Reviewing ENR’s top 250 global contractors:

China takes the lead
A recent ranking by Engineering News-Record (ENR) of the top 250 international contractors would seem to suggest that, while perhaps not taking over the world, Chinese construction companies are making their presence felt in the global construction industry. Of the top 10 global contractors (by revenue) on the list, the top three are Chinese companies. With combined revenues that are 6% greater than the combined revenue of the next seven contractors, these three firms stand out as major money makers in a highly competitive global market. In addition to earning the most, these three Chinese companies also invest more in research and development (R&D) than their Western counterparts. It should be noted, however, that these large companies benefit significantly from backing by the Chinese Government and have been the major beneficiaries of China’s infrastructure-gearred stimulus packages. China’s continued focus on developing infrastructure has led the Government to increase its infrastructure expenditure budget by 4.4% in 2015.

Because of globalization, a contractor’s ability to grow is no longer limited by the size of its domestic market. This development, however, comes at the cost of greater exposure to major global economic fluctuations. Chinese contractors are in the unique position of having a very large domestic market from which they are able to derive the majority of their revenue, while remaining somewhat insulated from global economic fluctuations. In order to pre-empt a heavy dependence on the local market conditions, Chinese contractors are increasingly looking for new opportunities overseas, particularly in Africa and North America. As an added element of support, the Chinese Government often uses these contractors as an extension of their international investment, especially in Africa and the Caribbean.

It was observed that Chinese and French companies are the least diversified contractors among the top 25. However, in contrast to the relatively risk-free, state-supported nature of the top three Chinese contractors, European contractors operate in a highly competitive environment and exhibit an over-reliance on domestic markets still in the grip of a stubborn recession. Although Chinese contractors lead in terms of revenue generation, their ability to generate profits falls below that of French contractor VINCI, which ranked fourth overall on the ENR list. The presence of three French companies in the top 10 is a testament to their expertise, self-reliance and dominance. However, these companies still derive most of their revenue (more than 60%) from a saturated and stagnant domestic market and, as a result, have seen negligible growth in their top line over the past two years. Consequently, these firms risk losing future revenue if they do not focus on diversification and global expansion.

Of the top 25 global construction contractors (by revenue), the top 10 companies actually contribute around 75% of the total revenue.

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3 EY research.
The financial dominance of the top 10 extends to profitability as well

Large contractors dominate the top 25 list and the data suggests that the big companies are getting bigger while the smaller firms are becoming smaller. The combined profitability (measured by revenues) of the 2014 list’s top 10 companies increased by 30% from 2013, while the combined profitability of the 2014 list’s next 15 dropped by more than 50% for the same period.

Moreover, the ENR list’s top 10 companies’ combined profitability was about 11 times the combined profitability of the next 15 companies, while in 2013, the top 10’s combined profitability was only 4 times greater than that of the next 15 companies.

<table>
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<tr>
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<th>Top 10 Combined profit</th>
<th>Next 15 Combined profit</th>
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<tbody>
<tr>
<td>2013</td>
<td>x</td>
<td>1/4x</td>
</tr>
<tr>
<td>2014</td>
<td>x</td>
<td>1/11x</td>
</tr>
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</table>

Source: EY.

South Korean contractors on the list played a major role in the profitability of the bottom 15. While Daelim Industrial Co. incurred considerable losses in 2014, 4 a refocusing by other Korean contractors on overseas opportunities contributed significantly to a general rise in revenue for 2014. Korean contractors are also spending more on technology investments and innovation to bring down costs and achieve superior quality.

Overall, net profit of the top 25 amounted to 2.3% compared to 1.6% in 2013. Of the 13 companies that had negative profit change in FY14, nine are European. 5

It is not just South Korean contractors that are stepping up their investment in technology to reduce costs and improve quality. Of the top 25 contractors under review, the overall R&D expenditure increased by around 9% in 2014 over the previous year 6 (note that some companies do not report their investment expenditure or have not significantly increased their R&D expenditures over the last two years). Moreover, almost 50% of contractors on the list have started or are in the process of deploying building information modeling (BIM) for their projects, enabling them to use virtualization in the design planning process.

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5 EY research of company financial statements.
6 EY research of company financial statements.
Gearing is proportional to the contractors’ position in the top 25

The top five companies on the ENR list have the highest average gearing ratios and, as the ranking lowers, the average gearing ratio reduces in step.

