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FOCUS ON

Are we born or do we become explorers? Risks and opportunities in the portfolio strategy of Italian construction companies

Produced by the Economic Analysis and Research Office

Executive summary

- **The percentage of turnover generated abroad by Italian contractors has increased considerably in recent years**, rising from 3 billion euro in 2004 (31% of the total) to 14 billion euro in 2016 (73% of the total). Besides intercepting an unprecedented and perhaps unrepeatable increase in demand by new markets (in a phase of crisis on the domestic side), **the works portfolio of these companies has expanded above all in areas with high-risk opportunities and medium-high risk showing significant margins, as well as on contracts of considerable amount**.

- **Italian companies have traditionally positioned themselves in markets that are often peripheral, but yet to be explored**, partly overlooking the opportunities for growth offered by investments and infrastructures planned in developed and nearby countries. The top 15 countries for global construction investments, equal to 75% of the market, represent in fact less than 20% of the works portfolio of Italian companies.

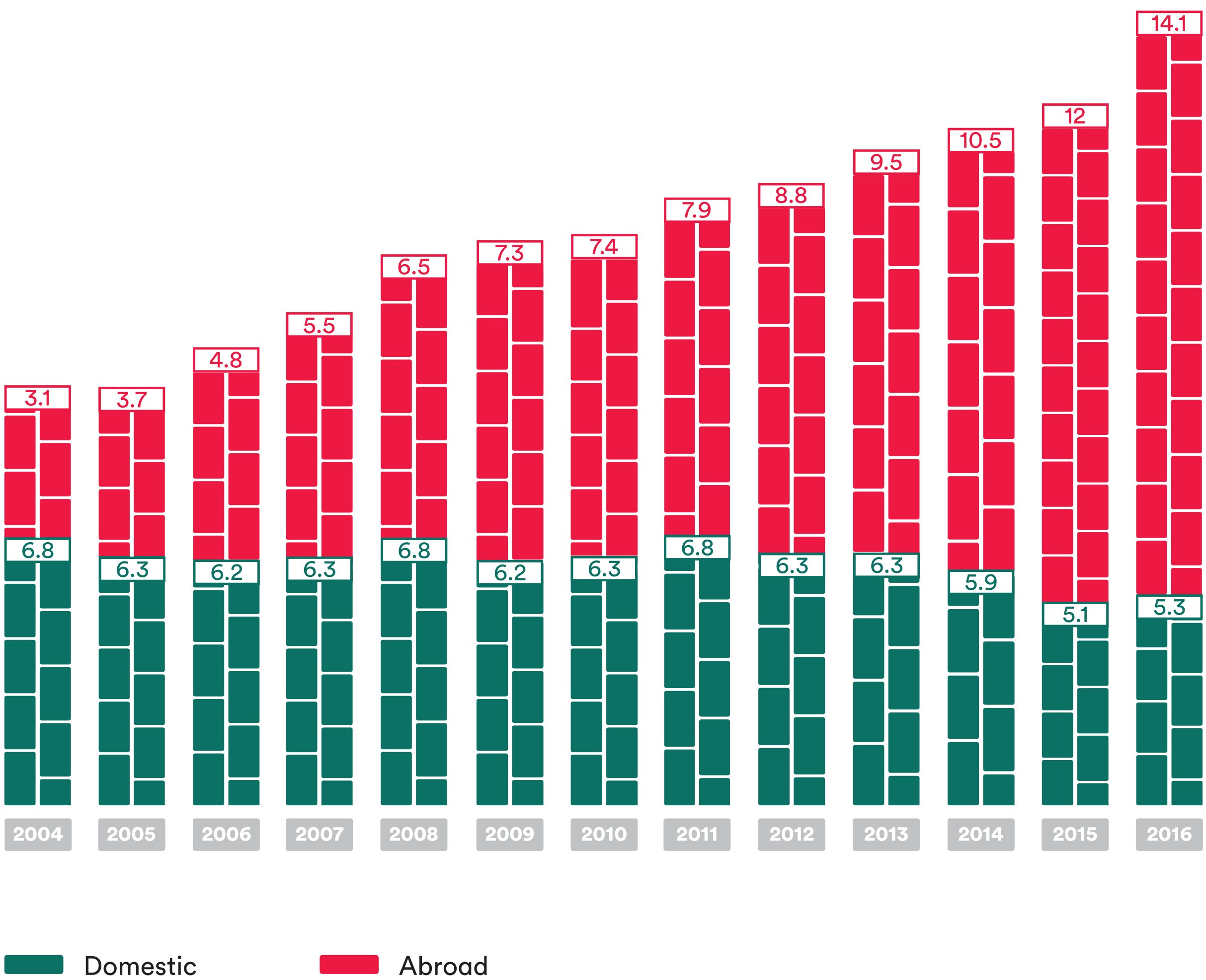
- We have classified Italian companies in this sector into **three categories, based on the characteristics of their operations abroad: the "Christopher Columbus"** that intervene in high-risk contexts, the **"Amerigo Vespucci"** that operate in medium-risk geographic areas and, finally, the **"John Cabot"** that compete in developed and more reliable markets. The latter are certainly a minority, while the Italian presence in countries which are strongly exposed to the volatility of international investment flows and still dependent on raw materials, remains high. Also geographic areas characterised by a relatively stable regulatory framework, credible public-private investment plans and good growth prospects remain unexplored and require, in some cases, system support to reduce entry barriers.

