Executive Insights

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Building Success: Why the French Residential Construction Sector May Be Poised for Growth

The residential construction sector in France suffers from the misconception that it has slow growth that is unsuitable for investment. An analysis of market fundamentals, however, suggests a long-term growth story that could be on the cusp of a new growth cycle.

1) It benefits from long-standing favorable demographic and sociological factors (high birth rate, aging population, high divorce rate, etc.) that provide this market with particularly robust underlying growth
2) The factors that have recently restricted growth in the residential construction sector have become more positive influences

L.E.K. Consulting believes numerous investment and growth opportunities can be found in this sector. Based on our research, we have identified several distinctive traits that characterize the winning players in this market:

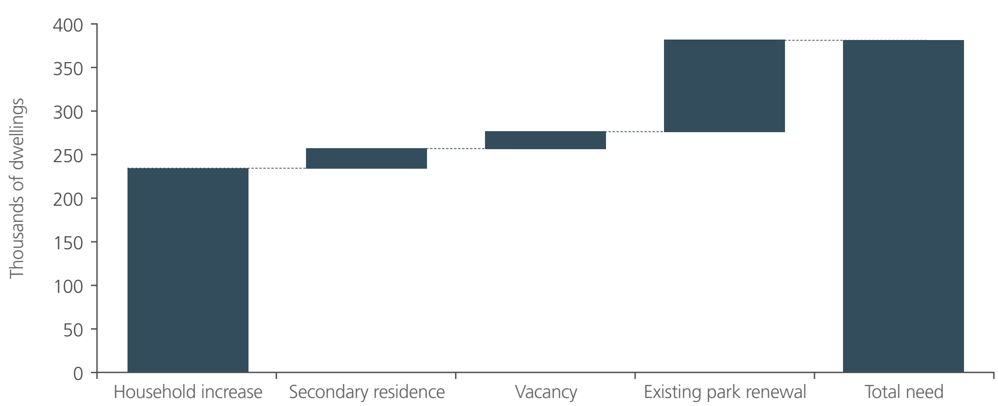
1) Excellence in operational execution makes the difference between success and failure
2) Innovation, especially in digital, can create a distinctive advantage, even for smaller players
3) Positioning on new/emerging demand segments limits exposure to demand volatility and grants attractive development prospects

Construction sector growth is supported by strong long-term structural factors

Today, 34 million dwellings shelter 28 million French households (designates all the occupants of the same dwelling). We estimate that an average of 382,000 new dwellings will have to be built every year until 2020 to accommodate the natural population

Figure 1

New residential build requirements in France (average 2015-20)



Source: INSEE; L.E.K. analysis

Building Success: Why the French Residential Construction Sector May Be Poised for Growth was written by **David Danon-Boileau**, **Frédéric Dessertine** and **Maxime Julian**, partners in L.E.K. Consulting's Industrials practice. David, Frédéric and Maxime are based in Paris.

For more information, please contact industrials@lek.com.

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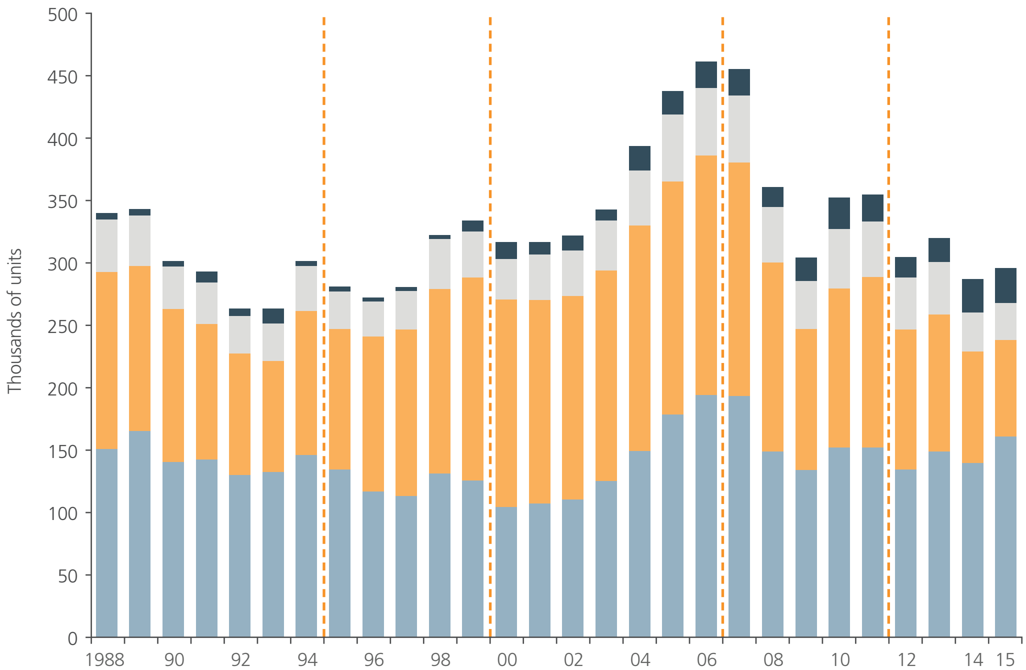
Figure 2

