TÜRKİYE İŞ BANKASI

Construction Sector

in Turkey

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April 2018

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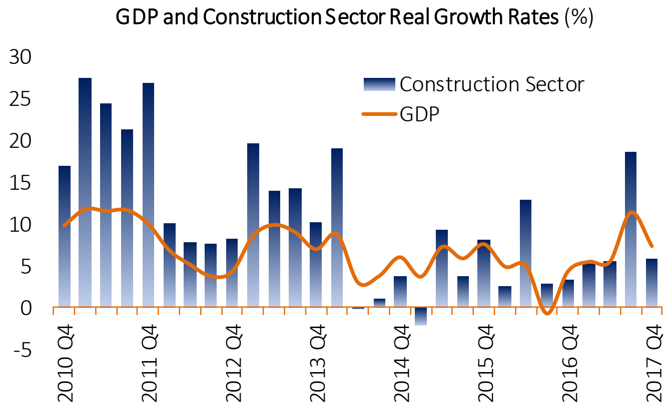
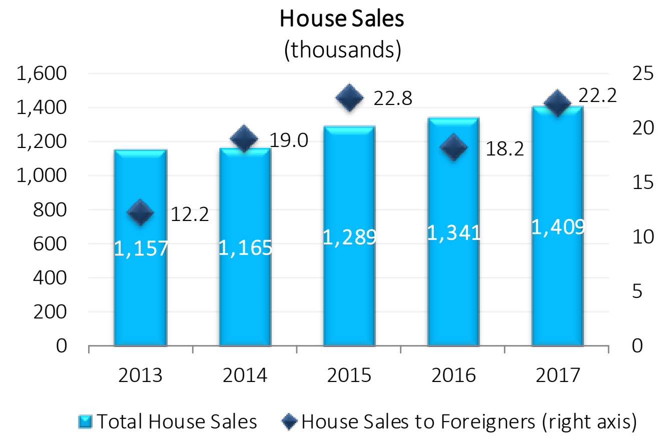
Performance of the Construction Sector in 2017

Turkish construction sector which stood out with its robust growth performance in recent years, grew by 8.9% yoy in real terms in 2017. The sector posted its highest growth rate for the last 3.5 years by growing 18.6% yoy in the Q3. This development stemmed from the measures taken by the government to support economic activity. Additionally, sales campaigns conducted by some construction companies throughout the year and low base effect also contributed to this robust growth. Although the sector's activity lost some pace in Q4 after the expiration of some government incentives by the end of September 2017 as well as the investment and consumption appetite declined gradually, construction sector grew faster than the GDP in 2017.

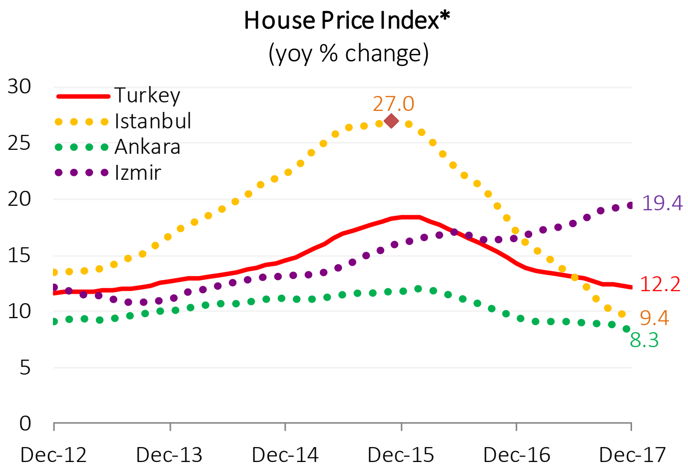


Housing Market

Housing market, having almost 60% share in total construction activity, happens to be the major business field where we can observe the outstanding rise in sector's production. In recent years, demand for housing was fuelled from many different factors like constantly rising population and urbanization rate, need for modern and earthquake resistant buildings, urban transformation projects, favourable financing opportunities, strong investor preference due to relatively higher returns and increasing foreign investors' appetite. House sales throughout Turkey went up by 5.1% yoy to 1,4 million items in 2017. House sales to foreigners which constitute 1.6% of the total sales had a sharp rise with 22.2% in the same period.