- These considerations become even more significant if we consider that **in 2017 construction investments showed a recovery also in developed markets, with a reversal of the growth trend of emerging markets**, which went back below 60% of global demand. Within the framework of investment optimisation in these geographic areas, infrastructures show a higher resilience than other sectors. **In this sector we often see the direct intervention of public entities and, to access the necessary financing, the sovereign guarantee of the country in which the work is carried out is needed**. Therefore, it will be essential to keep the focus on the country risk of the geographic areas concerned, using the most appropriate protections.

A riskier positioning in a consolidating market

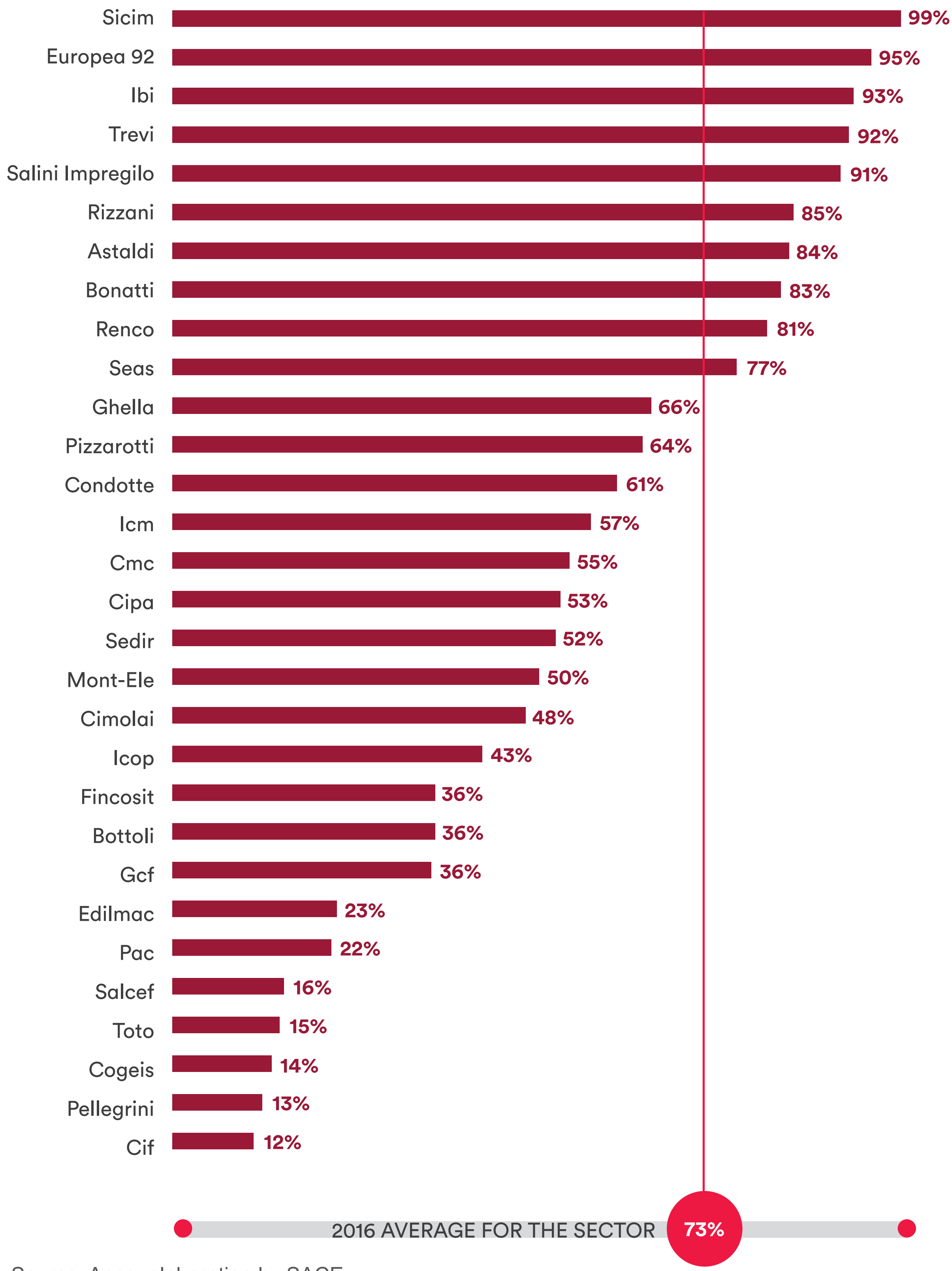
For some years now, Italian contractors' financial statements have shown a greater percentage of turnover generated abroad (Fig. 1). **The average percentage of turnover generated abroad by Italian companies in this sector grew from 31% in 2004 to 73% in 2016** (Fig. 2), above the global average of companies of the sector (around 66%).

