



CONSTRUCTION: MEXICO

RISK ASSESSMENT: **VERY HIGH**

HIGHLIGHTS AND OUTLOOK

The sector in Mexico faces some risks in the short term. Its activity has been impacted by a tighter public budget, which prompted the reduction of public works. The latter has shrunk for the last 27 months in a row. In parallel, limited public resources have also negatively impacted the part of residential construction that relies on government subsidies. Moreover, since December 2015 the central bank has raised interest rates in response to sticky inflation and the gradual tightening monetary cycle in the US. More precisely reference rates in Mexico now stand at 7.75% per annum, implying a hike of 4.75 percentage points in the mentioned period. Last but not least, the sector is also affected by the presidential elections, which took place on July 1st 2018. The change in power scheduled for December 2018 and the possible impact on economic policy tends to keep investment decisions on hold. Finally, Nafta renegotiations are also taking a toll on construction, as investors halt investments fearing that possible changes in the deal may impact their business strategy. On August 28th 2018, the US and Mexico announced that they have reached a preliminary agreement in principle, subject to finalization and implementation.

The imposition by the US government of tariffs on steel (25%) and aluminium imports (10%) coming from Mexico has indirectly put pressure on the production costs of construction companies in Mexico. The tariffs, which took effect in June 2018, prompted retaliatory measures by the Mexican government. Among them a 25% tariff was announced on imports of steel, cement, concrete and steel rods. Mexico consumes per year 24.4 million tons of steel, of which it imports 10.8 million. The construction sector is responsible for 61.5% of steel consumption in the country. As a result, the construction industry has struggled to deal with higher costs. Even if local steelmakers are able to increase production, it would require several months of such increase to meet the demand.

In the longer term, the sector perspectives tend to be more encouraging. In terms of residential construction, a growing population and a high housing deficit represent a potential demand to be explored. Indeed this situation provides an outlook of business opportunities for the Mexican construction sector. Additionally, the program of government of Mexico's new president André Manuel Lopez Obrador (AMLO), who will take office on December 1st 2018, contemplates higher spending on infrastructure and housing. However doubts remain about how they will conciliate higher public expenses with tight public resources.

Strengths

- Regulatory reforms have opened new pools of capital to the market
- High potential demand due to considerable housing deficit
- The PPP law launched in 2012 offers investors greater contract security

Weaknesses

- Major cuts to public spending on infrastructure due to tight budget
- In past years several large-scale bids have been postponed or cancelled eroding investor confidence
- Exposed to the Nafta renegotiation

Key Players

(in terms of turnover, All companies below are listed on Mexico Stock Exchange)

- **Empresas ICA**
- **Ohl Mexico**
- **Impulsora Del Desarrollo Y El Empleo En America Latina**
- **Promotora y Operadora de Infraestructura**

Source: EMIS securities

Regional Risk Assessments: Construction

ASIA	VERY HIGH
CENTRAL & EAST. EUROPE	HIGH
LATIN AMERICA	HIGH
M. EAST & TURKEY	VERY HIGH
NORTH AMERICA	MEDIUM
WESTERN EUROPE	MEDIUM

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DEMAND

Construction activity dropped by 1% in 2017, down from growth of 2% registered in the previous year. The weak outcome was mainly led by the subsector of civil engineering works, which observed the highest slowdown in demand. The tight public budget due to the persistence of lower oil prices at that time played against the performance of the segment. While this year oil prices have improved, the positive impact is partly undermined by the steady decline in oil production since the mid-2000s.

In 2018 some slight improvement in demand is expected. On the one hand, The Mexican Construction Chamber (CMIC) estimates the sector to grow this year between 1 and 2%, driven mainly driven by the building subsector (private construction). Moreover the subsector of specialized works for construction has recently also been favoured by the demolition and reconstruction after the September 2017 earthquakes. On the other hand, government expenses will remain at a low level. In fact, the subsector of civil engineering works (public works) continues to undermine the general performance of the sector. All in all, in the first half of the year total construction activity increased by 2% YOY.