Contractors generating higher revenue exhibit a tendency to leverage up and spend more heavily with debt. This is in contrast to smaller contractors with lower revenues that spend more with cash and abstain from overleveraging.

Overall, the average gearing ratios of the top 25 companies dropped from 56% in 2013 to 47% in 2014. It is debatable whether some of these companies are maintaining a conservative approach to acquiring debt in a still-recovering economic environment, or they have begun to pay down their debts as they grow and recover from the recession.

Ideally, a low gearing ratio is desirable, however, due to the capital-intensive nature of construction, high gearing is considered a norm for the industry. It is the shrewd balancing of the gearing ratio that drives a firm’s profitability. Around 25% of the companies on the list had more cash than outstanding debts, making their net debt position positive for the last two consecutive years. Almost 50% of the contractors on the list have reduced their net debt positions over the year.

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7. EY research of company financial statements.
8. EY research of company financial statements.
Debt servicing: win for some, miss for others

The low average debt service ratios of the top five companies on the list is due in large part to the substantial amount of short-term debt held by the top-ranking Chinese contractors. Reports suggest that debt owed by China's nonfinancial sector have climbed by more than 90% relative to GDP since 2008. Chinese companies are now among the most indebted worldwide.\(^9\) Around 30% of the overall debt in the Chinese economy is owed by the real estate, construction and engineering sectors and most of the beneficiaries have been state-run enterprises.\(^10\) Since a majority of the construction and engineering companies in the region are state-backed, it comes as no surprise that these companies are highly leveraged with low debt service ratios. The uncertain nature of this situation has led many economists around the world to ask the same questions: What happens if the Chinese economy slows? Will the Central Government absorb losses from the contractors’ defaults, if any? Will they default? Could a Chinese state-owned entity (SOE) actually go bankrupt, and what would this mean for the rest of the world? Finally, in the event that these firms fail, will a foreign contractor be able to penetrate the Chinese market and take its place? Only time will tell.

Chinese companies are not alone in exhibiting a greater appetite for debt. European companies across industries have increased their corporate debt burden by 40% in 2014 alone (the current debt of the European contractors increased by 20% in 2014 over the previous year).\(^11\) With interest rates remaining at all-time-lows, many companies are taking the easy but risky route of financing their projects with debt in a financial game of musical chairs. The high debt burden of the Chinese and the European contractors could cause deterioration in their debt serviceability.

As opposed to the Chinese, the US-based contractors in the top 25 have the least amount of current debt on their balance sheets. Managing their debt positions wisely, these companies have managed to deleverage their balance sheets in the years since the recession. This is evidenced by the fact that the interest expense to sales ratio for the S&P 500 companies is said to be at the lowest level since the beginning of the 1970s – a period marked by rapidly rising inflation.\(^12\) There has also been a decline in the net debt to market cap ratio for American companies.

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*Source: EY.*

### Average debt service coverage ratio for top 25 contractors

*Low coverage ratio, mainly because of high short-term debt levels of the top three Chinese contractors.*

<table>
<thead>
<tr>
<th>Top 5</th>
<th>0.39</th>
<th>0.45</th>
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<tbody>
<tr>
<td>Both years influenced by a US contractor with exceptionally low debt.</td>
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</table>

<table>
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<tr>
<th>Middle 10</th>
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<tr>
<td>Influenced by a US contractor that incurred losses in FY14.</td>
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<table>
<thead>
<tr>
<th>Bottom 10</th>
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<tbody>
<tr>
<td>FY14</td>
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<tr>
<td>10.43</td>
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</tbody>
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10. Ibid.


Liquidity: South Korean construction companies have working capital concerns

Of the top 25 companies on the list, US-based companies have the best liquidity/cash position, with outstanding accounts receivable and accounts payable not exceeding 40 days. On the other hand, European companies have the longest pay periods (~200 days), followed by the Chinese (~165 days). The average number of days for accounts receivable of both European and Chinese companies in the top 25 is approximately 90-96 days. The above is a desirable situation for these companies as they get paid much earlier than the amount of time they take to honor their outstanding payables.