FIGURE 1. Breakdown of turnover of Italian construction companies (2004-2016), billions of euro



Source: Ance (Italian association of construction contractors), elaboration by SACE

FIGURE 2. Main Italian contractors' percentage of turnover generated abroad in 2016



Source: Ance, elaboration by SACE

In view of the fact that national companies have become entrenched in some markets which in the past recorded particularly attractive economic returns (and which were also historical landmarks in political and cultural terms), **emerging countries have become a good outlet for Italian companies in this sector in a phase of sharp contraction in domestic demand. However, it is necessary to go back to distinguish between high-risk contexts and medium-risk geographic areas with a good expected profitability and a more developed regulatory and industrial framework**. So far, the latter appear less explored.

By adopting the explorer metaphor, we have classified the Italian companies in this sector into three categories, based on the characteristics of their operations abroad: the “Christopher Columbus” that intervene in high-risk contexts, the “Amerigo Vespucci” that operate in medium-risk geographic areas and, finally, the “John Cabot” that compete in developed and more reliable markets.
The fact that several Italian companies of this sector can be included in the first group in several cases has entailed - despite a consolidated local presence and a recognised leadership - delays in works, increased expenses, cancellation or postponement of major projects and difficulties to be repaid, with a consequent deterioration of the operating indices and execution times. For example, the parameters relating to the final costs of projects and their punctual completion have worsened from 2015 to 2017 respectively by 25% and 67% in Kenya and by 10% and 31% in Ethiopia. Those relating to financing cost with respect to infrastructure projects in Russia worsened by 41% since 2014[1].

The positioning of Italian companies in the sector appears to be in line with the global market only in Latin America where, except for Venezuela, **interesting opportunities are opening up**, for example in Brazil, following also the events that involved the main local operators. **The Italian presence is above average in Africa and the Middle East, while it remains below the global average in the Far East, Europe** (EU and non-EU, also due to the lower weight of domestic demand) **and the NAFTA area. Russia**, which we have included among medium-high risk markets, **deserves a separate consideration due to the deterioration of financing conditions**, resulting from international sanctions, and to the concentration of Italian companies’ works portfolio (3.5% of the total against 1% of global investments). This figure shows an **overexposure with respect to competitors**, but it may also be the result of delays in completing some works.

[1]Source: Business Monitor International (Fitch group)

