CFO CONCERNS REMAIN WITH SOURCES OF WORRY CONTINUING TO SHIFT

Demand Expands, but Future of Profitability at Issue

Macroeconomic data have been generally upbeat. The nation has added nearly 2.5 million jobs over the past year. The average quality of jobs being added has been improving, with job growth in middle-wage construction, manufacturing, and professional services accelerating recently. The economy expanded by a better than 4 percent annualized rate during 2014’s second quarter and the balance of the year is shaping up to be decent given recent increases in consumer confidence and promising trends in industrial and energy production. Financial market performance has remained generally positive despite a recent uptick in volatility and worrisome geopolitical events.

More to the point, nonresidential construction spending has been on the rise. In July, nonresidential construction spending was up 8.6 percent on a year-over-year basis. Construction employment nationally has expanded by roughly 4 percent over the past year, or roughly twice the rate of job growth recorded by the balance of the U.S. economy.

Correspondingly, one might expect CFOs to be overjoyed and laden with optimism. They are not, at least according to third quarter data. During the most recent reading of CFMA’s CONFINDEX, the Overall Index slipped from 129 to 127 on a quarterly basis and is unchanged from a year ago. The overall sentiment seems to be that demand for construction services continues to rise, but the pace of improvement is perhaps falling a bit short of previously forged expectations.

As a result, the Business Conditions Index declined 4 percent during the third quarter from 149 to 143. The Index is up less than 1 percent on a year-over-year basis. While the Financial Conditions Index rose 0.9 percent during the quarter (113 to 114), it is unchanged from a year ago. The Current Confidence Index expanded 0.8 percent during the most recent survey, rising from 124 to 125. The index is up 4.2 percent from a year ago, the largest year-over-year increase of any Index and an indication that demand for construction services will continue to firm.

However, the 2015 Year-Ahead Outlook Index fell 4.4 percent during the third quarter, dipping from 136 to 130. That represents the largest quarterly decline among the indices. This key Index reading is also down 3.7 percent from a year ago perspective, the largest year-over-year decline in any of the indices.

How does one reconcile expectations for demand growth with a declining Outlook Index? Simple – the work to come may not be particularly profitable. At the heart of the matter are skills shortages. The issue of skills shortages has, of course, been a central focus for years, but the most recent survey indicates that construction markets have now recovered sufficiently to convert theoretical concerns into actual impact. During the second quarter of 2014, 62 percent of surveyed CFOs indicated that they were very or highly concerned about skills shortages. Just one quarter later, that figure had ballooned to 72 percent.

Given that most construction firms continue to report slender margins, prospects for significant construction wage inflation have alarmed a number of CFOs. The result is that construction revenues appear poised to expand faster than construction profits, at least among many firms. Fully 86 percent of surveyed CFOs expect profit margins to be roughly the same or only slightly better than they are now, despite a common belief that the volume of work is set to expand meaningfully.

In addition to prospects for wage inflation, there are also prospects for input price inflation, particularly given increasingly stormy geopolitics. Forty-seven percent of CFOs expect input prices to be slightly worse a year from now, through only 1 percent expect them to be significantly worse. Another 47 percent expect materials prices to be the same one year from now. A handful of CFOs also have become concerned about the direction of interest rates.

While CFOs express much concern regarding costs during the year-to-come, to date, profit margins have generally been improving. Forty-three percent of respondents to the most recent survey indicate that profit margins have improved recently. However, virtually no one is reporting “significantly better” profit margins. The conventional wisdom is that margins are only “slightly better”.

Similar to prior quarters, to the extent that demand is a concern, much of it relates to public spending. There was also concern regarding bank financing for construction firms, though CFOs broadly believe that financing for developers has generally become more plentiful.

All told, third quarter survey data indicate that CFOs remain on edge, though the source of primary concern has largely shifted from demand considerations to ones of cost. The extent to which skills shortages translate into rising hourly costs and slender profit margins remains to be seen.
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) 2015 Outlook – look ahead to September 2015

• 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.