The base scenario of some recovery is nevertheless not without risks. In the short term, private investments should remain constrained amid the current high political and economic uncertainties. Namely the Nafta and with a new President André Lopez Obrador (AMLO) taking office in December 2018. For instance, AMLO promised to hold a public consultation to decide if the construction of the new international airport at Mexico City (a USD 13 billion project) should be continued. Similarly, he has also positioned himself in favour of consultation on the energy reforms. If this promise is carried forward, it will certainly hurt investors' confidence.

It is worth noting however, that in the medium term, public investment might increase during the next government. While AMLO's victory raises in the short term the uncertainty related to key infrastructure projects, it should in the medium term expand spending on infrastructure and housing. His government program indeed includes an additional USD 2.4 billion investment for reconstruction works, investments in improving water infrastructure to support agriculture activity and building two new refineries to increase the country's energy independence. The question is however, how the new government will be able to raise the necessary funds. They claim that the resources would come by fighting inefficiencies and corruption, a plan that seems somewhat too optimistic.

Finally likelihood of tighter global financial conditions increased in recent months. Currently the policy rate in Mexico stands at 7.75% a year, but rates could be reviewed upwardly if the US Federal Reserve fastens its interest normalization pace. This in turn, would increase the cost of mortgage loans and of infrastructure projects.

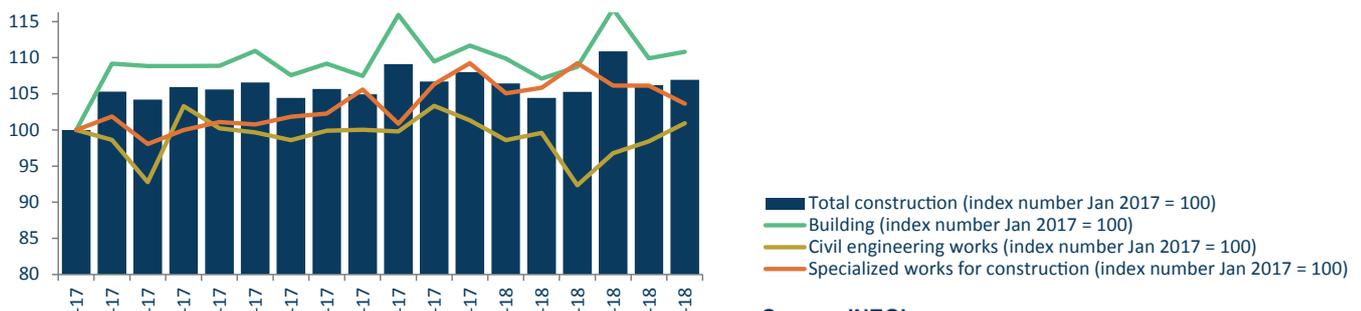
SUPPLY

Rising production costs pose a risk to profitability. According to INEGI, the construction producer price index increased by 10% YOY in July 2018. In addition, the sector's material prices climbed by 11.1% in the same period, the greatest variation in the last twelve months.

The movement mentioned above is mainly explained by the indirect impact of the steel and aluminium import tariffs imposed by the US government. As a response to the US imposition, the Mexican government established retaliatory measures, such as a 25% tariff on imports of steel, cement, concrete and steel rods. Steel is one of the most important inputs for construction. According to the National Chamber of the Steel Industry (Canacero) 61.5% of the national consumption of steel is directed at the construction sector. This way, CMIC estimates that the tariffs on the import of steel from the US will prompt an additional 3 to 4% rise in the prices of construction materials derived from steel. The latter, in turn, would lead to annual inflation in the Mexican construction sector of between 12% to 13% in 2018. It is also worth noting that the preliminary trade agreement reached by the US and Mexico on August 27th 2018 will not remove the US' existing Section 232 tariffs on Mexican exports of steel and aluminium in its current state (at least at first).

Higher costs pose downside risk to the construction activity growth forecast and to the job market. During the first half of 2018, the number of employees in the construction sector affiliated to the Mexican Social Security Institute (IMSS) recorded a growth of 6.5% YOY, meaning the creation of 101.5 thousand formal jobs. This growth can be explained by the process of formalization of employment that the construction companies are carrying out before the IMSS. Though, specialists warned that this tendency could be reversed due to higher cost pressures.

CONSTRUCTION IN MEXICO



Source: INEGI