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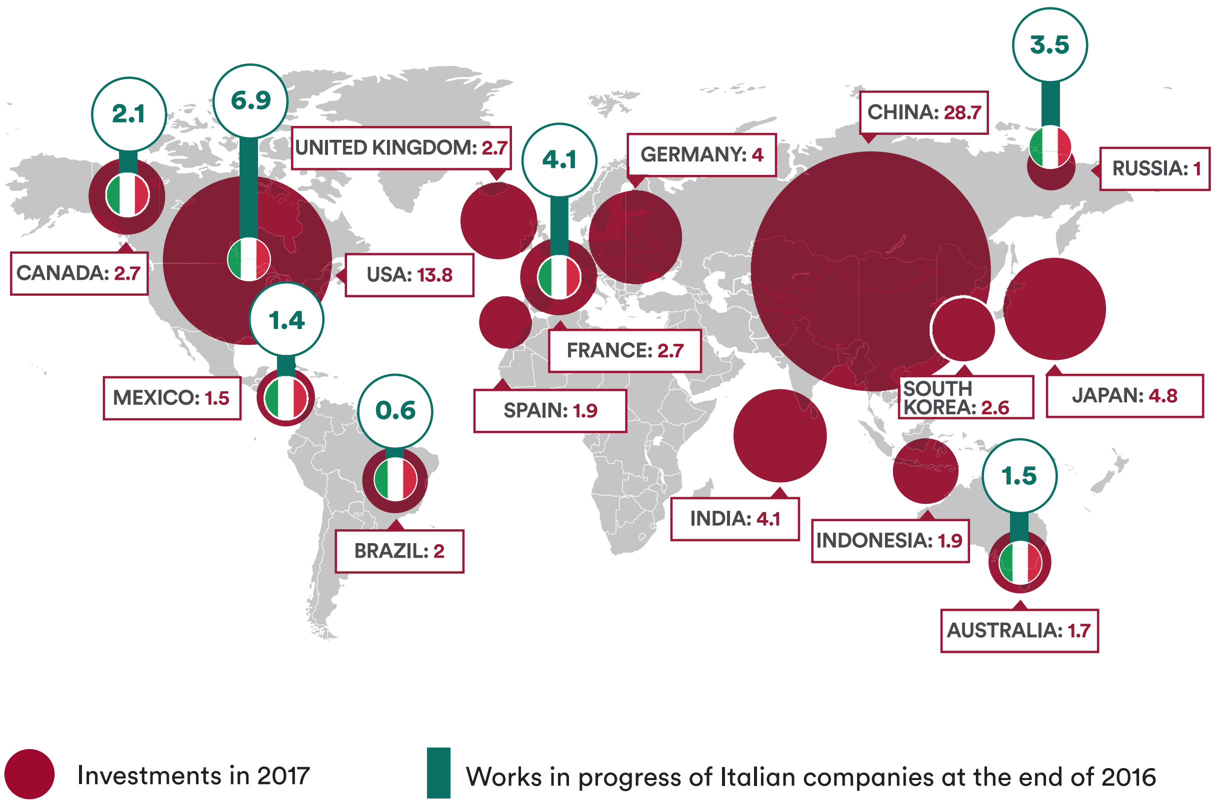
	The “Christopher Columbus”	The “Amerigo Vespucci”	The “John Cabot”
WHO ARE THEY	They are companies operating in the frontier market: geographic areas that are strongly exposed to the volatility of international investment flows, with a large unexpressed potential and which remain highly dependent on raw materials.	They are companies operating in speculative-grade countries: markets characterised by a relatively stable regulatory framework, credible public-private investment plans and good growth prospects. Foreign operators may encounter difficulties in entering these markets, where a support from the system is needed.	They are companies that compete on investment-grade markets: high-income countries where significant and realistic infrastructural initiatives are being developed, towards which the industrial system’s efforts should be addressed. They are highly competitive markets in which the size and the managerialisation of the company make the difference.
COUNTRY EXAMPLES	Algeria, Argentina, Ethiopia, Iran, Kenya, Russia	Brazil, Philippines, India, Indonesia, Malaysia, Mexico, Peru, Vietnam	South Korea, Germany, Poland, Czech Republic, Spain, USA
IN FIGURES: Average percentage of companies in the sector in the portfolio	18%	5%	8.7%*
IN FIGURES: Percentage of investments in the sector in 2017 on the total	3.4%	9.8%	25.1%**
IN FIGURES: SACE average credit risk	70	49	25
IN FIGURES: SACE average political risk	64	47	18
SOME EXAMPLES	Combined-cycle power plants, gas pipelines, energy transmission, renewables.	Off-grid renewables, local public transport, port and airport infrastructures, shipbuilding.	Upgrading of existing works, high-speed railways, social housing, energy reconversion.

* excluding USA: 1.8%
** excluding USA: 8.5%

Where are sailors going? Italian construction companies and demand markets

If we consider the top 15 countries in the global construction sector with respect to investments expected in 2017, amounting to 75% of total global investments, it emerges that these markets represent less than 20% of the works portfolio of the companies included in the Ance sample (Fig. 3).

