OUTLOOK RESEARCH

MOODY'S
INVESTORS SERVICE

Construction – Global

2018 Outlook

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2018 Global construction outlook - stable

Demand in US/APAC balances modest growth in Europe

NEGATIVE ← **STABLE** → **POSITIVE**

What could change outlook to negative

- Signs of slowing organic revenues over the next 12-18 months
- Shrinking order backlog (book-to-bill below 1.0x)
- Lower infrastructure spending and/or slowdown of existing construction works

STABLE

- Organic revenue growth flat to 6%; book-to-bill of at least 1.0x
- Many projects under construction support revenue growth; competition constrains margins
- Several opportunities due to expanding renewable energy and transportation infrastructure, but public spending remains constrained in some regions

What could change outlook to positive

- Organic revenue growth in excess of 6% over the next 12-18 months
- Growing order backlog (book-to-bill at least 1.25x)
- Stable or improving operating margins (e.g. accelerating infrastructure spending, construction works)

Note: A negative industry outlook indicates our view that fundamental business conditions will worsen. A positive outlook indicates that we expect fundamental business conditions to improve. A stable industry outlook indicates that conditions are not expected to change significantly. Since industry outlooks represent our forward looking view on conditions that factor into ratings, a negative (positive) outlook indicates that negative (positive) rating actions are more likely on average.

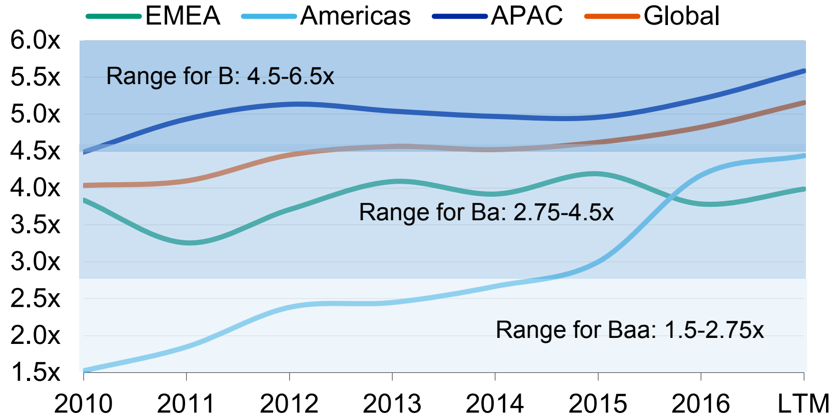
Supportive growth drivers to be sustained in 2018

Key credit themes

- » Increased infrastructure and private sector investments on the back of low interest rates fuel sector-wide revenue growth of 0%-6% over the next 12-18 months
- » Recovery in the energy and mining sectors (LatAm, Middle East) as commodity prices stabilize
- » Moderate growth in Europe with differences across major countries
- » Private residential and government policies (e.g. FAST Act) spur volumes in North America
- » Highest growth in APAC driven by China, but likely below record levels seen in recent years
- » High debt leverage across the sector with signs of stabilization
- » Continued focus on asset disposals supports deleveraging, but unstable macro/geopolitical conditions in some regions pose risk
- » Liquidity remains a constraint for some southern European/LatAm construction companies

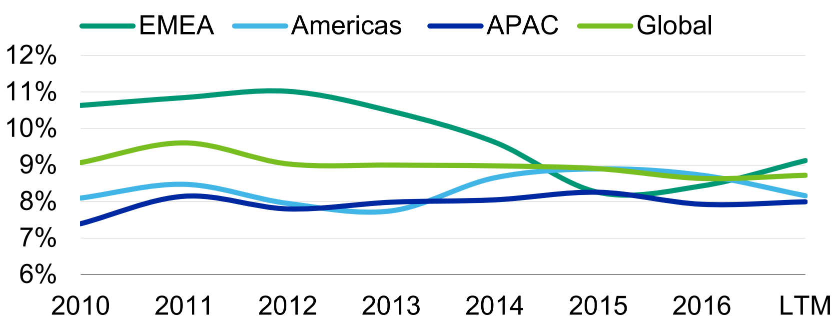
Weaker credit profiles driven by APAC

Debt / EBITDA evolution



Ranges relate to Moody's Global Construction Methodology, Factor 3; expectations for individual ratings may be different, considering all other rating factors

