

Construction Industry Market Report

Third Quarter Update 2009

CONSTRUCTION INDUSTRY MARKET REPORT 2009 - THIRD QUARTER UPDATE

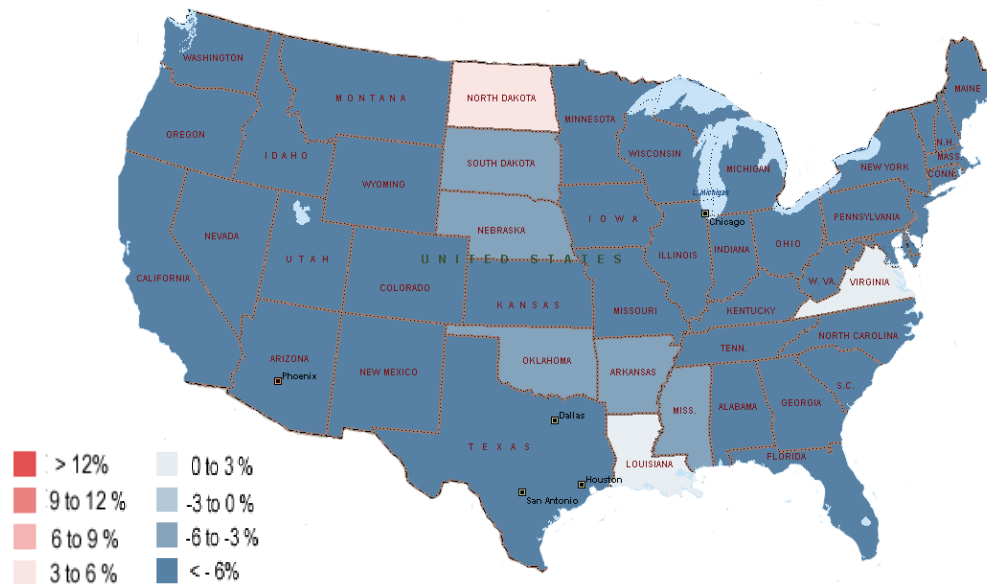
Overview of the Current Construction Market

In comparison with 2008, the third quarter of 2009 has been relatively calm in the construction markets. While the markets have remained significantly depressed, with construction activity running well below the rates of the past few years, the structural economic fears that were present in September and October of 2008 have now largely abated. The broader financial markets are recovering a semblance of strength, and lending is beginning to flow more freely again. While job losses are continuing, the rate of attrition appears to have slowed in the recent months, and owners are beginning to consider reviving current projects and initiating new projects, particularly in the governmental and institutional sectors. Nevertheless, construction markets continue to be extremely weak, and it is likely to be some time before construction activity shows any sign of appreciable recovery or growth.

Of the 50 states, only two are showing growth in activity, year on year, these being Louisiana and North Dakota. Forty are showing double digit falls in activity, of which six are shrinking at over 20%. Altogether a total of 1.7 million construction jobs have been lost since the peak monthly employment in the summer of 2006, and over 1.5 million on a seasonally adjusted basis. Total construction spending is down sharply, with an annualized estimate of roughly \$940 billion, some \$130 billion below last year. Year to date spending through August 2009 is \$84 billion less than year to date in August 2008.

This reduction in activity is leading to greatly increased competition among bidders and putting pricing pressure on projects. In most areas cost trends continue to be sharply negative, leading to moderate to strong construction price deflation.

Percentage Change in Construction Employment
from August 2008 to 2009



The American Recovery and Reinvestment Act (ARRA) is still taking time to work through the economy. As of the end of August, about \$107 billion has actually been paid out from the entire package; of this, about \$3.6 billion is specific to transportation projects. Given the depth of the recession in the construction industry, the ARRA funds may only be sufficient to reduce the depth of the cuts in employment, rather than creating an increase. Nevertheless, it would be incorrect to conclude that the stimulus spending has not been effective.

As the signs of a recovery grow, the questions now turn to the nature of the recovery and the likely shape of the post-recovery economy. The indications are that the recovery will be slow and erratic, with sustained low employment levels, particularly in the United States. There is also a real, but diminishing concern of a second period of recession, or a second round of financial failures. There is little chance that the recovery will gather momentum rapidly, sometimes described as a 'V' shaped recovery.

Not only is the recovery likely to be weak, but also the post-recovery economy is likely to be markedly different from the one preceding it. The expectations are that growth will be low for a prolonged period of time, as economies absorb the costs of the recession, and struggle to bring budgets closer to balance. For the United States, balancing currency value, interest rates, and economic stimulus, as well as demand for new programs such as health care, will be very challenging, and there is a strong probability that growth will be attenuated for several years as the economy reflects the new global realities.