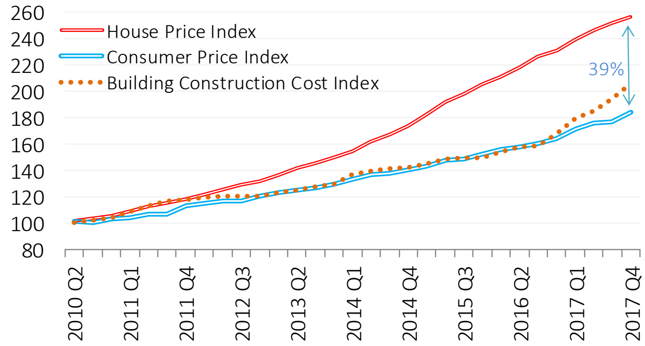
Nevertheless, the gap between the rising pace of supply and demand in recent years eventually caused an excess supply in the housing market. This supply and demand imbalance can be observed in the figures of building and occupancy permits. In 2013-17 period, average annual increase in number of building permits was 12% whereas the number of occupancy permits grew only by 3.1%. Therefore, since the end of 2015, there has been a downward pressure on house prices, which got even stronger in 2017. By December 2017, annual rise in house prices throughout Turkey (12.2%) was actually slightly above the consumer inflation (11.9%). On the other hand, house prices in cities like Yalova, Bursa, Trabzon and Antalya that are also preferred by foreign investors kept on rising thanks to strong demand.



(*) 12-month moving average
Source: CBRT, Turkstat

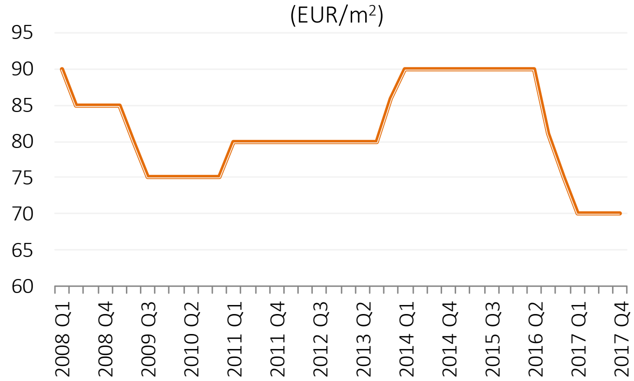
Although the annual rise in house prices have been decelerating for the last 2 years, prices were increasing rapidly for quite some time. And this price increases raised the question of whether there has been a bubble in the housing market and would it burst if it really exists. Related studies suggest that identifying a housing bubble requires observation of price increases which cannot be explained by fundamental factors such as household demand (usually fuelled by demographic structure) and rising costs. In Turkey, both robust domestic demand and recent surge in production costs played an important role in this upward trend in house prices. Rising land prices, constituting almost half of the total production costs, unexpected surge in the price of construction iron as well as the increase in financing costs led by tighter liquidity conditions have all contributed to the increase in house prices.

Price and Cost Developments in the Turkish Housing Market

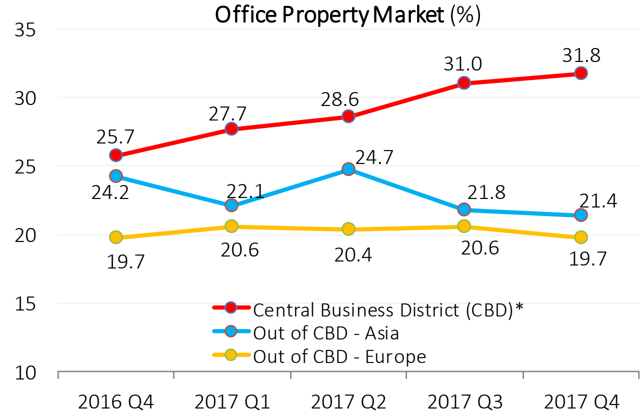


In 2010 Q1 - 2017 Q4 period, consumer prices rose by 84% while the increase in building construction costs was 106%. Excluding the cost effect, inflation-adjusted figures pointed out that real price increase in the housing market was 39% during that period. In fact, real price increase went up to 73% in the US when the house prices reached its peak in 2006 and right before the bubble burst. Thus, in this case, there is not enough evidence to prove the existence of a housing bubble in Turkey. As a matter of fact, recent outlook in the housing market indicates rather a price correction than a bursting bubble as the excess supply conditions started to push down the prices.