Evolution of housing construction starts by type in France (1998-2015)



CAGR%

	(88-94)	(94-99)	(99-06)	(06-11)	(11-15)
Total	(1.9)	1.8	4.8	(5.1)	(4.5)
Residences	4.5	5.7	13.8	0.8	5.8
Grouped individual dwellings	(3.6)	0.3	6.7	(2.7)	(9.6)
Pure individual dwellings	(3.3)	7.0	2.4	(7.0)	(12.7)
Collective housing	(0.5)	(2.9)	6.4	(4.6)	1.1

About a 12% decrease in 2015, following about an 20% decrease in 2014

Source: Sitadel 2; L.E.K analysis

growth and favorable demographic and sociological trends. The increased number of households accounts for around 235,000 of this annual total. Population growth is driven by a high birth rate and positive net migration. The number of households is developing even faster and reaping the "benefits" of structural sociological trends (divorce, increased life expectancy, etc.). This "core" need must be grossed up with the share of vacant dwellings (constant at about 8% of the installed base), the proportion of secondary residences (9.6%) and old dwellings that need to be rebuilt every year (about 50,000 — see Figure 1).

Compared with 2015 housing starts (296,000), this structural need shows significant potential for an increase in new builds in the coming years. Factoring in an ongoing and healthy growth in construction prices (around 1 to 2% per annum), the new residential sector benefits from attractive growth prospects.

An unusually long downward cycle

It is not enough to assess investment opportunities in the sector solely on the basis of these structural trends. Correctly assessing the timing of the investment in this cyclical market is also paramount. So where are we in the cycle?

Historically, new residential construction has revolved around regular eight-year market cycles (see Figure 2).

However, the last cycle trough has been unusually long (starting in 2007), indicating a profound and potentially long-lasting dysfunction in the usual construction cycle drivers.

In theory, several factors could explain the new residential cycle, both from a demand (household confidence, purchasing intention, etc.) and a financing / supply perspective (access to and level of market financing conditions, regulatory subsidies such as prêt à taux zéro – 0% interest loan (PTZ) etc.). In practice, market financing conditions have improved over the past eight years, with mortgage interest rates decreasing from about 4% to a mere 1 to 1.5% on standard repayment terms. The unexpected drop in new housing starts is instead explained by the combination of two simple yet impactful drivers:

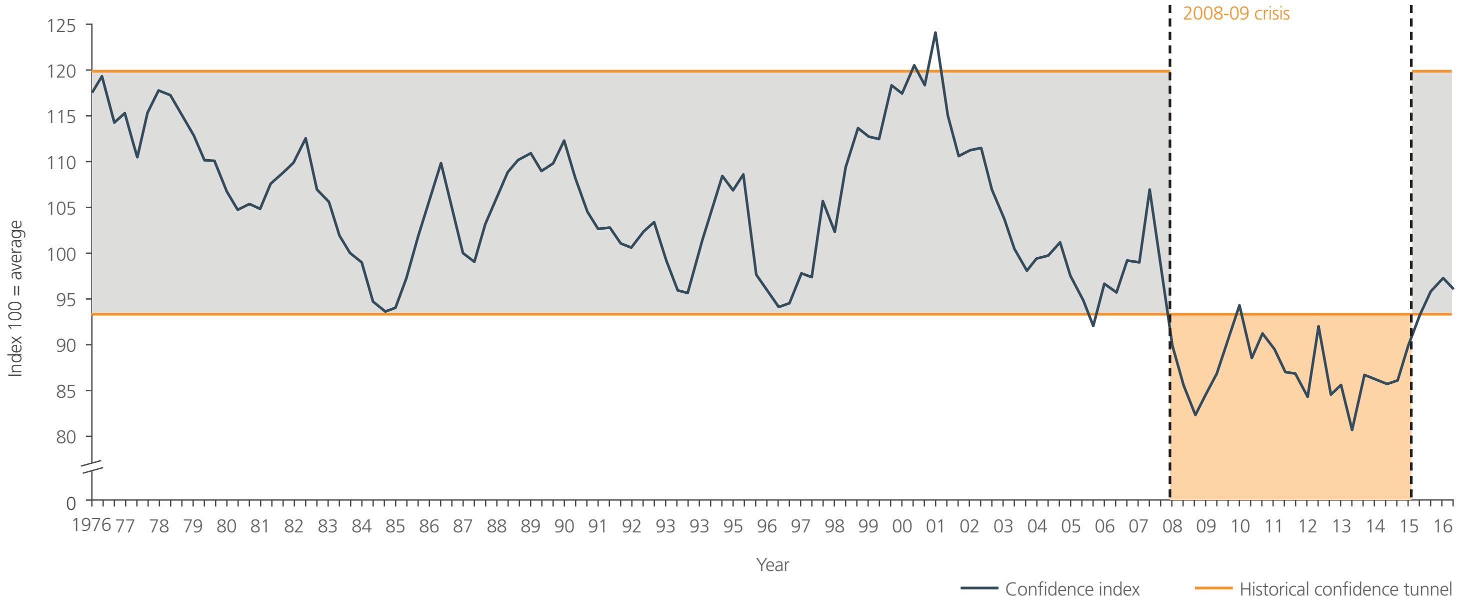
1) Household confidence plummeted to levels unseen since the beginning of the 1980s and remained at these levels until 2015

2) Access to subsidized loans (such as PTZ) was drastically reduced after 2012, limiting first-time buyers' ability to match relatively high dwelling prices

As a result, most French households lost hope in the future and settled into a wait-and-see approach, while first-time buyers were left with diminished purchasing power.

Figure 3

Household confidence in France (1976-2016)



Source: INSEE; L.E.K analysis

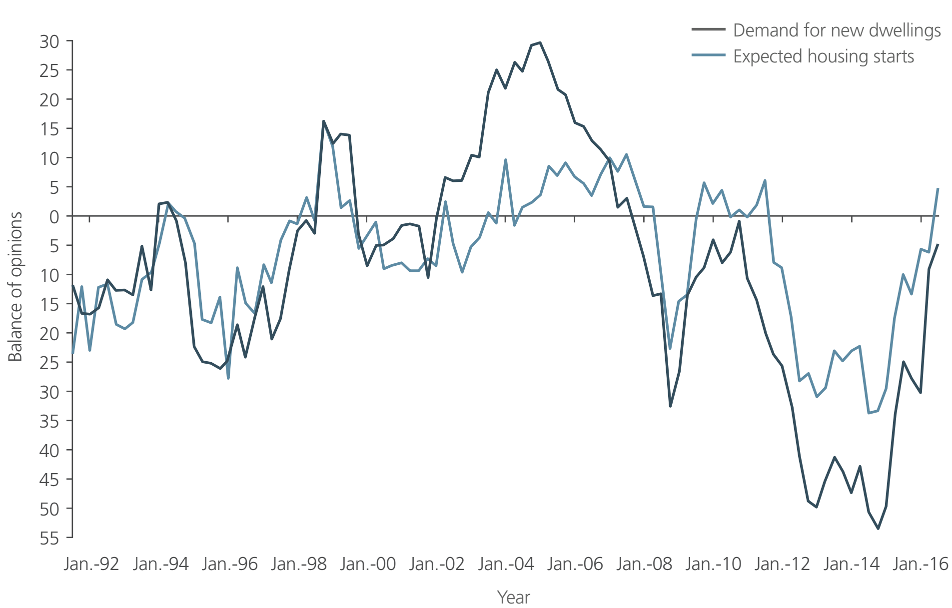
The signals suggest a new growth cycle

In many ways, 2016 has been a game-changing year, with the very drivers that depressed the new residential market now on a reverse trend:

1) In 2016, consumers' confidence returned to "normal," albeit low levels for the first time since 2008, most likely on the back of regained optimism linked to the current economic recovery (see Figure 3); property developers also share this newfound confidence and are expecting an upturn in their business (see Figure 4)
2) The government issued a new PTZ scheme much more favorable than its previous one, attracting first-time buyers back to the market
3) Current interest rates remain at historically low levels

Figure 4

Property developers' sentiment (1991-2016)



Source: INSEE

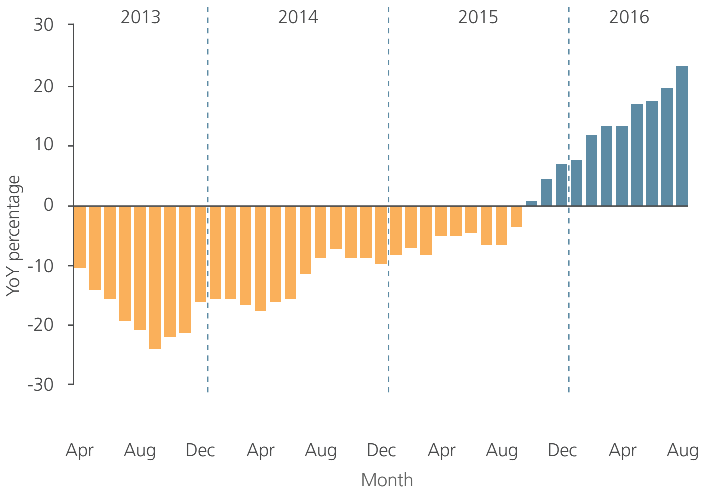
Example: A commercial organization's winning strategy

A leading building material distributor managed to outperform its market while maintaining a business almost immune to the underlying construction downturn.

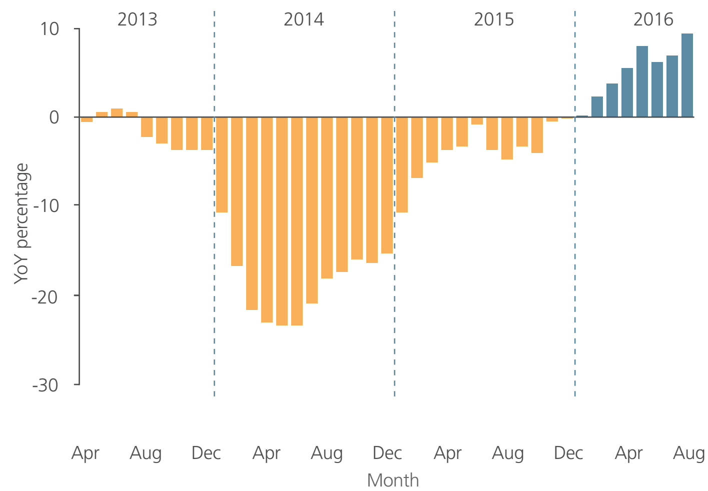
Two factors explained its success. First, the company, although modest in size, implemented an efficient ERP system, including D+1 reporting of the most important business KPIs. Second, the company implemented a very simple customer segmentation generated by sales rep feedback. Clients are classified as either "noncore" (limited potential), a "B" client to be developed with an objective of 50%+ share of portfolio or an "A" client to be maintained.

Figure 5
Housing permits are peaking on a last 12 months basis

Rolling evolution of **collective** building permits (2013-16)



Rolling evolution of **individual** building permits (2013-16)



Source: Euroconstuct June 2016; Sitadel 2; L.E.K analysis

The first signs of a construction recovery are now materializing, as evidenced by an increase in the number of building permits (see figure 5) and accelerated sales levels in sectors such as individual housing.

Overall, L.E.K.'s analysis points toward a gradual recovery in the residential sector, fostered by the return of owner-occupiers to the market, along with individual and institutional investors.