While the broader economy appears to be emerging from the depths of the recession, there are no signs that there is any momentum building towards a recovery in demand for construction. Demand for new construction in the commercial and residential sectors is very low; many areas remain overbuilt, and it will take quite some time for the excess to be absorbed. Institutional and governmental agencies are beginning to explore new projects, or re-open current projects, but the level of activity is still well below that of the past few years. Even so, construction is still a major contributor to the national economy, employing over 6.3 million people, and spending some \$80 billion per month.

Even if the recovery proceeds without major challenges, there is a good likelihood that any recovery will experience significant dips in confidence and demand. This means that there will be a very uneven response in the construction market, with periods of relative optimism and pessimism. Construction demand and bids for construction projects are likely to be reactive to swings in the mood of the market, leading to the potential for sharp shifts in escalation.

The weakness of the recovery will have a significant impact on providers of design and construction services. Many have maintained a presence in the market due to momentum from the pre-recession period. As projects wind down, the stress on their working capital will be severe. Having capacity to grow into the recovery will demand robust working capital, and many firms may have survived the recession, only to fade in the recovery. We may be entering the period of greatest failure of firms in both the design and construction sectors of the economy, which will have an impact on the later stages of the recovery. For construction firms in particular, but also to some extent for design and management firms, the barriers to entry are quite high, both due to the need for financial strength in the form of capital or bonding capacity, and due to the need for a demonstrated track record for most project types. It could be that when the recovery finally hits its stride, the capacity will simply not be there.

All of these factors are finely balanced, and very small changes in regional or global economic conditions can have significant effects on local construction market responses. The period of greatest uncertainty in inflation is late 2010 to 2011, where much depends on the speed and strength of the recovery, both locally and globally. The range of possible escalation scenarios is significantly greater than has been experienced in recent markets, both in the escalation rate and the speed of change in escalation. For this reason, planning for uncertainty is more important than planning to a specific escalation target. This involves developing strategies for accommodating both lower and higher than expected rates of escalation. These could include alternates and set based design, owner managed contingencies, active monitoring of market changes, and open communication among project and user team members.

It is also important to manage escalation through the construction period, as well as through the design period, particularly for large or long term projects. If bidders are concerned about the possibility of cost increases, or even cost fluctuations, during construction, they are likely to increase their bids to cover the risk. This is particularly noticeable in fixed price contracts. As the global economy resolves the current recession over the next five to ten years, there is a significant probability of a return to the very volatile markets in commodities and raw materials seen in recent years. There is also the possibility of strong localized demand for construction work as investment returns to real estate and market capacity seeks to respond. This means that bidders on long term projects face significant price risks during construction.

In the current market, the most cost efficient procurement method would be to introduce some form of competitive bidding. This approach carries with it appreciable risks related to quality of construction and costs associated with change orders, and possible contractor/subcontractor insolvency. These risks are often greater in highly competitive markets, where bidders may have reduced margins sharply in order to secure the work, and are in a weaker position as a result. Change orders are also more likely on remodel work, where the complexity and site conditions are more difficult to capture in the final bid documents. In competitive bidding there is less opportunity for bidders to explore and understand these conditions, and hence more likelihood of post-award changes. If the scope can be adequately defined, however, the cost risk on competitive bidding is likely to be less than the benefit accruing from the lower initial price. For highly specialized trades, or ones with limited market capacity, sole source or negotiated bid will still have an overall price advantage.

For 2010 and 2011, it would be more cost efficient to introduce some form of inflation management to bid projects, either through fluctuation clauses or cost reimbursement. It would also be desirable to use integrated forms of design and procurement, such that project teams can respond quickly to changing market conditions, and can incorporate alternate materials, methods or design approaches seamlessly into the project.

OVERALL ESCALATION OUTLOOK

In the current economic climate, the inflation experienced on any given project will be the result of the interplay of many factors, including demand, retained risk, financing and input costs. In order to estimate escalation, it is necessary to estimate both the magnitude and the influence of all of these factors. This is challenging at the best of times, and particularly difficult in the current economic uncertainty. It is therefore necessary to introduce a higher level of active escalation risk management to projects, in addition to developing estimates of the most likely escalation rates prevailing in the area. This will entail more frequent monitoring of market changes, and potentially, using a more conservative escalation allowance.

In the short term, bid prices are likely to remain low due to the very weak demand and lower input costs. This will be most pronounced on smaller projects, but should be evident across the range of projects.