Primary Rent in the Retail Property Market
(EUR/m²)



Vacancy Rate in Class A Buildings in the Office Property Market (%)



Commercial Real Estate Market

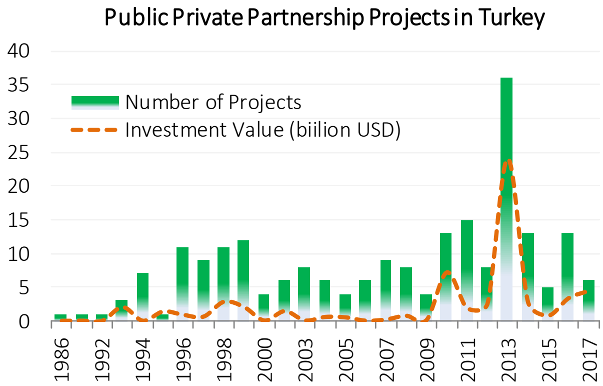
In addition to the housing market, excess supply conditions occurred in the commercial real estate market as well. Driving factors behind the supply and demand imbalance were robust growth in production and the rapid rise in FX-based commercial rents. In 2017, continued depreciation of TRY led to significant rise in rental costs of the retail sector. Consequently, number of closed shops kept on rising in many shopping malls and major shopping districts like Nişantaşı, İstiklal and Bağdat Avenues. Despite the latest recovery in foreign visitor numbers, ongoing geopolitical risks and substantial change in the spending behaviour linked to the change in visitors profile caused business volume remain sluggish for the shops in the touristic areas as well. So called risks also limited investment appetite for building new shopping malls. Accordingly, some of the planned projects have been either postponed or cancelled. Moreover, rise in stocks and vacancy rates in the office market also led to discounts in rental prices in 2017.

In the logistics market, however, hiring volume went up as a result of better demand conditions due to favourable price levels and also strong economic activity.

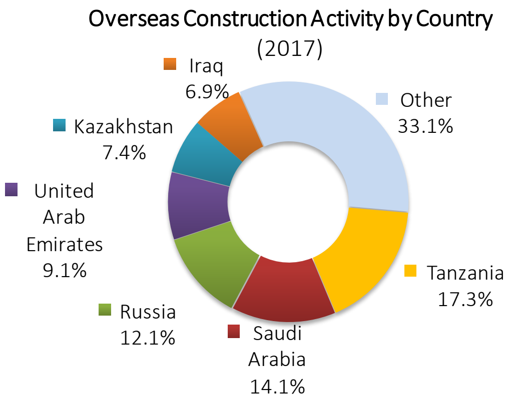
All in all, decreasing profit margins and ongoing geopolitical risks made a negative impact on new investments and overall business activity in the real estate market.

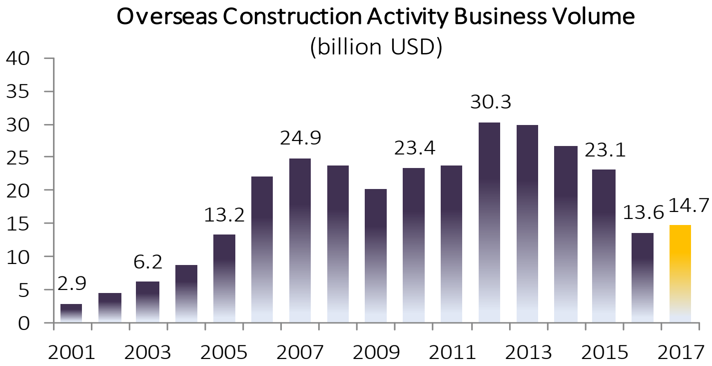
(*) Büyükdere Avenue
Source: CBRT, JLL, PROPIN, Turkstat