Identifying opportunities for investment

Although the construction market is showing signs of recovery – at least in the new residential sector – it is clear that it will still have to weather economic ups and downs. While many companies may see their financial performance improve in the months or years to come, investors and market players need to identify the best-performing assets. We have identified several winning strategies that have enabled companies to thrive – even in a harsh economic environment.

1) Keep it simple

Winning companies stay ahead of the game first by managing their operations rigorously. The last recession taught us a valuable lesson: Businesses that were operationally efficient survived and even prospered during the crisis. How did they do it? Contractors optimized their operational control, their delivery quality and the efficiency of their sales teams. Manufacturers adjusted their product lines and their prices appropriately, finding middle ground to maximize the economies of scale while keeping a highly local business profile. Distributors optimized the management of categories and their offerings in a scientific way. Winners all made these changes while excelling operationally every day.

2) Rapidly adapt to changing circumstance and needs

Over time, many companies have increased their operating complexity at the expense of efficiency (e.g., an inadequate, decentralized industrial footprint based on back-to-back M&As, etc.) and operate under legacy systems that used to be core to their success but now only hinder their development (e.g., dense point-of-sale network in the era of ecommerce, sales organization based on former French regions, etc.).

Successful companies are generally the ones able to rapidly abandon what made them great in the past in order to adopt the strategy that best answers evolving customer needs. The NOTRe law, for instance, is an opportunity for construction players to turn the tables and gain market share in civil engineering. The future winners are likely to be the ones courageous enough to adapt and change their sales team structure to mirror public authorities.

3) Innovate, innovate, innovate

Innovation has proven to be an extremely effective way for construction businesses to thrive, especially in such a difficult economic environment.

Winning players have developed in particular innovative digital strategies that allowed them to stay ahead of the game without having to spend fortunes on them. Beyond

Digital strategy examples

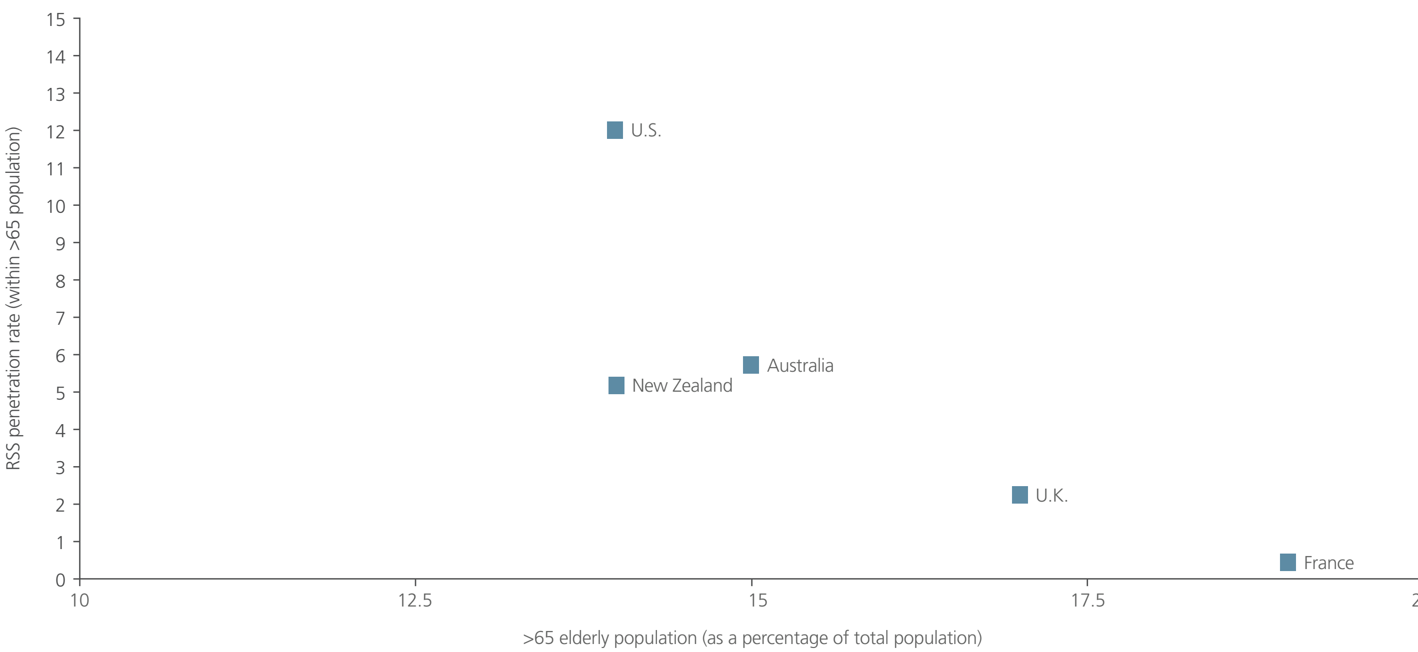
Successful digital strategies are accessible to Small Medium Enterrpises without requiring significant capex:

- A leading residential builder successfully deployed an innovative digital strategy combining improved commercial lead generation through numerous channels (SEO and astute redirection of web traffic of qualified potential customers) and enhanced client experience (e.g., the possibility of visualizing a house in 3-D on the website)
- A European precast concrete supplier has been using building information modeling (BIM) solutions since 2006 to differentiate itself in a commoditized market. BIM allows it to better estimate costs, minimize errors and improve planning while creating a collaborative approach with the client.

e-merchants' sites whose success was often limited, digital marketing has done wonders just by improving web visibility (e.g., search engine optimization [SEO]), providing advanced digital customer services (instant and automatic access to past purchases, copy of invoices, real-time stock availability) or generating commercial leads through third-party websites. Further down the road, digital solutions can even improve customer experience, providing end customers with advanced previews of their dwellings or, as is planned for the near future, letting them track the construction of their house in real time.

Likewise, growing environmental concerns and more stringent regulations (such as the RT2012 and the soon-to-come RT2020 in France) provide significant opportunities. They allow innovative products / solutions (e.g., positive-energy buildings, heated glass, flat roofing) but also leave more narrow margins for maneuvering, as they usually increase costs and complexity, therefore favoring the most mature / efficient companies.

Figure 6
Senior service-integrated housing (2015)



Source: L.E.K analysis

4) (Emerging) niches are beautiful

The construction sector in France has a number of potential growth opportunities, with new market segments (re-) emerging and proving particularly dynamic. Operators are now addressing the more sophisticated needs of the sector's end-user base by segmenting demand and developing new propositions. For example, the broader "residence service" market is an attractive concept because it provides attractive investment opportunities for institutional investors while addressing a growing demand for premium rental solutions for specific population segments (students, elderly people, etc.). According to L.E.K.'s research, the potential market in France for residence services could be up to 10 times larger than it is today (see Figure 6).

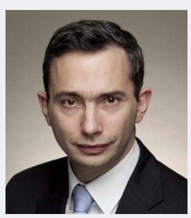
With strong underlying fundamentals and several market drivers shifting from negative to positive, the construction sector offers attractive opportunities for well-positioned businesses that are successfully adopting winning strategies.

Further reading

European Building Contractor Survey 2016: Value Creation Opportunities for Building Merchants and Manufacturers in France

About the authors:

Frédéric Dessertine has 20 years of experience in management consulting and leads client case team projects focused on strategy and operational transformation. He has extensive experience working in the building and construction and industrial sectors in Europe and Asia.



David Danon-Boileau has a strong background in a number of sectors, including building and construction and private equity. He has more than 16 years of professional experience and has worked on numerous assignments, including market entry, performance improvement, benchmarking, growth strategies, company screening, valuation, and mergers and acquisitions.

Maxime Julian has about 10 years of consulting experience and has completed a large number of pan-European projects, advising on strategy reviews, market entry strategy development and transaction support on both the buy and sell side. Prior to joining L.E.K., Maxime worked as analyst for Eurostar in London.

About L.E.K. Consulting

L.E.K. Consulting is a global management consulting firm that uses deep industry expertise and rigorous analysis to help business leaders achieve practical results with real impact. We are uncompromising in our approach to helping clients consistently make better decisions, deliver improved business performance and create greater shareholder returns. The firm advises and supports global companies that are leaders in their industries — including the largest private and public sector organizations, private equity firms and emerging entrepreneurial businesses. Founded more than 30 years ago, L.E.K. employs more than 1,200 professionals across the Americas, Asia-Pacific and Europe. For more information, go to www.lek.com.

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