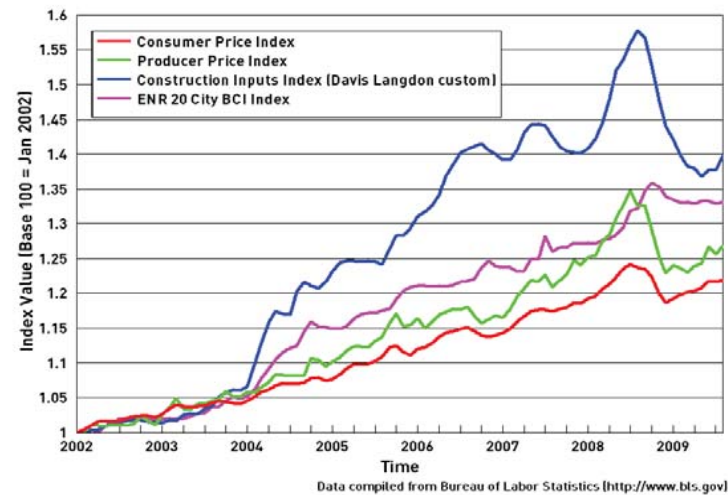
Looking to the longer term, the outlook is far less clear. The high level of volatility in the economy means that there is a wide range of potential outcomes. It is likely that the construction market will have a slow and painful recovery over several years, and it will take some time for investment to return in most construction areas. Nevertheless, there is a strong possibility that there will be surges of investment. Experience has shown that the global economy is in a very reactive period, where investors flood (or abandon) markets rapidly and in large numbers.

There is also the problem that markets have become far more synchronized than ever before, and so there is a much finer balance between supply and demand. This was evident in the last few years as commodity prices became very volatile even with very small shifts in demand, because there was no global slack to cushion them. Even if construction is slow to recover, other market sectors may well drive prices and volatility, mainly for commodities, but also for manufactured goods and labor. Also, the recession has driven, and will continue to drive, capacity out of the construction market, such that even a small growth in demand could overtax the surviving resources.

The most likely escalation scenario is an uneven slow recovery where, over the next five years, we see very erratic pricing; commodity prices jump up and down while some jobs get good bids, some bad, depending on the mood of the market at that time and on the global trends in material pricing.

Escalation planning will be marked more by the need to manage the uncertainty than to accommodate the actual escalation rate, and projects will need to recognize that increased risk in the planning process. In many respects the construction market is entering entirely new territory, with factors and conditions that are unprecedented. Traditional responses to these new challenges are unlikely to be adequate.

**Comparison of Construction Inputs
to Published PPI, CPI, and ENR's BCI**



Direct Costs

Materials

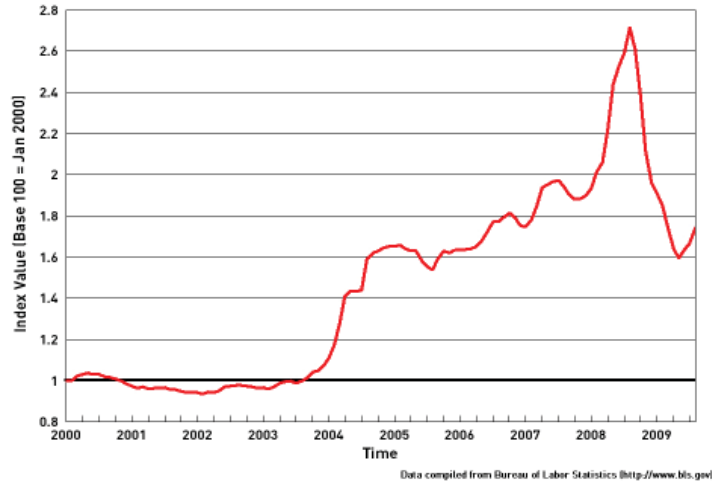
There are two main components to the inflationary impact of material prices. The first is the overall trend of prices, and the second is the volatility of those prices. Because bidders must set their price at the start of the project, but may not be able to control the actual cost at the time of purchase, they carry significant fluctuation risk. In the past five years, material prices, particularly those tied to primary commodities, have shifted dramatically, creating unprecedented uncertainty for bidders. A consequence of this is that bidders must now respond both to the expected price trend and to the likelihood of further fluctuations through the course of the project. This creates 'price stickiness', where falling prices are not reflected in bids, except where the bidder can either tie down a supply price at the time of bid, or when the bidder has confidence that the falling price will hold until they procure the materials.

This material price volatility creates an asymmetrical risk for bidders. If prices rise suddenly, bidders can be caught in fixed price contracts with no ability to recover the increased input cost. If the material in question is one of their key materials, or if the increase is large, the increase could be sufficient to put them out of business. On the other hand, if prices fall sharply, the consequence is a windfall profit.