FIGURE 3. Main countries for construction investments in 2017 and works in progress of Italian companies in the sector, %



Source: Cresme, Ance, elaboration by SACE

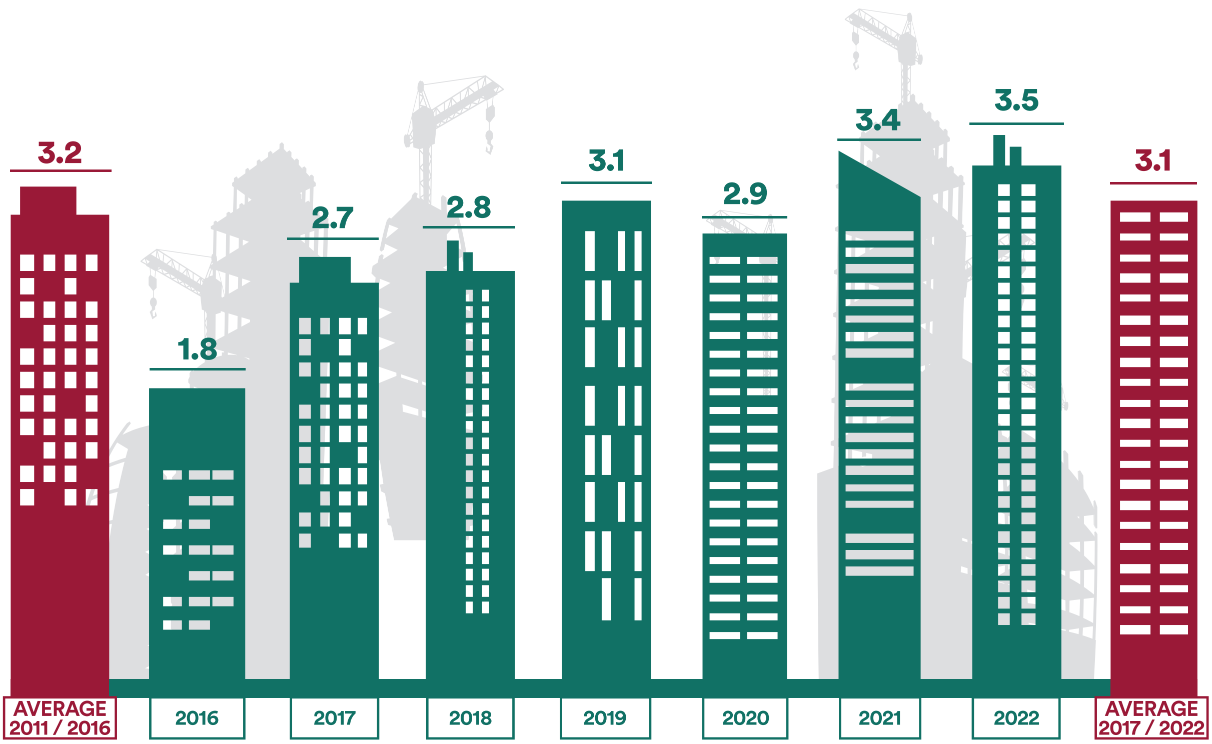
This characteristic of the Italian presence indicates an historical difficulty in penetrating mature and less risky markets, but often with excellent potential: the United States (where the works portfolio before 2016 is smaller, for example, than in Ethiopia), Germany, Spain, United Kingdom, South Korea, Japan.

These countries have a fierce competition from domestic conglomerates, entry barriers or particularly high minimum requirements for participating in tenders.

However, a more rigorous selection of counterparties and the launch of large projects are bringing balance to the sector. **A decrease in the average riskiness of Italian contractors' portfolios is already underway, and some companies are changing their positions**, not without efforts, towards a more cautious exploration approach.

The greatest competitive pressure on these markets is also linked to the slowdown in demand. In 2016, **growth in construction investments stopped at 1.8%** (Fig. 4), slightly more than half of global GDP growth (3.2%). **In 2017 it should have re-approached the average for the 2011-2016 period**, which will however remain unapproachable until 2021 (as well as the pace of GDP growth).