EBITDA margins

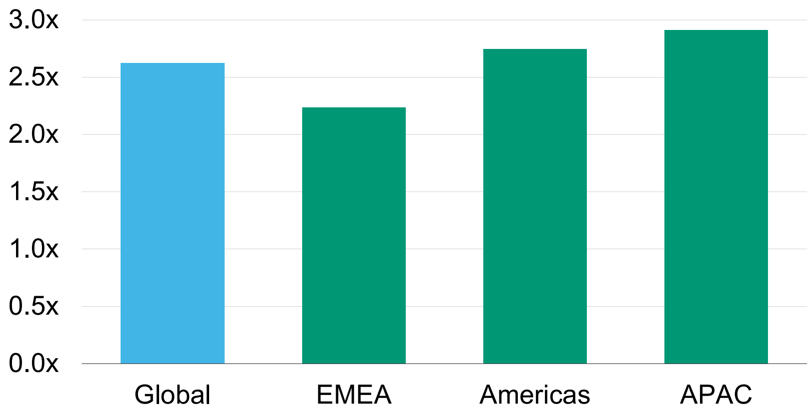


All ratios are calculated using Moody's standard accounting adjustments, based on consolidated numbers, Ratios only include companies rated by Moody's
Source: Moody's Investors Service

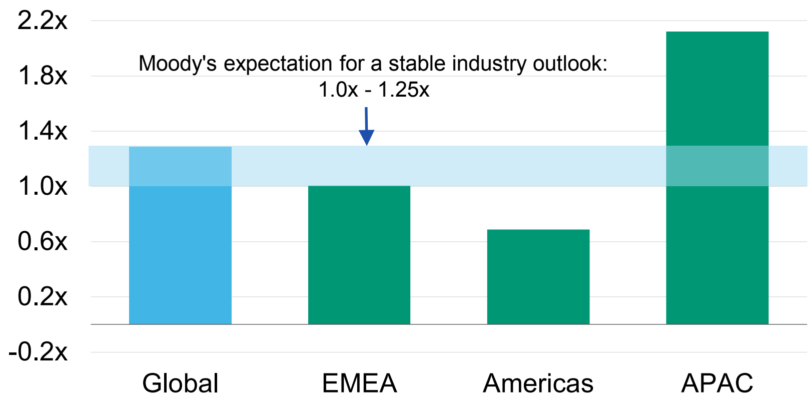
- Further increased leverage across the sector, driven by APAC and LatAm, but expected to stabilize in 2018
- Increased focus on debt reduction and capital spending, supported by asset disposals and capital increases
- Volatility in credit profiles and frequent rating actions likely to persist; potential further divergence of credit quality of higher- and lower-rated companies
- Low but relatively stable EBITDA margins in the mid to high single-digits globally; higher margins of EMEA-based companies due to more asset-intensive business models (especially concession assets); more aggressive bidding activity for new (more risky) projects could pose risk for more weakly positioned companies
- Potential corporate governance issues may put ratings stability at risk for individual companies

Solid order backlog underpins growth

Construction Order Backog / Construction Revenue



Book-to-Bill Ratio



Source: Company data, Moody's Investors Service, calculations as per 30 June 2017