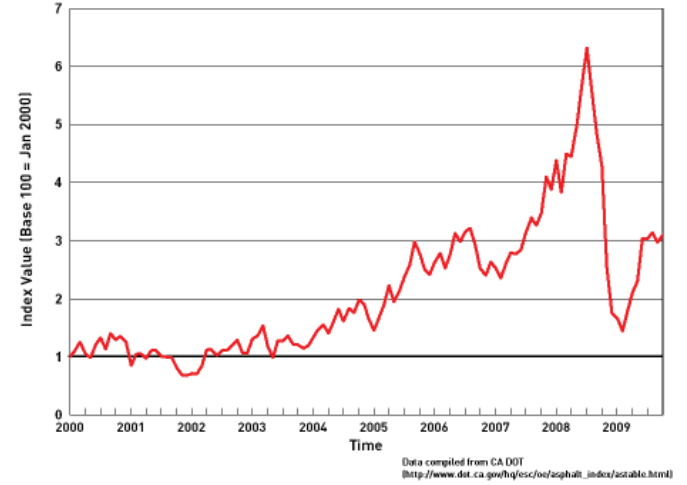
Material price volatility is more pronounced on larger, longer term projects, or on projects heavily vested in individual commodities. This has been a major factor for larger, more complex projects such as healthcare, which require long term contracts and high residual risk for bidders. Smaller scale projects are less vulnerable to impact by material price volatility; however, there is still the possibility of impact due to fluctuations in specific key materials.

The direct cost of construction materials has seen significant fluctuation over the past two years. At the macro level, the major indexes all show a peak in 2008, followed by a sharp fall, then the start of a modest recovery. Looking at individual materials, however, there are a wide variety of profiles, from steel which has a sharp single peak, to softwood lumber which has been falling steadily from a peak in 2004, and ready-mix concrete which has continued to grow throughout the recession.