FIGURE 4. Change in worldwide construction investments, %

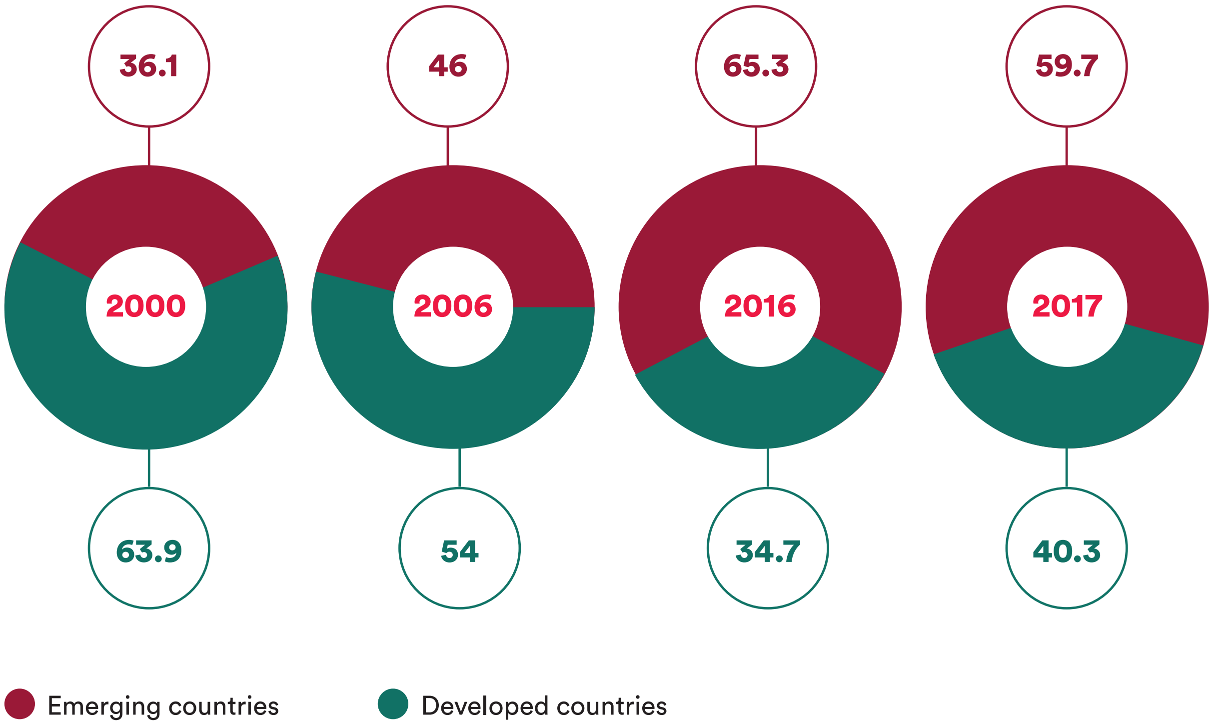


Source: Cresme, elaboration by SACE

The slowdown does not only relate to a minor additive effect on mature markets, i.e. a search for solutions that are less expensive, more attentive to environmental impacts and energy efficiency, and possibly concerning the redevelopment of existing assets. **The lower growth also derives, if not above all, from the slowdown in spending in medium-high risk markets**.

After a significant growth of the percentage of investments by emerging countries between 2000 and 2016 (from 36% to 65% of the total), in 2017 there has been a trend reversal, with developed countries rising again to 40% of total investments. If it is therefore unavoidable that emerging markets invest in construction to bridge the infrastructural gap, **in the long run the trend appears to be a slow re-balancing**, also because the percentage of global GDP attributable to emerging markets in 2017 still amounts to 39.5% (source: IMF).

FIGURE 5. World percentage of construction investments by economic development level, %



