Construction CFOs Remain Cautiously Pessimistic

Confindex Fails to Rebound Meaningfully

Confindex during the second quarter of 2019 will be remembered for what failed to happen as opposed to what did. During 2019’s initial quarter, Confindex continued a collapse that began in 2017, but which gained momentum in late-2018. The first quarter reading on Confindex was the lowest in many years (2012). Many construction CFOs have been unnerved by the combination of rising costs of delivering construction services and a sense that the current construction expansion is approaching its conclusion. This dynamic would tend to squeeze profit margins.

But such bouts of doubt have occurred in the past, often during the end of calendar years. The tendency during much of the current cycle has been for a decline in Confindex to be followed almost immediately by a rebound in Confindex as the worst of CFO fears are not realized.

This served to shape expectations for second quarter Confindex. With the U.S. economy registering 3.1 percent growth on an annualized basis during the first quarter of 2019 and with construction spending data remaining strong, particularly in a handful of public construction segments, one anticipated a forceful rebound in Confindex.

That did not transpire. While the Overall Confindex rose 1.8 percent to a reading of 111 during the second quarter, it remains down nearly 7 percent from a year ago. There wasn’t much movement among subcomponents either. The Business Conditions Index was unchanged during the second quarter and stands at 102. Among all of the Confindex subcomponents, this index has experienced the sharpest decline, falling nearly 18 percent over the past year. This index captures many factors shaping business performance, including the ongoing and growing shortage of skilled labor.

The Financial Conditions Index rose 2.6 percent during the second quarter (to 118), but is still up less than 2 percent on a year-ago basis. Many CFOs indicate that there is still plenty of capital available to finance construction firm operations and new construction projects.

However, while demand for construction services is positioned to remain elevated over the near-term, that in and of itself fails to guarantee profitability. To the extent that cost growth outstrips pricing power, profit margins will be squeezed. Accordingly, the Current Confidence Index, which reflects views regarding near-term prospects in the U.S. construction industry, declined 3.3 percent to a reading of 117 during the second quarter. Current Confidence is down nearly 6 percent on a year-ago basis.

This comports neatly with expectations regarding profit margins. Fully 38 percent of CFOs indicate that their profit margins have been improving recently (4% significantly better; 34% slightly better). However, when CFOs consider margins a year from now, only 20 percent expect them to be better, with only 3 percent anticipating that they will be significantly better. Many CFOs appear to believe that margins will be flat. About 31 percent of CFOs currently indicate that their profit margins have been flat recently. But when these same respondents consider the next year, 58 percent believe that their margins will be the same as they are now.

The implication is that given backlog and current industry momentum, CFOs expect that their firm’s services will be in demand. But any expansion is profit margins associated with that demand will be roughly offset by rising costs, whether compensation or materials costs. Only 4 percent of CFOs indicate that they are not concerned at all about skills shortages. Nearly four in five CFOs indicate that they are highly concerned or very concerned by skills shortages. There are also a growing number of CFOs who expect that construction materials prices are set to deteriorate after a period of surprising stability.

Looking Ahead

Interestingly, the one index subcomponent that bounced back with some vigor during the second quarter was the Year-Ahead Outlook Index. That index now stands at 103, up 8.4 percent from the previous quarter. But even in this category, recovery is far from complete. The Year-Ahead Outlook Index remains nearly 10 percent below its year-ago level.

Based on a variety of comments, many CFOs expect the current growth cycle to end within the next two years. Oddly enough, it is in part the current strength of the industry that could itself contribute to the cycle’s end. The notion is that construction is becoming too expensive for many prospective buyers of construction services. Ultimately, this will translate into lower demand. Of course, many construction CFOs are also concerned about broader macroeconomic forces in light of the fact that many economists and businesspeople are predicting the onset of recession in the U.S. sometime next year.
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) Year Ahead Outlook – look ahead to June 2020

• 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.