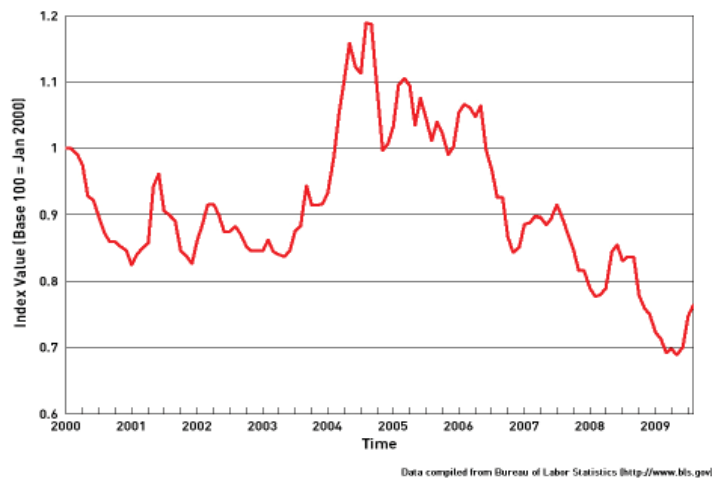
STEEL



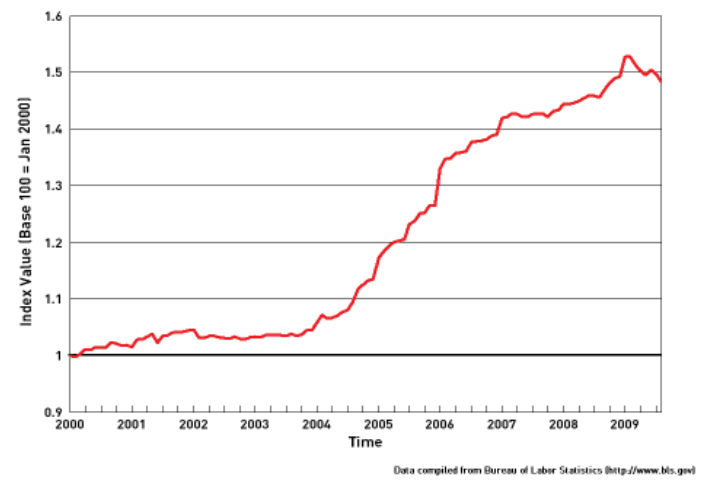
ASPHALT



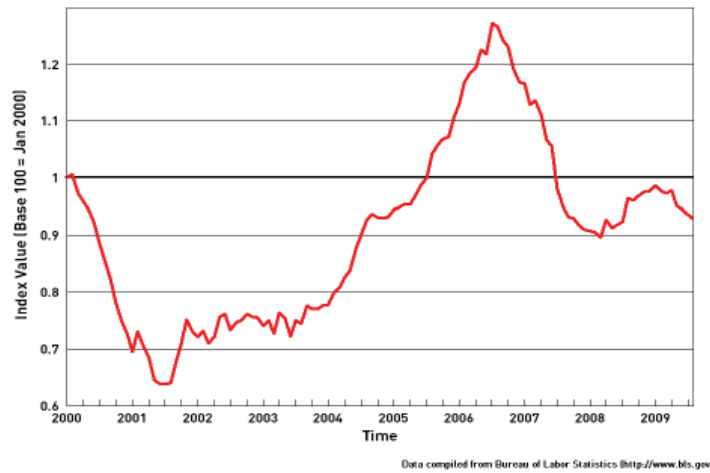
SOFTWOOD LUMBER



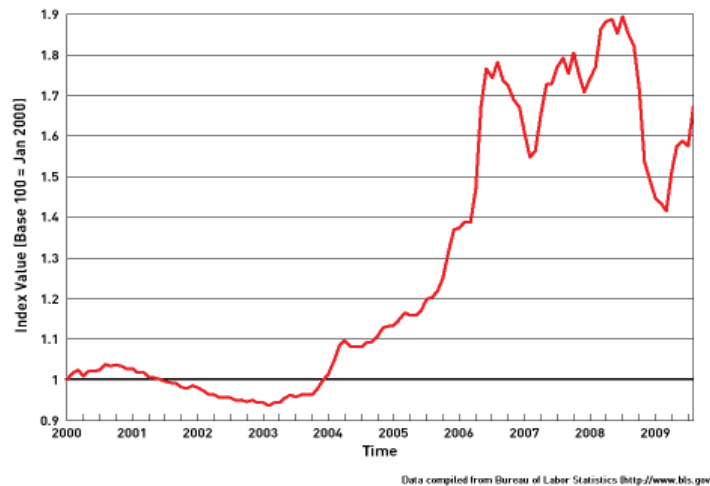
READY-MIX CONCRETE



GYPSUM PRODUCTS



COPPER WIRING



Direct Costs (cont'd.)

Labor

Labor costs are showing some decreases, due mainly to informal concessions at a project level. Labor agreements are not showing a formalization of the decreases, although there have been some contract concessions in some cases. It is unlikely that new contracts will show significant labor cost reductions, but the rate of increase may well be lower than would otherwise have been expected.

Overall Implications

For construction, as with the wider economy, the future is uncertain. There is no way of knowing how the construction markets will fare over the next one to two years, and no way of forecasting likely cost trends.

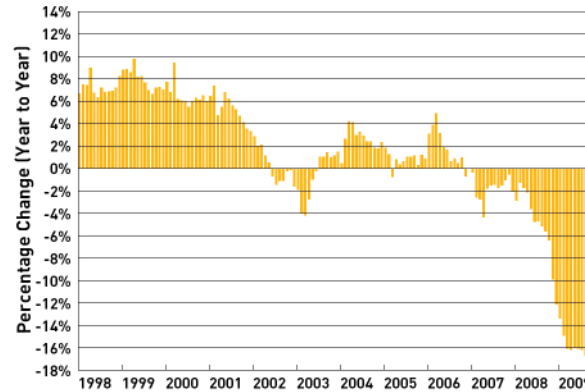
For most markets the deflationary effect of falling demand is likely to be the prevailing driver. These include the hitherto strong regions such as the western and southeastern states, and the residential and small, simple non-residential sectors. These markets could experience flat or falling prices, with escalation running from extremes of -15 to -20%, to a more likely range of -3 to +3%.

For markets with limited range to absorb material and risk premiums, escalation is likely to remain positive. These include markets with limited contractor pools, such as those for large, complex or specialized projects, or projects with limited bid invitations. These markets could see escalation in the 3 to 5% range.

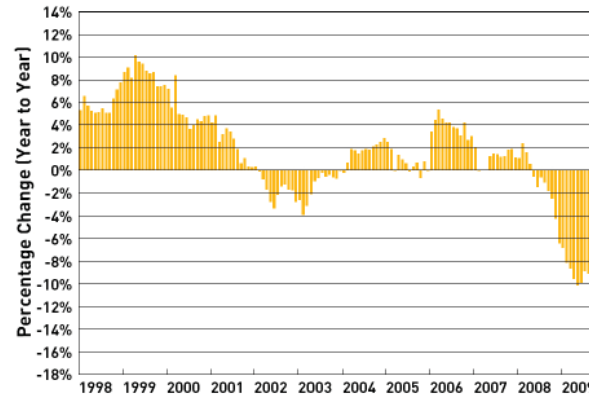
Within both these pools, there will be aberrations as bidders seek to gauge the competition for any given project. This could lead to localized significant bid overages or savings on individual projects.

Escalation planning will be very difficult for the next two to three years as escalation becomes more reactive to external factors and thus more unpredictable. The best inflation planning will be risk planning; developing risk management protocols to identify and manage the greatly increased risks related to construction costs inherent in the current market. Escalation risk mitigation strategies should include a careful assessment of the appropriate allocation of risk across the project team as far as possible, by contractual clauses addressing such issues as material price volatility, financing risk, prompt retention release, and targeted reductions in bonding requirements.