The South Korean contractors have an average days sales outstanding (DSO) of 98 days, and the average days payables outstanding (DPO) for them is 54 days. This is an alarming situation for companies, which leads them to a cash crunch in their working capital cycle. On a country level, South Korea has one of the highest cash conversion cycles among the Asian economies.

Although US companies exhibit the least number of days to pay, this number has increased in 2014. A contributor to this slip in the number of days to pay is an increase in payment delays to small suppliers. As a result, the US Government launched the SupplierPay initiative in 2014 to ensure a healthy supply chain for businesses. Under the initiative, companies have committed to pay small suppliers more rapidly or help them get access to reduced-cost capital. While 25 companies have already signed on to the initiative, there is a distinct absence of companies from the construction and engineering sectors.

While US efforts to improve the timeliness of supplier payment are geared toward instituting fair economic practices, the insufficient timeliness by major Chinese companies has had a significant adverse effect on local suppliers. It has been projected that the number of local Chinese supplier bankruptcies will increase by 5% in 2015. The liquidity position in China has tightened over the last few years because of the confluence of overcapacity in the real estate market and an increase in strict fiscal discipline by local governments. In a survey by credit insurer Coface, 8 out of 10 Chinese companies reported payment failures by customers in 2014.

The DSO in China has reportedly increased by 22 days between 2007 and 2015. Companies affected by the recent slowdown in the Chinese economy are passing on payment pressure to their suppliers and clients. Additionally, recent Government crackdowns on the shadow banking industry have resulted in a rise in intercompany credit.

The table below depicts the insights from a research report by Euler Hermes and Bloomberg on the days sales outstanding of select countries and of the construction sector in those countries. Spain, China and Italy’s construction companies receive their payments later than their country’s average receivable days. On the other hand, the Netherlands, the US and the UK’s average receivable days for the construction sector and the country are in harmony.

<table>
<thead>
<tr>
<th></th>
<th>Netherlands</th>
<th>US</th>
<th>UK</th>
<th>Spain</th>
<th>China</th>
<th>France</th>
<th>Italy</th>
</tr>
</thead>
<tbody>
<tr>
<td>Construction</td>
<td>46</td>
<td>50</td>
<td>55</td>
<td>87</td>
<td>91</td>
<td>66</td>
<td>102</td>
</tr>
<tr>
<td>Country</td>
<td>47</td>
<td>55</td>
<td>56</td>
<td>69</td>
<td>74</td>
<td>77</td>
<td>99</td>
</tr>
</tbody>
</table>


13 EY research of company annual reports.
Companies in the construction sector lack transparency. One of the key performance indicators for a contractor is the order book (backlog). While all the European- and Americas-based contractors report their order book, many Chinese and Korean contractors do not report the backlog numbers.

In addition to not reporting order book numbers, many Chinese contractors do not disclose the expenditures incurred for general administrative expenses and R&D. The unique reporting styles of construction companies make a wholesale comparison and evaluation among them difficult. This lack of transparency and comparability is one reason why the sector does not enjoy as much of an economic spotlight as the other sectors, such as the fast-moving consumer goods (FMCG), retail or technology sectors do. Overall, the order book represents 1.5 times annual sales and companies on average witnessed a 9% increase.

A company that exercises full disclosure will certainly be considered of better repute and valued more highly among its peers in an industry-wide comparison. Going forward, global construction companies need to utilize technological advancements to achieve operational effectiveness and adopt government policies to better manage their accounts payable and optimize supply chain efficiency. As the world continues to shrink and emerging technologies continue to increase corporate transparency, it is clear that global confidence and a strong reputation for performance and accountability will be essential in determining the future rankings of key players in the global construction industry.

Four out of the top 25 do not report order book figures

Two Chinese companies in the top 25 do not report according to International Financial Reporting Standards (IFRS), which makes their reporting style different from the others. However, the South Korean K-IFRS is identical to International Accounting Standards Board (IASB) IFRS.

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Please contact any of the people listed below with questions about the material including in this article.

Ad Buisman
EY Global Construction and Engineering Services Leader
+31 88 407 9433
ad.buisman@nl.ey.com

Erin Roberts
EY Americas Construction and Engineering Services Leader
+1 713 750 1373
erin.roberts@ey.com

Mark Gibson
EY Americas Construction Advisory Services Leader
+1 949 437 0499
mark.gibson@ey.com

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