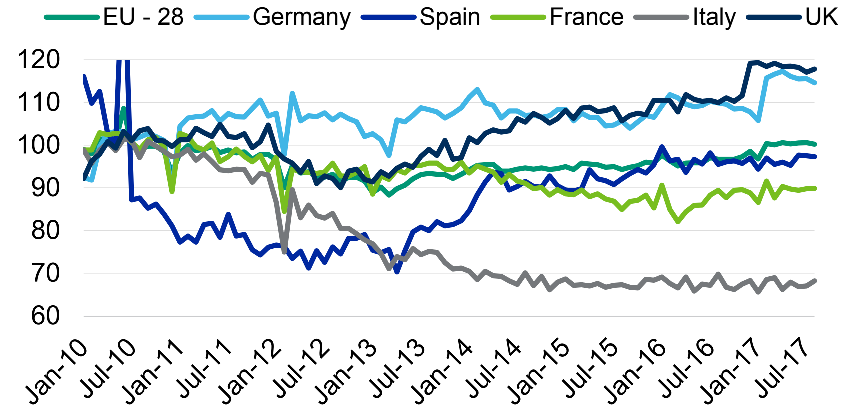
- Good order backlog of over two years of revenues provides some visibility on earnings and cash flows
- Companies with a high order backlog are less dependent on winning new orders and can focus more on profitability than others
- Around 1.0-1.25x book-to-bill ratios on at least stable revenues seen as ideal from a credit perspective, as revenue is sustained and growth manageable
- Aggregate global book-to-bill ratios in H1-17 just exceed our range for a stable outlook, driven by APAC, but are expected to normalize during 2018
- Whilst book-to-bill in EMEA has been close to our expected range, new orders in APAC suggest further above-average growth in the region
- Corruption investigations and fiscal consolidation in LatAm resulted in a low backlog renewal rate, while US-based companies have averaged around 1.0x

Modest growth in EMEA

Moderate GDP growth, higher construction spending in EU

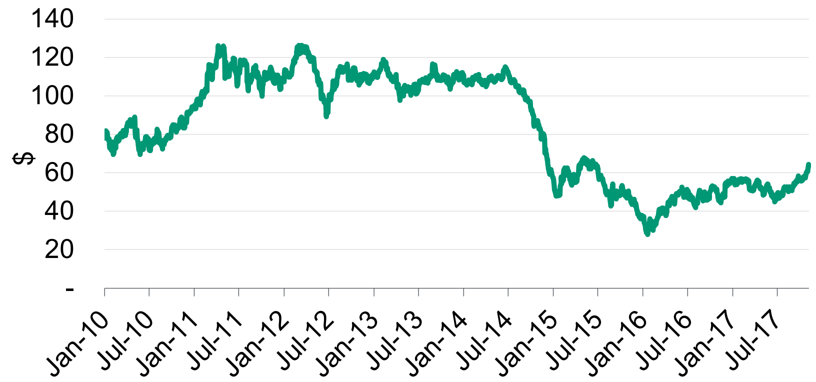
- Overall low-single-digit growth expected in the EU, with mixed regional trends:
  - Low to mid-single-digit expansion in France, after several years of contraction; growth acceleration in Spain after a dull H1-17
  - Italy expected to stabilize during 2018, but sustained recovery remains questionable
  - Robust construction activity in Germany to continue at more normalized levels in 2018
  - Construction works in the UK likely to slow down in 2018 amidst Brexit uncertainty
  - Depressed volumes in Russia to stabilize in 2018 with the country's exit from recession
- Middle East: Political risks in some regions weigh on investment spending, but moderate growth likely in some areas as oil prices stabilize
- Increased M&A activity in Europe expected (e.g. recent takeover bids for Spain's Abertis)

Production Volume



Source: EuroStat, monthly production volume in construction sector, seasonally adjusted, 2010=100