Source: Cresme, elaboration by SACE

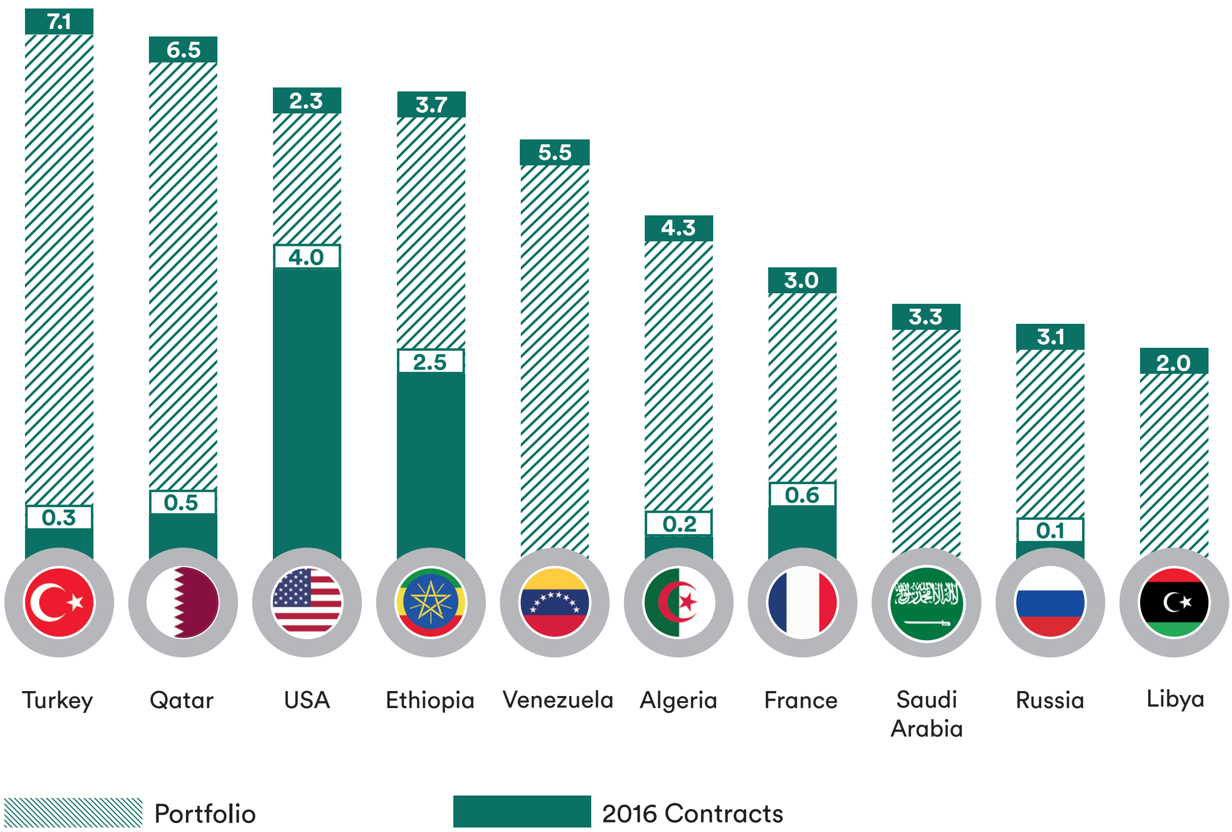
In this scenario, contracts won by Italian companies in 2016 increased by more than 20%, for a total of 20.8 billion euro, mainly due to an increased demand from OECD economies[2], which represent 46% of the orders acquired during the year (42% in 2015). The percentage of contracts from G-20[3] countries also increased by 1.7% (from 32.7% to 34.4%), demonstrating the lower attractiveness of high-risk markets. So, **although rather tentatively, Italian companies' repositioning effort has begun, but - based on what we see globally - it is not enough**.

[2]OECD countries are: **Australia**, Austria, **Belgium**, **Canada**, **Chile**, South Korea, Denmark, Estonia, Finland, **France**, Germany, Japan, **Greece**, **Ireland**, Iceland, **Israel**, **Italy**, Latvia, **Luxembourg**, **Mexico**, **Norway**, New Zeeland, **The Netherlands**, **Poland**, Portugal, **United Kingdom**, **Czech Republic**, **Slovak Republic**, Slovenia, Spain, **United States**, **Sweden**, **Switzerland**, **Turkey**, **Hungary** (the countries in which Italian companies are present are highlighted in bold, source: Ance).

[3]G-20 countries are: **United States**, Japan, Germany, **France**, **United Kingdom**, Italy, **Canada**, **Russia**, **China**, **Brazil**, **India**, **Australia**, **Mexico**, South Korea, Indonesia, **Turkey**, **Saudi Arabia**, **Argentina**, **South Africa**, European Union (the countries in which Italian companies operating abroad are present are highlighted in bold, source: Ance).

A demonstration is also given by the analysis of contracts won compared to the existing portfolio (Fig. 6), equal to 90.7 billion euro at the end of 2016, which does not show significant increases in several markets which were considered very attractive in the past. However, the figure includes works that are experiencing delays with respect to the originally agreed deadlines (Libya, Venezuela).

FIGURE 6. Major countries for works in progress by Italian companies, billions of euro



