CFMA’s Construction Financial Executives Confidence Index

CFOS CONCERNED BY CYCLE’S SUSTAINABILITY

The U.S. economic recovery completed its seventh year in June—one of the lengthiest recoveries in U.S. history, though not one of the most profound. The construction industry’s recovery has not been quite as long, but based on the latest CFMA CONFINDEX survey, a growing share of construction industry CFOs has become concerned that the beginning of the end of the current cycle approaches.

This is likely due to a combination of quantitative and anecdotal information. Recent nonresidential construction spending data have been lackluster. Construction industry employment declined in both April and May. There are also anecdotes regarding regulators and bankers becoming more concerned about possible overbuilding in certain key construction segments, including multifamily, office, lodging, and commercial markets. Concerns regarding overbuilding are more acute in first-tier markets—New York, Boston, Washington, San Francisco, Miami, and Seattle. These are the markets most likely to attract global capital seeking to be invested in commercial real estate.

There is a conventional wisdom suggesting that commercial real estate is likely to be less problematic than during prior cycles, including during the late 1980s, because bankers have become so cautious in the aftermath of the Great Recession. The idea is that bankers are requiring more equity in individual deals, which makes it less likely that the value of collateral will decline below what is owed.

However, with so much capital flowing into America from underperforming emerging nations - China, Russia, Brazil, and South Africa - and developed nations - Japan and Germany - projects are still able to move ahead in larger numbers. The global search for investment yield in the face of ultra-low interest rates has also induced considerable investment in commercial real estate. This is true for both domestic and international investors. In other words, some meaningful fraction of commercial construction is not being driven by fundamental demand and supply factors, but by the tremendous availability of worldwide investment capital searching for places to land.

This global liquidity has produced many contributors to today’s significant construction volume, including low capitalization rates and low interest rates. However, it also may be sowing the seeds of the next commercial real estate and construction downturn.

The Recovery Continues for Now
This is not to suggest that the current construction cycle is over; rather that CFOs are becoming a bit more concerned regarding its durability. The most recent CONFINDEX Overall Confidence Index reading stands at 121. That’s down 1.6 percent from the previous quarter and nearly eight percent from a year ago. The overall index has been in decline since its cyclical peak achieved during the first quarter of 2015 and is now back at 2012 levels.

The Business Conditions Index (BCI) fell by another 3.2 percent during the second quarter of 2016, and is down by more than 15 percent over the past year. This represents the largest year-over-year decline in any of the indices. Still, at 122, the BCI is up 94 percent from December 2008’s reading of 63. The BCI reflects many factors, including the cost of delivering construction services. CFOs have become more alarmed by the ongoing shortage of human capital. Nearly four in five (79%) CFOs are very or highly concerned by construction skills shortages, up from 73 percent the prior quarter.

The Current Confidence Index, which provides a sense of how CFOs feel about the very near-term, rose 1.6 percent during the second quarter, making it the only sub-index to experience an increase in value on a quarterly basis. The index is down 4.4 percent from a year ago, but still consistent with the notion that the typical contractor is busy and will stay that way in the immediate future. By contrast, the Year-Ahead Outlook Index slipped 5.1 percent during the quarter (from 117 to 111) and is down by nearly 13 percent on a year-over-year basis. It is this sub-index more than any other that suggests that CFOs are becoming increasingly wary regarding how long this period of elevated construction activity can last.

Related to this are perspectives on profit margins. During the most recent CONFINDEX administration, 30 percent of CFOs expressed the view that profit margins will be significantly better or slightly better a year from now. During the prior quarter, the corresponding proportion was 41 percent.

While this may at least partially reflect a view that demand for construction services may not be quite as strong a year from now, it also likely reflects the pressure that rising wages are imposing upon margins. Despite construction employment losses in both April and May, the construction unemployment rate has continued to fall. Construction firms continue to report large-scale shortages in a number of occupational categories, including estimators, project managers, electricians, and carpenters.

The most stable sub-index in the Financial Conditions Index: unchanged during the second quarter of 2016 and down by less than 1 percent over the past year. This stands for the proposition that money is still available, including equity capital.

It is not clear whether, or to what degree, the current election cycle has impacted CFO perspectives on the year ahead. It is said that financial professionals dislike uncertainty, and the current election cycle is presently supplying plenty of it. That said, the decline in the overall CONFINDEX began before the presidential election or other elections emerged as front and center in the media and in the national conscience.

Concerns Become More Apparent
While many construction firms continue to report lengthy backlog, which essentially shields them from harshly negative outcomes over the near-term, concerns regarding how long the current construction recovery will last have become more apparent. The CONFINDEX reading has been in steady decline for five quarters, with the Year-Ahead Outlook Index representing a primary contributor to the overall index’s decline. Moreover, for the first time in many months, contractors are also facing the prospect of rising materials prices, which threaten to further curtail profit margins.
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) 2017 Outlook – look ahead to June 2017

• 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.