Brent oil price, $/bbl

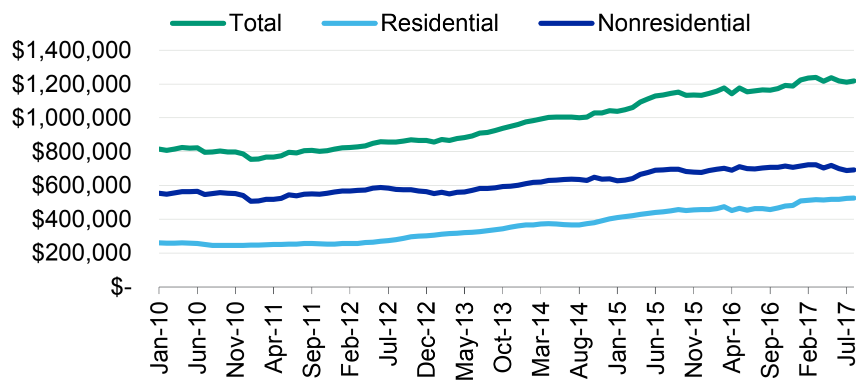


Moderate growth expectations in US

North America offers modest growth opportunities

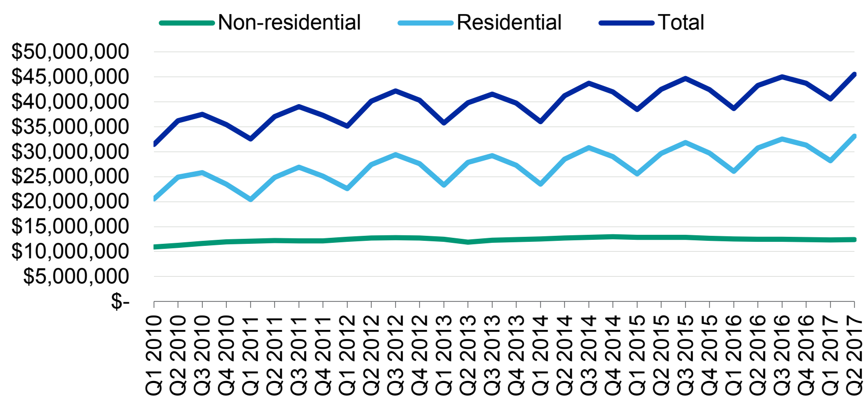
- United States: Growth in the mid-single digits with competitive market conditions limiting margin upside
  - Residential construction to grow at a moderate pace driven by low interest rates, healthy job creation and low debt service ratios. Inventory shortages will limit the upside
  - Non-residential construction should continue its gradual recovery; although growth could accelerate supported by $305 billion in transportation funding and additional state and local government infrastructure investments
- Canada: Modest growth with competitive conditions limiting margin upside
  - Residential construction growth will likely slow to a more modest pace due to new mortgage rules, capital gains tax changes, rising interest rates and reduced affordability due to higher home prices
  - Non-residential construction should begin to recover along with commodity prices and infrastructure investment

US Construction Spending



Source: US Census, Seasonally Adjusted Annual Rate

Canada Construction Spending



Source: Statistics Canada; non-residential is a seasonally adjusted, residential is unadjusted

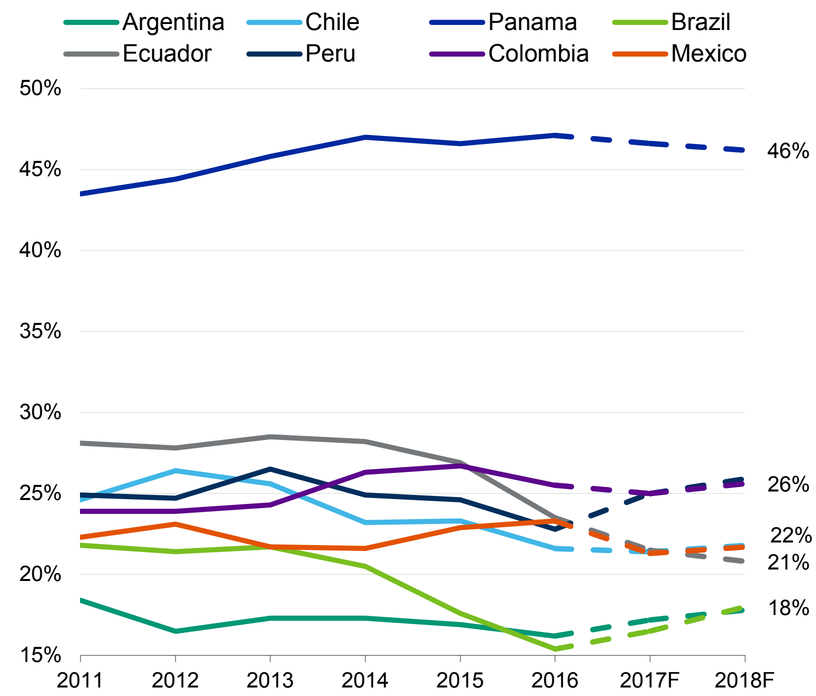
Signals point to recovery in LatAm

Overall construction to remain stable in 2018

Regional trends:

- **Argentina and Peru**: Recent rebound in growth signals an economic recovery with public spending via infrastructure projects an important driver. In Argentina, main public projects include expansion of highway network and airports. Peru will benefit from reconstruction related to El Niño.
- **Brazil:** Government budget cuts, weak order intake and project cancelations linked to corruption scandals will continue to hurt the sector. No signs of a sustained medium-term recovery, with fiscal constraints still weighing on new infrastructure investment. Corporate investment likely to remain slow.
- **Chile, Colombia and Mexico**: Investment as % of GDP will remain stable. Upcoming presidential elections add uncertainty over future economic policy. Chile is better positioned to attract private investment. Lower-for-longer oil prices will keep public spending subdued in Mexico and Colombia. Uncertainty related to Odebrecht scandal and ongoing NAFTA negotiations will further affect investment.

Gross Investment to GDP 2011-2018E



Source: Gross Capital Formation (GCF) - IBGE; Projections Moody's Investor Service

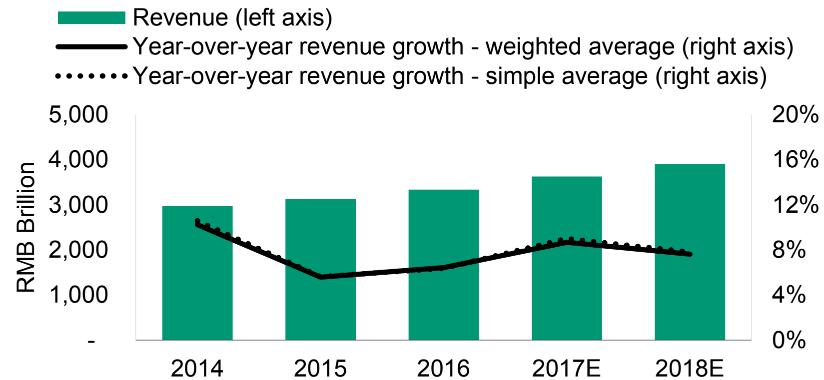
- **Ecuador and Panama:** Investment declining after intense infrastructure investment period; business-friendly market environment continues to be attractive to engineering & construction companies.

Continued moderate demand in China

Infrastructure and real estate investments will drive moderate revenue growth

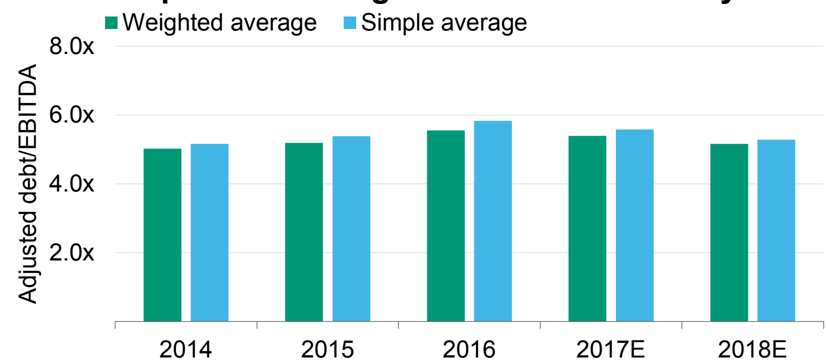
- » Demand growth will increase, supported mainly by solid domestic and overseas infrastructure investments and a large order backlog for existing property projects.
- » Margins will expand slightly with focus on more profitable operations, cost and expense controls, and continued investments in build-transfer (BT), build-operate-transfer (BOT) and public-private-partnership (PPP) projects, and real estate development with higher margins.
- » Adjusted debt/EBITDA will decline modestly with moderate earnings growth and slowing debt growth.
- » Continued or higher investments in BT, BOT, and PPP projects and real estate development would raise debt and leverage.