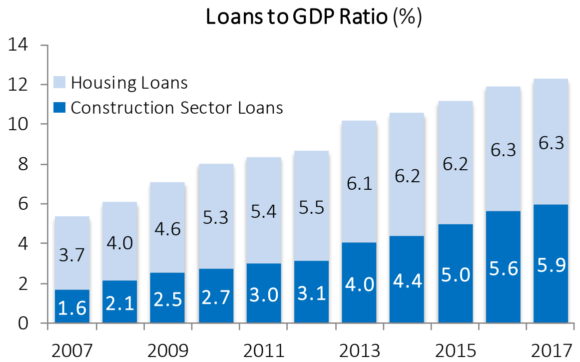
Infrastructure Investments & Overseas Activity



As being another important contributor to strong growth in the construction sector, investments in infrastructure projects continued in 2017. Widely known as "mega projects", these large scale investments are mainly undertaken in Istanbul. The major ones are the 3rd airport, Channel Istanbul and Istanbul Finance Centre. During 1986-2017 period, 221 projects worth of 60.7 billion USD have been undertaken via Public Private Partnership (PPP) model in Turkey. In the following period, infrastructure projects are expected to continue having positive effects on the sector's activity. As the majority of private contractors utilize long term FX loans, rising financing costs may cause some delays or postpones in new investments though. In 2017, the total value of overseas projects undertaken by Turkish contractors reached 14.7 billion USD, increasing by 1.6 billion USD yoy. Thanks to the recovery in energy prices, business grew in energy exporter countries, while improved relations with Russia affected business volume positively as well. On the other hand, activity in the traditional markets remained sluggish and ongoing geopolitical risks kept on limiting business expansion. Sub-Saharan Africa came to the forefront as an alternative market for the sector.







Financial Outlook

Financing figures demonstrate that construction sector loans to GDP ratio grew gradually in the last 10 years, while housing loans to GDP ratio remained relatively flat after 2013. Housing loans to GDP ratio in Turkey (6.3% as of 2016) which is well below the EU-28 average of 27% indicates that there is still a growth potential for housing loans in the country. According to CBRT figures, leverage (Debt/Assests) ratio in the construction sector was 40% and FX open position to assets ratio was approximately 20% as of 2016 year-end. As for the private sector's outstanding loans received from abroad, construction sector corporates' short term external loan liabilities were realized as 1.3 billion USD as of December 2017. Long-term external liabilities of the sector rose by 21.5% yoy and reached 15.9 billion USD during the same period. In this context, high volatility in the FX market has been considered as a risk factor for the sector's exposure. On the other hand, majority of these FX loans were utilized by the contractors in PPP projects. The long term structure of these loans and the FX denominated revenues of the contractors (there is the public purchase guarantee in FX terms for many of the infrastructure projects) are the mitigating factors for above-mentioned risks on private sector.

Source: Ministry of Development, Ministry of Economy, Turkish Contractors Association

Trends and Expectations

In 2018, we expect that growth in the construction sector will continue thanks to ongoing infrastructure projects and urban transformation facilities. Nevertheless, growth rate in the sector is likely to remain below the previous year's performance. We think that production in the housing sector will slow down while contractors will focus on destocking via price discounts and easing terms of payments. As the sector faces regional demand-supply imbalances rather than a housing bubble as a whole, it would be better to evaluate the investments on city, region and district basis. The sector is also expected to focus more on the demand of middle-income-consumers instead of luxury segment projects in order to eliminate supply-demand imbalance. We also estimate a flat course in commercial real estate market as well as overseas contracting.

At the beginning of 2018, government officials announced that they have been working on redesigning the "savings account for housing" system. The planned measures like rising public contribution to savings, providing mortgage loans with lower interest rates and making discount in some legal fees in house purchases may ease the pressure on domestic demand slightly. Moreover, recent changes made in the Building Law are expected to help urban transformation projects to continue more smoothly and less problematic, hence stimulating domestic construction activity in 2018.

However, while costs are rising, downward pressure on prices stemming from loose demand will continue to affect profit margins and investment appetite negatively. Developments in inflation, interest rates and FX rates as well as geopolitical risks will be in the focus of the sector players in making investment and consumption decisions in the coming period.

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