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CFMA's Construction Financial Executives Confidence Index

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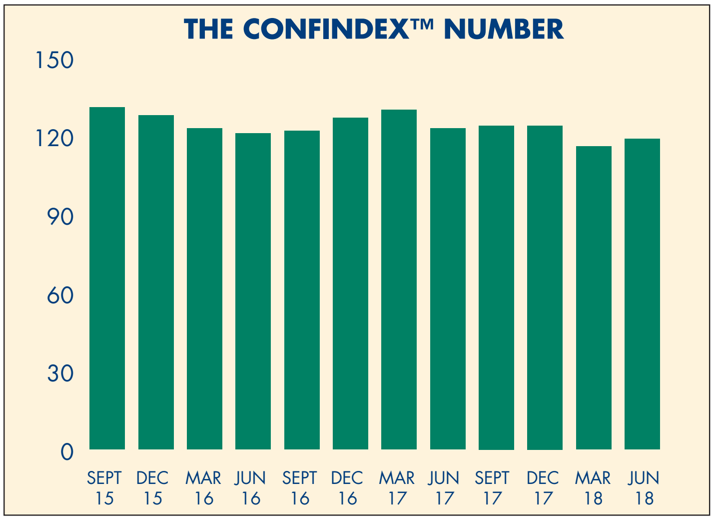
CURRENT CONFINDEX™

119

Since Last Reading

Anirban Basu
CFMA's Economic Advisor

CONFIDENCE REMAINS STABLE DESPITE RISING HUMAN CAPITAL AND MATERIALS COSTS



While the CONFINDEX Overall Confidence Index rose from 116 to 119 during the second quarter of 2018, it is still down 3.3 percent on a year-ago basis. It would be simple to attribute at least some of this wobbliness to the first quarter's winter weather and the fret and turmoil associated with potential trade wars, tariffs, and rising materials prices that characterized the second quarter.

But the downward trend in the Overall Confidence Index has been apparent for more than three years. During the first quarter of 2015, the Overall Confidence Index reached a cyclical apex of 137. Since that time, the Overall Confidence Index has declined by more than 13 percent, despite rising for much of 2017.

As construction spending has been expanding for much of the past three years, the likely explanation lies in rising costs. At the heart of long-lived concern is America's construction skills crisis. Construction industry CFOs continue to bemoan short-staffed subcontractors, the lack of entry by young people into a host of occupational categories, and accelerating rates of retirement among experienced workers. Some openly wonder about the ultimate impacts of emerging immigration policies. In the most recent CFMA survey, 83 percent of survey participants indicated that they were either highly concerned or very concerned by skills shortages. A quarter earlier, this proportion stood at 81 percent.

Addressing Rising Costs Concerns

Concerns regarding rising costs of delivering construction services have broadened significantly in recent months, but not simply because of human capital considerations. Interest rates are on the rise, which means that both construction firms and their customers are facing increased borrowing costs. The Federal Reserve raised rates in June, and indicated at a recent meeting that rates may be increased not once but twice more during the current year. Materials costs have also been surging, including petroleum, softwood lumber, and metals prices.

Despite this, CFOs do not appear to be unduly unnerved. The Business Conditions Index rose 4.2 percent during the most recent quarter and is unchanged from a year ago. More than four in ten (42%) of responding construction executives indicate that their profit margins are significantly better (3%) or slightly better (39%). That's actually better than in June 2017, when unemployment rates were higher and materials prices were lower. Back then, it was 37 percent of survey respondents who had indicated that their profit margins had improved.

The implication is that contractors have generally been able to offset rising costs with higher pricing. Purchasers of construction services are likely aware that construction firms face a combination of rising human capital, borrowing, materials, and other costs. Given a strong economy that is characterized by both aggressive consumer and business spending, many purchasers are not willing to wait for their projects to come online. The demand for immediacy helps support higher charges for construction services.

With ongoing increases in interest rates, including the prime rate, which now stands at almost five percent (up from four percent a year ago), the Financial Conditions Index has been under some pressure. The most recent reading came in at 116, which was up slightly on a quarterly basis (1.8%), but down by nearly six percent on a year-ago basis. That represents the largest year-over-year decline in any of the indices.

While much has changed over the past year, some things have remained the same. Contractors are generally busy, which was also true a year ago. They are generally profitable. They are associated with significant backlog – so significant that some indicate that their current workforce is inadequate to meet the demand. Accordingly, the Current Confidence Index has barely budged over time. On a quarterly basis, the Current Confidence Index rose from 123 to 124, an increase just short of one percent. On a year-over-year basis, this index is down by less than two percent, an indication of relative stability.

The Year-Ahead Outlook Index remains especially revealing. Despite headlines fixated on tariffs and trade wars, this leading index rose nearly six percent on a quarterly basis (108 to 114). While this index is down by approximately four percent on a year-over-year basis, there is little indication that industry circumstances are set to deteriorate substantially over the next year.

Keeping Profit Margins Stable

The environment in which contractors are operating is swirling with change. Evolving policies on trade, immigration, and interest rates are likely to drive the costs of delivering construction services higher. Tariffs are likely to shift materials prices higher. Restrictions on immigration (including legal immigration) will serve to further tighten labor markets, lifting compensation costs in the process. Concerns regarding inflationary pressures will move borrowing costs higher. These views seem to be broadly shared by economists and construction executives alike.

Given this, the only way for profit margins to remain stable is for demand for construction services to remain elevated. With backlog still healthy, many firms appear reasonably well positioned to reckon with rising input costs over the next year. However, as time passes, it may be that CFOs will reveal growing concern regarding the demand-supply equilibrium. Conversely, there may be positive surprises, including those related to much-discussed plans for stepped up infrastructure investment in America.

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A SIMPLE EXPLANATION OF CONFINDEX™

- **The Overall CONFINDEX™ Number**
  - Composite Index Comprised of 4 Sub Indices
    1) Business Conditions
    2) Financial Conditions
    3) Current Conditions
    4) 2018 Outlook – look ahead to June 2019
- ***Measurements Taken Using 8 Questions***
  - Current Business Conditions
  - Future (1 year) Business Conditions
  - Current Bank Credit Availability
  - Future (1 year) Bank Credit Availability
  - Future (1 year) Bonding Credit Availability
  - Line of Credit Status
  - Current Backlog
  - Future (1 year) Backlog
- We calculate indices by taking the "net" of positive responses minus negative responses and adding 100. (Neutral and No Answers are excluded)
- Any index greater than 100 reflects more positives than negatives. Any index less than 100 reflects more negatives than positives.

CONSTRUCTION FINANCIAL MANAGEMENT ASSOCIATION
CFMA

For more information on CONFINDEX™ contact Fern Oram
Director, Content Marketing & Communications • 609-945-2494 • foram@cfma.org