Region 1. Construction Employment Percent Change



Region 2. Construction Employment Percent Change



Region 1.
Connecticut, Maine,
Massachusetts, New
Hampshire, Rhode Island,
Vermont¹

The decrease in growth in Region 1 appears to have leveled off, much as is being seen in most of the rest of the country. Connecticut is still experiencing declines over 20%, but the other states have begun to show some faint signs of recovery. The region as a whole has been severely impacted by the recession, and is second only to Region IX in its continued rate of decline.

The overall economic picture in the region is generally poor. There is weak job growth and a limited prospect for growth in demand for construction services, in the short term. Connecticut is highly dependent on residential construction serving the New York region, and it is likely to be several years before this demand returns. In the long term, the region does have the potential for stable market growth with strong regional economic drivers, particularly in the southern portion of the region.

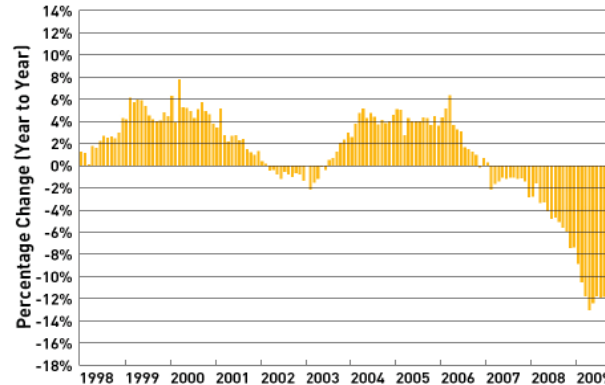
Region 2.
New Jersey, New York, Virgin
Islands, Puerto Rico

The construction industry in Region 2 is beginning to show some faint signs of decreasing job losses, and the overall regional loss is the lowest in the country. Much of this has been due to New York, which, while still declining, is one of the few states in the country experiencing that decline at less than 10%.

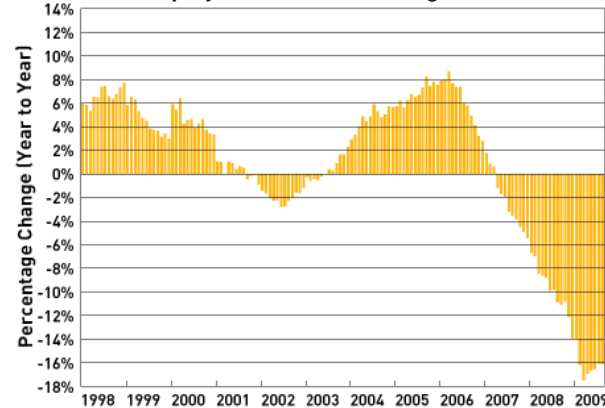
In the short term, the region is likely to see continued shrinking of construction activity, but perhaps to a lesser extent than the surrounding regions, and the country as a whole. It may also be one of the regions that recovers the quickest, due to the long term economic strength of the region. That strength, however, is concentrated in the areas surrounding New York City. Upstate New York in particular is likely to continue to struggle economically.

¹ Data in all regional graphs in this report are from US Bureau of Labor Statistics (<http://www.bls.gov/>)

Region 3. Construction Employment Percent Change



Region 4. Construction Employment Percent Change



Region 3. Delaware, District of Columbia, Maryland, Pennsylvania, Virginia, West Virginia

Construction activity in the region continues to slow, although like most other regions, the decline has begun to level off over the past few months.

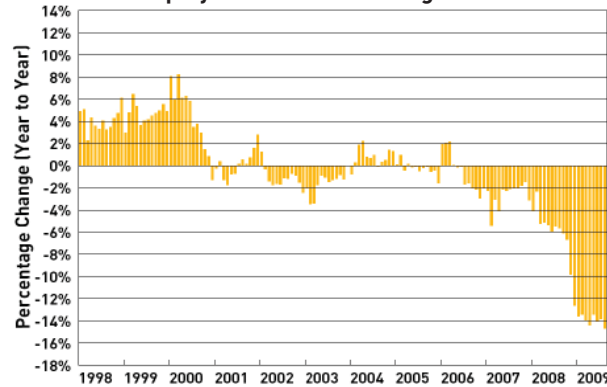
The long term economic picture in the region is relatively strong. The DC region is set to receive significant stimulus funding, and there is likely to be steady job growth and reasonable prospects for continued long-term demand for construction services. In the short term, however, the region is likely to experience continued job losses and weak demand, along with the rest of the country. The decline will not be as severe as the south east and western portions of the country, and the recovery could be more rapid.

