales target of 1% of the social housing stock per year (a target already set during Nicolas Sarkozy's five-year term: in 2012, sale of 8000 social housing units and construction of 25,000 new social housing units): this target is, however, limited by the small amount of "sellable stock" available and by the difficulties experienced by the households in question in accessing loans.

Jean Luc MÉLENCHON
- Introduction of new rules for the lease market prohibiting tenant evictions without rehousing and strengthening rent control, while creating a "universal rent fund" paid for by landlords and used to cover unpaid rent
- Introduction of a tax regime which is less favourable to private investment with the introduction of progressive taxation on "major property transactions", an increase in taxation on vacant properties and a review of tax credit provisions including an immediate halt to assistance to private rental investment.
- Prioritising of social housing with the construction of 200,000 public housing units per year for five years and the extension of interest-free loans to providers of social housing
- Construction of 75,000 homes for students over 5 years

5 - In France, a political shock of the magnitude of Brexit could cost French growth 0.6 percentage points in 2017.
See Coface Panorama, European economies: will political risk spoil the "party" in 2017? October 2016.
6 - Factor Autoregression (VAR) is a statistical model. This model is used to capture the linear interdependencies among several series.
7 - Defaults outside the construction industry are captured through an AR(2) model. Overall defaults are subsequently produced by combining the two.
8 - The calculation of household purchasing power (C) depends on maturities (M), the average price of new property (P), average mortgage interest rates (i) and household income. $(W). C = \frac{M*W}{P} * \frac{1}{((1+i)^{\frac{1}{12}})^M}$

In these circumstances, a potential increase, in the second quarter of 2018, of Central European Bank refinancing rates could quickly stymie the recovery.

Our main scenario for 2018 projects terms of loans stabilising at 212 months (17.5 years), an increase in real average household income of 1.5%, an increase in the prices of new-build of 3% and an average interest rate of 3% in late 2018. This leads to a loss of purchasing power of 18 m^2 for households on average incomes. We would therefore be back at 2012 levels, i.e. 61.1 m^2.

Our risk scenario projects an increase of pressure on buyers to take advantage of low rates. This will have no effect on incomes or average loan terms, but would create a price increase of 5.5% for new property and lead to an average rate of 3.6% by the end of 2018. The purchasing power of a household on average income would then be 53.8 m^2 (2010 levels). As a corollary of this forecast fall in purchasing power, growth in demand for property on the part of private individuals is likely to slow down in 2018.

CHART 3

Trends in French household purchasing power in terms of new build real estate, main Coface scenario.

Sources : ACPR, Observatoire Crédit Logement, calculs Coface

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