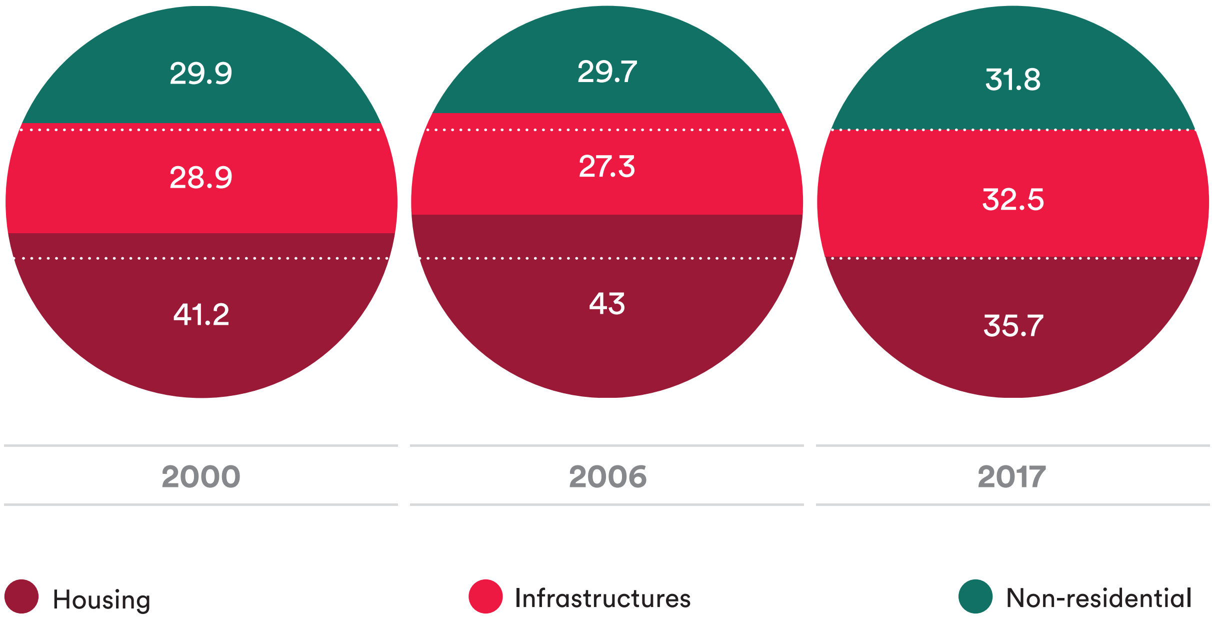
Source: Ance, elaboration by SACE

Just to give some examples, according to McKinsey & Company, Turkey, after China, is the G-20 economy where infrastructure spending increased more in the aftermath of the financial crisis. In 2017, per capita spending in the construction sector was just over 2 thousand euro, amounting to 8.7% of GDP. For comparison purposes, in Italy this percentage is 9.7% and in Brazil 9.8%. In Algeria, cement consumption grew by an average 10% per year in the three-year period 2012-2014, and remained virtually unchanged over the following two years, as in other African countries. The five-year plan approved in 2014 provided for investments of 215 billion dollars, but the halving of oil revenues resulted in the halving of growth estimates for the sector. Final costs and execution times remain below the average of this region and of neighbouring markets such as Morocco.

Not just “where”, but “what” to build: from housing to infrastructures

In 2016, despite the slowdown in demand by some emerging countries, which remain characterised by a large infrastructural deficit, **the trend clearly appears to favour a rebalancing of the market from the housing sector to non-residential and civil engineering sectors** (Fig. 7).

FIGURE 7. Breakdown of world market by type of construction, %



Source: Cresme, elaboration by SACE Studies Office

On the other hand, **infrastructures are historically driven by regional development banks and multilateral institutions** (such as those included in the scope of the World Bank) and typically fall within sustainable lending granted to countries receiving help from the International Monetary Fund. This kind of lending can be obtained provided that it is directed to priority works for economic and social development of the country concerned, and it is usually supported by a sovereign guarantee. **Therefore, in a context of weak growth the progress of infrastructures should be stronger compared to the other sectors.**

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Boost and attention for a priority sector of the country: SACE SIMEST support

Construction has always been an essential driving sector within Italian economy, both in terms of employment and contribution to GDP: **it has been estimated that an additional million euro invested in the sector generates, directly, indirectly and in related industries, the activation of 14 jobs in Italy, besides 990 thousand euro of GDP**. However, it is necessary to readjust its course towards growing geographic areas, not yet adequately explored, and which can become the "sustainable" centre of gravity for companies that legitimately wish to increase their percentage of international revenues.

We often look at SACE SIMEST as a partner for growth in particularly difficult markets, but the support given to the sector is not intended just for the "Christopher Columbus" or to quickly and effectively interface with financial partners, multilateral institutions and development banks. Entering or expanding into markets that provide greater opportunities also means dealing with contexts that are less risky, but difficult to penetrate and characterised by high competition, such as those of the "Amerigo Vespucci" and "John Cabot" companies. **In addition to the typical protection against commercial and political risks in high-risk countries, SACE offers the possibility to directly finance a foreign counterpart with competitive credit lines for the purchase of Italian products and services and to improve the project liquidity with the transfer of receivables without recourse along the supply chain**.

Technical and construction skills, but also a good basket of financial-insurance solutions specifically devised for the destination country, mark the difference between dealing with easy and impossible markets.

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