

## Commentary

# Global Construction 2024 Outlook: Building on Stable Foundations, Despite Headwinds

### Morningstar DBRS

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#### Key Highlights

- Stable outlook due to strong balance sheets, high backlogs, and strong long term demand.
- Sector challenges remain and must be actively managed for margin stability.
- Small players may face prolonged strain through 2024.

Margaret Rabba

Vice President

+1 416 597-7410

margaret.rabba@dbbrsmorningstar.com

Scott Rattee, CFA

Senior Vice President

+1 416 597-7336

scott.rattee@morningstar.com

Timothy O'Brien, CFA

Managing Director

+1 416 597-7364

timothy.obrien@morningstar.com

### 2024 Outlook: Stable

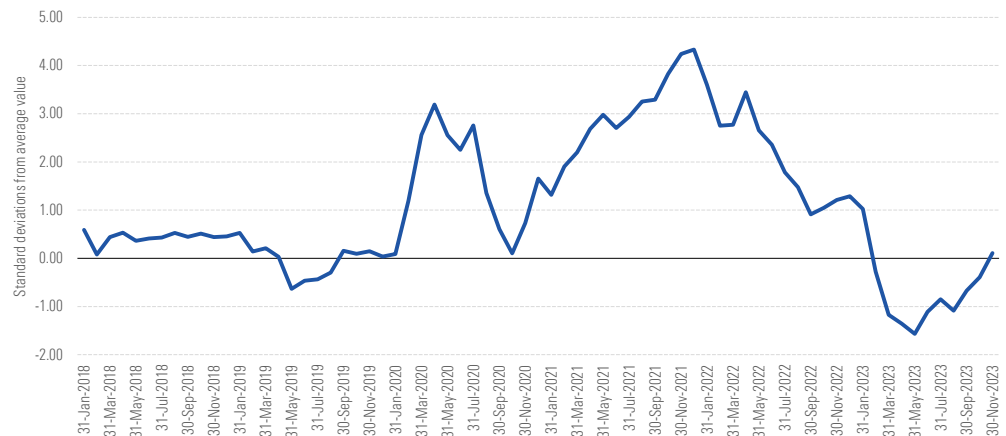
We expect the credit profiles of construction companies within our rated universe will continue to remain supportive of their ratings in 2024. The recent positive dynamics, such as supply chain debottlenecking and moderating input cost inflation, are expected to make for a more normalized operating environment for construction companies, despite continuing to face a weak economic backdrop and inflationary price pressures, including interest rates, labour costs and continuing high construction material costs, along with the shortage of skilled labour.

Spending dynamics are expected to be positive with public sector spending expected to remain strong and outperform that of the private sector. In 2024, we expect moderate revenue growth and stable margin performance as firms remain cautious in their project pursuits while working off their currently strong backlogs. We expect small to medium-size contractors may face greater challenges in this tighter credit market than more globally diversified peers.

### Credit Ratings Are Expected to Remain Stable

Our credit ratings universe largely consists of large-scale national and global players. Barring any issuer-specific project-related challenges, the strong balance sheets, large backlogs, high spending commitments made by public sector counterparties, and favourable long-term demand fundamentals support the stable outlook for our construction firms. Strong backlogs allow firms to continue to be selective with regard to the projects they choose, as they closely pursue projects for which they have a competitive advantage and/or strong long-term client relationships. Coronavirus Disease (COVID-19) pandemic-related project challenges for long-term fixed-price projects that were bid pre-pandemic may continue to affect balance sheets in 2024, but we expect that resolution through continued negotiations with clients, arbitration or litigation will be required to resolve any issues.

The stabilization of supply chains should make project bidding and project execution much easier to navigate in 2024. That being said, significant uncertainty remains as supply chain disruptions, for example, from natural disasters and increasing geopolitical tensions, can result in more volatile input prices. Exhibit 1, the Global Supply Chain Pressure Index, developed by the Federal Reserve Bank of New York, illustrates the monthly supply chain pressures, which have eased considerably since 2022.

**Exhibit 1** Global Supply Chain Pressure Index

Sources: Federal Reserve Bank of New York, Global Supply Chain Pressure Index, <https://www.newyorkfed.org/research/gscpi.html>. Note: Positive values represent how many standard deviations the index is above the average (zero), implying that supply chains are under pressure. Negative values are shown when supply chains are functioning well and experiencing limited disruptions or pressure; i.e., in a normal state.

### Public Sector Spending Is Expected to Continue to Outperform Private Sector

Global public spending to support transit and social infrastructure projects as well as energy transition is expected to remain strong in 2024. As large projects take several years to complete, such public spending provides a healthy degree of near-term stability for large construction companies. Generally speaking, however, public sector work tends to be less profitable than private sector work.

We expect private sector spending will remain subdued due to higher financing costs and stricter lending standards as lenders remain cautious amid rising costs of material and labour as well as the risk of default. Therefore, in 2024, construction firms with heavy reliance on commercial industry (offices, discretionary retail, etc.), could be challenged due to reduced private-sector investment and delayed projects. Construction firms with heavy reliance on the homebuilding sector may find 2024 to be a challenging year as increased interest rates heavily affect home-building activities.

### Revenue and Margin Performance

We expect construction companies in our portfolio (which have a significant proportion of public-sector clients) to have single-digit revenue growth in 2024. As it relates to margins, in 2024 we expect large construction companies to carefully manage selling, general, and administrative (SG&A) costs and, for the most part, be able to pass on higher material costs while carefully managing inflationary labour costs and maintain margins. We expect large firms will continue to prioritize investments in technology, aiming to improve overall efficiency as well as ease workforce and supply-chain challenges. That being said, we anticipate the higher interest rate environment will remain an obstacle and continue to affect capital allocation decisions.

Contractors who traditionally generate a larger proportion of their revenues from private-sector work may see margins deteriorate as their project mix continues to evolve toward more public-sector projects. For construction companies with auxiliary concessionary businesses, we expect to see a more

normalized level of revenue and gross profits as toll road and airport activity complete the recovery from pandemic lows.

**Smaller Players May Face Prolonged Strain Through 2024**

Our credit ratings of small regional contractors without diversification in scope or geography may be pressured in 2024. Notably, those companies working as subtrades for general contractors or private owners are at a heightened risk of revenue impacts from project delays or cancellations.

Liquidity continues to be extremely important for these small players that face longer cash-conversion cycles (often as a result of "paid-when-paid" clauses or lack of payment term negotiating powers). These companies remain very exposed to rising input costs and financing issues, such as pandemic loan repayments and high energy costs amid high interest rates and tight financial conditions. As price is a significant factor in contract awards, in an industry with extremely tight margins, this poses a threat to these smaller companies who may lack the negotiating power with their clients and ability to offer valuable expertise and/or specialized differentiated solutions.

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