Rated companies' revenue growth will be moderate



Sources: Company information, Moody's Investors Service estimates

Rated companies' leverage will decline modestly



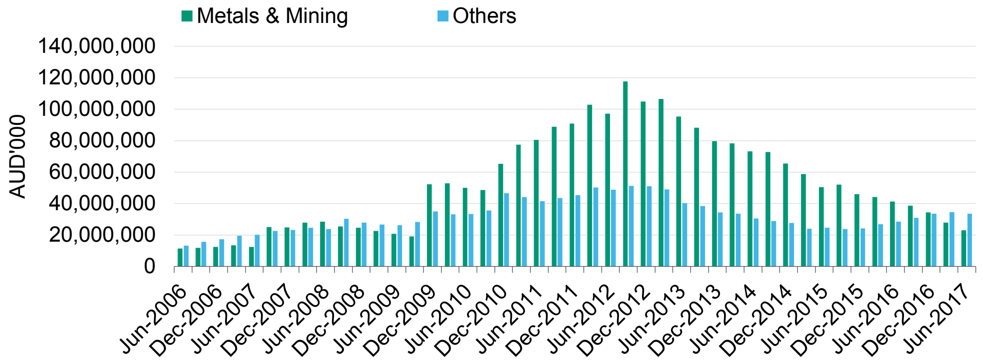
Sources: Moody's Financial Metrics, Moody's Investors Service estimates

Australia stable as sector activity shifts

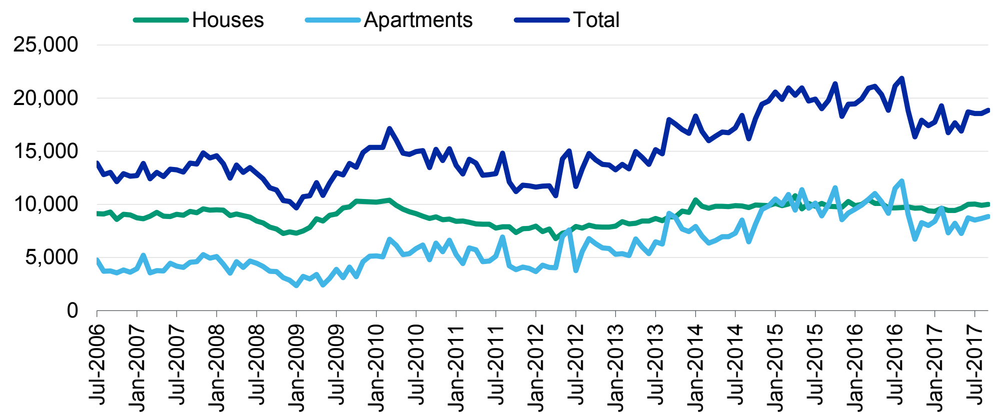
Earnings growth underpinned by transition from residential to road, rail infrastructure spending

- Residential construction to remain high over the next 12 months, but ease as cyclical housing boom tapers off. Although housing approvals remain high, developers are cautious. Underlying demand dynamics will continue to support the residential market.
- Government infrastructure spending on road and rail projects underpins solid earnings growth in 2018. Resources-related construction spending to remain subdued. Other areas of non-residential construction activity to remain broadly steady.