Region 4. Alabama, Florida, Georgia, Kentucky, Mississippi, North Carolina, South Carolina, Tennessee

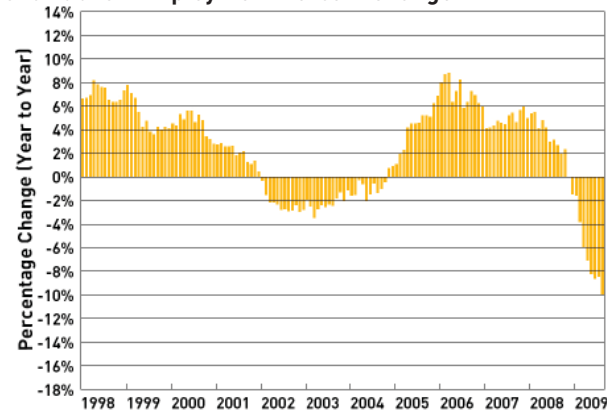
Region 4 continues to struggle. Tennessee, Kentucky, and Alabama are all within the ten worst hit states in the country, declining at a rate of 20% or higher, while Georgia and the Carolinas are contracting at a rate of more than 18% and 15%, respectively. Despite these high levels of decline, the region as a whole has begun to show some signs of stabilization of job losses. Florida, the largest employer in the region, and for a long time one of the hardest hit states, has cut the rate of job losses to 13%, possibly because it was one of the first to be severely hit.

The Atlantic states have experienced significant overbuilding, particularly in residential and hospitality construction. The backlog will take time to eliminate, and with these sectors being among the most impacted by the current recession, they are unlikely to see a rapid strengthening any time soon. The western portion of the region experienced far less excess, but it, too, is struggling to find an economic footing for growth. Recovery is likely to be some way off in this region, with recovery occurring more rapidly in the western states than in the Atlantic ones.

Region 5. Construction Employment Percent Change



Region 6. Construction Employment Percent Change



Region 5. Illinois, Indiana, Michigan, Minnesota, Ohio, Wisconsin

Region 5 remains one of the weakest overall construction markets in the country, and is one of the few where the rate of decline in jobs is still growing. Employment levels have been falling sharply since 2006, although the past year has seen even steeper declines, with the decrease in demand doubling over the past twelve months.

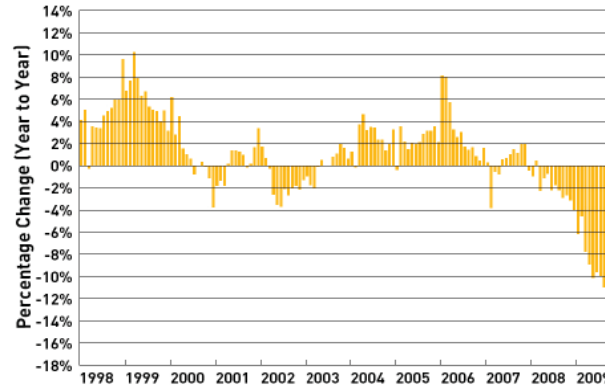
The overall economies in the region remain very vulnerable, with low employment growth and low economic activity. The region has been severely impacted by the current economic conditions, and there is little sign of a pick up in demand for construction in the region over the next two to four years.

Region 6. Arkansas, Louisiana, New Mexico, Oklahoma, Texas

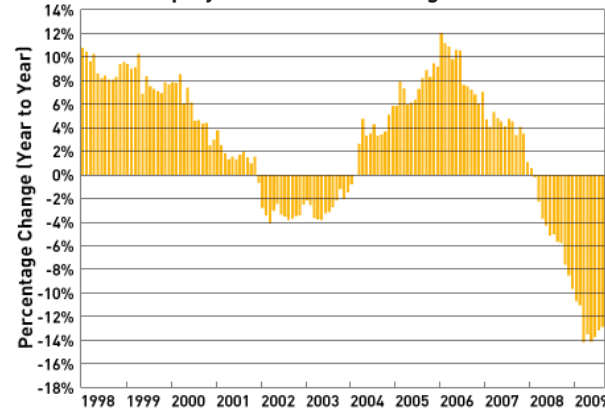
Region 6 has the distinction of having one of only two states in the country which are still showing any positive growth, and of having two of only nine states in the country experiencing contraction at less than ten percent per annum. However, this gain has been overshadowed by contraction within the rest of the region, most notably Texas. Even so, the decline in Texas, the largest state in the region, has been relatively modest – at just over 10% – when compared to the rest of the country.

The region also has relatively good economic prospects, both in the short and mid term, although it is unlikely to escape the effect of the current recession all together. In general, however, the region may experience a shorter downturn, and a quicker recovery than many other areas.

Region 7. Construction Employment Percent Change



Region 8. Construction Employment Percent Change



Region 7.
Iowa, Kansas, Missouri,
Nebraska

All the states in Region 7 are in very mild decline. This region is not one given to rapid changes in activity. It did not participate in the boom of the past four years, and it is likely that the slowdown will be similarly modest, as will be any coming recovery.

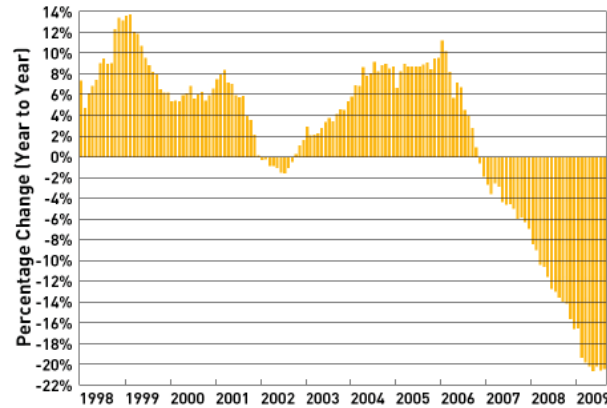
Escalation in the region is more likely to be driven by external factors, which should be moderately negative in the coming year, due to the substantial weakness in the neighboring regions, particularly the larger markets to the south and west. The region will also be vulnerable to shifts in primary input costs arising in other regions.

Region 8.
Colorado, Montana, North
Dakota, South Dakota, Utah,
Wyoming

While activity in Region 8 is still about thirteen percent less than it was in early 2008, there are some signs of slow recovery. North Dakota is one of two states in the country that has experienced any positive growth in recent months, while South Dakota is showing only weak contraction, at less than 4% per annum.

In the short term, this region is likely to remain weak. Much of the construction growth had been driven by population movement, particularly in the two largest states of Colorado and Utah. The current economic downturn is dampening that trend, and the weakness in the housing market is likely to keep growth low for some time to come. In the longer term, the region should return to strength, but this may be three or more years away.

Region 9. Construction Employment Percent Change

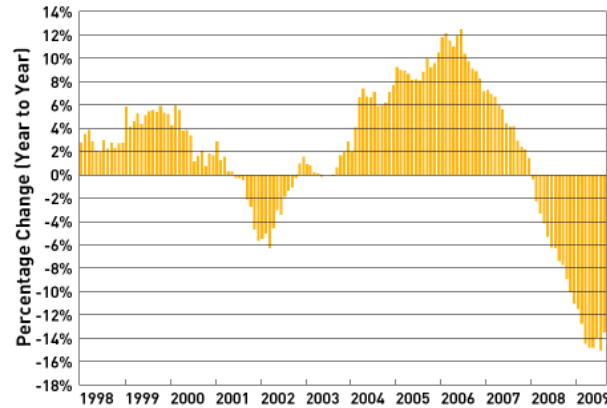


**Region 9.
Arizona, California, Hawaii,
Nevada**

This region continues to be the hardest hit region, both in percentage terms and in total job losses – almost one half million in the past year. It has shed more construction jobs than exist in four of the other nine regions. It also includes three of the most severely impacted states. Arizona and Nevada are the top two states, both experiencing over 26% decline, while California, at over 18%, remains in the top ten. Together these states account for roughly 15% of all construction employment nationally, and so the decline in this region is a significant part of the overall national decline. The weakness is largely driven by sharp reductions in housing activity. Non-residential work is declining as well, but to a lesser degree.

The economic outlook for the region in the short term is relatively weak. The State of California has significant revenue challenges, and public sector spending is likely to be limited in most sectors. The area has experienced a large degree of overbuilding, particularly in the residential sector. Population growth due to migration has all but stopped due to the fall in the residential market. All of these factors will take some time to correct, and it is likely that any recovery in the region will be slow. In the mid to longer term, the region has the potential for high construction demand to meet population growth and to support the expected long term economic growth.

Region 10. Construction Employment Percent Change



**Region 10.
Alaska, Idaho, Oregon,
Washington**

Construction activity in Region 10 continues to decline, but at a slightly slower rate than seen earlier this year. Alaska has the lowest rate of decline, but is a relatively small market, and was not as impacted by the rapid growth of the previous years. As such, it should not experience as severe a downturn in prices. Of the three contiguous states, Idaho is showing the least decline, at 11% per annum, while Oregon and Washington are contracting at slightly higher rates (14% and 16% per annum). All three states experienced strong growth in 2006 through 2008, and all are experiencing challenging conditions for bidders, with moderate to strong price deflation in the range of 10% to 20% from the peaks of 18 months ago.

Long term economic prospects in the region remain strong, but recovery in the region may be some years away, and escalation is likely to remain negative to flat for the coming year.

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