Engineering & Construction activity



Australia housing approvals



Source: Australian Bureau of Statistics

Growth in global infrastructure, buildings to continue

Stable commodity prices improve sentiment in O&G, mining

- Infrastructure
  - Increasing traffic volumes, especially in emerging economies, and trend towards urbanization should lead to expansion of roads and railways.
  - Electricity Transmission and Distribution (T&D) networks should see modest growth in developed countries to improve security of supply. Growing demand from new projects in emerging countries.
  - Potential extra projects supported by the Trump administration remain subject to funding and political risks.
- Buildings
  - Low interest rates and urbanization support investments in the residential building segment.
- Energy
  - Stabilization of oil prices will support construction activity, especially in the Middle East and LatAm.
  - Constrained capital spending for conventional power generation as coal companies remain in a secular decline (e.g. utilities gradually turning away from coal as an energy source); improved investment sentiment upon expected increase in exploration and development spending.
  - Renewable energies will continue to benefit from strong political support and efficiency improvements. Affordability is the main constraint.

Constrained liquidity continues for some companies

- Weak liquidity remains a constraint for credit profiles of several companies, especially in southern Europe
  - Positive free cash flow generation remains a key challenge for many issuers
  - Reliance on use of short-term uncommitted facilities (especially in Italy)
  - Use of confirming/reverse factoring
  - Short-term debt maturities and related refinancing needs pressures liquidity
  - Heavy working capital fluctuations throughout the year; uncertain timing and limited visibility of receivables collection
  - Refinancing of debt maturities could become more challenging, especially for lower-rated issuers facing operational challenges and tightening liquidity

What could change the outlook to positive/negative

- What could change the outlook to positive
  - More than 6% growth in organic revenues over the next 12-18 months
  - Growing order backlog (book-to-bill ratio at least 1.25x)
  - Operating margins at least stable
  - Higher infrastructure spending
  - Acceleration in existing construction works
- What could change the outlook to negative
  - Decline in organic revenues over the next 12-18 months
  - Shrinking order backlog (book-to-bill ratio <1.0x)
  - Lower infrastructure spending
  - Slowdown in existing construction works

Issuers of interest

EMEA

» Obrascon Huarte Lain (B3, review for upgrade)

– Rating review initiated following the signed Share Purchase Agreement with IFM Investors to acquire OHL's stake in OHL Concesiones for around €2.8 billion and expectation of proceeds to be mainly used for debt repayments. Weak operating performance continuing in 2017 due to legacy contracts. Challenges persist as benefits from execution of its '2020 strategy,' focused on core regions and more profitable projects are yet to materialize. Still unclear when earnings and cash flows might recover.

» Astaldi S.p.A. (B3, review for downgrade)

– Review process reflects uncertainties around execution and effectiveness of initiated capital and financial improvement measures, including a €200 million capital increase. Weak liquidity given negative free cash flows driven by high working capital consumption. Uncertain success of planned asset disposals and ability to obtain covenant waiver from banks by year-end 2017.

North America

» Fluor (Baa1 stable)

– Fluor is one of the largest E&C companies in North America with about $20 billion in annual revenues. Its rating was downgraded in August 2017 due to deteriorating operating results and credit metrics attributable to project execution issues, competitive pressures and project delays along with a recent focus on strategic investments and shareholder friendly actions. A strong backlog of orders should support near-term revenue growth, but earnings visibility remains uncertain.

Issuers of interest (continued)

North America

» AECOM (Ba2 stable)

– AECOM is a large North American E&C company with about $18 billion in annual revenues. A strong backlog of orders should support a moderately improved operating performance despite competitive pressures and weakness in its high margin oil & gas business and the winding down of nicely profitable government contracts. The company's capital allocation policy will limit its upside ratings potential.

Latin America

» Odebrecht Engenharia e Construção (Caa2 negative)

– Largest E&C company in Latin America with about $4.5 billion in net revenues in the LTM ended in June 2017 and $15 billion backlog.

– Main risks: deterioration in backlog and liquidity; uncertainties involving the company's operational recovery.

Moody's related publications

- [Construction - Global: Low interest rates, steady commodity prices support stable outlook](26 Sep 2017)
- Construction & homebuilding - EMEA : Bankruptcy of Isolux Corsan is credit negative for EMEA construction sector (05 Jul 2017)
- Construction - Europe: FAQ on Key Risk Factors of Contingent Liabilities for European Construction Companies (20 Apr 2017)