

2009 Market Update – A Guide to Working in a Recession



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The health of the construction industry has always been closely related to the general economy. In times of economic growth, the construction industry

experiences growth as well, while in times of economic hardship, the construction industry contracts. Recent reports declaring that the United States is officially in a recession, combined with the depth of the recession forecast for the coming year, point to a dismal outlook for the construction industry that is not expected to begin to recover until the later part of 2009, if not beyond.

Overall, the outlook for construction is quite poor. In recent downturns, the decrease in construction activity has been much milder than the decrease in broader economic activity. The current recession is markedly different, having been led, to some degree, by over-building in many sectors in the construction market. In addition, construction is highly dependent on capital financing, which has become extremely difficult to obtain in the current climate. The consequence is that construction is seeing one of its sharpest downturns in several business cycles, and the prospect for rapid recovery remains dim. The only bright spot is that construction is often a preferred approach for government economic stimulus activity. Indeed, there are some indications that construction will attract significant Federal and State investment in the coming months. This, however, is likely to have only a limited impact on the depth of the recession in construction.

Within the construction market, while escalation is likely to be much lower than in recent years, the level of activity is also likely to be much lower, and there is the possibility of business failures throughout the industry, from owners to contractors to design and consulting services. This possibility has the potential to create a feedback loop of distrust, similar to that which played a large role in the initial credit crisis, amplifying the effect of the initial shock. Overall, the risk for clients as well as for contractors remains high, and project teams will need to remain vigilant and well organized in order to secure value in the current market.

Introduction

The pace of change in the economy has been breathtaking, and between the publication of our third and fourth quarter forecasts, our prognosis has shifted from a slowing rate of price growth to price decreases in many sectors and regions of the country.

While falling inflation and price reductions will reduce the affordability problems that many projects are facing, such a rapid reversal in fortunes brings its own challenges. A low price of entry does not automatically equate to an affordable project and well advised owners may choose to review their project risk allowances at the same time as they reduce their inflation budgets. Both owners and project teams have an important role in creating conditions for success, and fully designed schemes that have been de-risked from the perspective of both the client and contractor will give all parties the best chance of a successful outcome. Now is not the time to attempt to deliver high risk projects on the back of low bids, based on an incomplete design.

The downturn in headlines

The key features of the current market conditions and Davis Langdon's forecast for 2009 and beyond are as follows:

- Recently published forecasts of construction activity suggest that new work will have fallen by 15 % by the end of 2008, despite continued growth in work in infrastructure and the public sector.
- Bid prices are likely to continue falling in many regions and sectors in 2009. This will be the first sustained fall in prices for many years.
- Escalation will be difficult to estimate, and we expect the uncertainty to continue for the next three to four years.
- Prices rose in most sectors during 2008, peaking in the second quarter. Price levels have since fallen during the third and fourth quarters. A steeper and earlier decline in prices has been more evident in some regional markets (such as California, Nevada and Florida in residential construction markets). Few of the reductions seen to date are at the level of deflation which we anticipate will occur from 4th quarter of 2008 onwards.
- Building cost inflation remains in the system, albeit that the rate of increase has begun to slow as energy costs and some commodity prices have fallen.

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- Ensuring that accepted bids and programs are realistic and deliverable, and that selected principal and trades contractors are financially secure.
- Including adequate contingencies in budgets to account for the likelihood of claims and other risk events, together with the security of adequately backed warranties and performance guarantees.

The downturn in headlines

After enduring years of rapidly rising prices, which have tested the viability and affordability of projects across the private and public sectors, this change might feel welcome to many owners and project teams. However, not all projects will be in a position to benefit from the greater competitive pressure that a decrease in workload will bring. Projects in sectors which continue to enjoy growth, such as infrastructure, are not likely to garner significantly lower bids. Furthermore, contractor selection strategies such as two step negotiated procurement, which rely less on head to head competition, may also be taken by contractors as opportunities to maintain more healthy margins in some elements of their portfolio.

In sectors which are shrinking, securing a low entry bid will be relatively easy. However, converting that into a successful project will require hard work by the client and project team, focused on the following key issues:

- Elimination of sources of uncertainty – Incomplete design, poor coordination and so on increases the risk of disruption, overrun and claims. Clients, project managers and design teams must give a higher priority to eliminating these risks than has recently been the case.
- Minimizing project risk – Optimum prices for lump sum contracts and overall cost certainty could be enhanced by isolating major sources of risk such as demolition and below-ground work from the main contract.

What can we learn from the past?

Boom and bust has long been a characteristic of the construction industry, as is evidenced in Figure 1, which compares the percent change in new housing starts and the total put-in-place value for construction in the United States, to the change in national GDP over the past five decades.

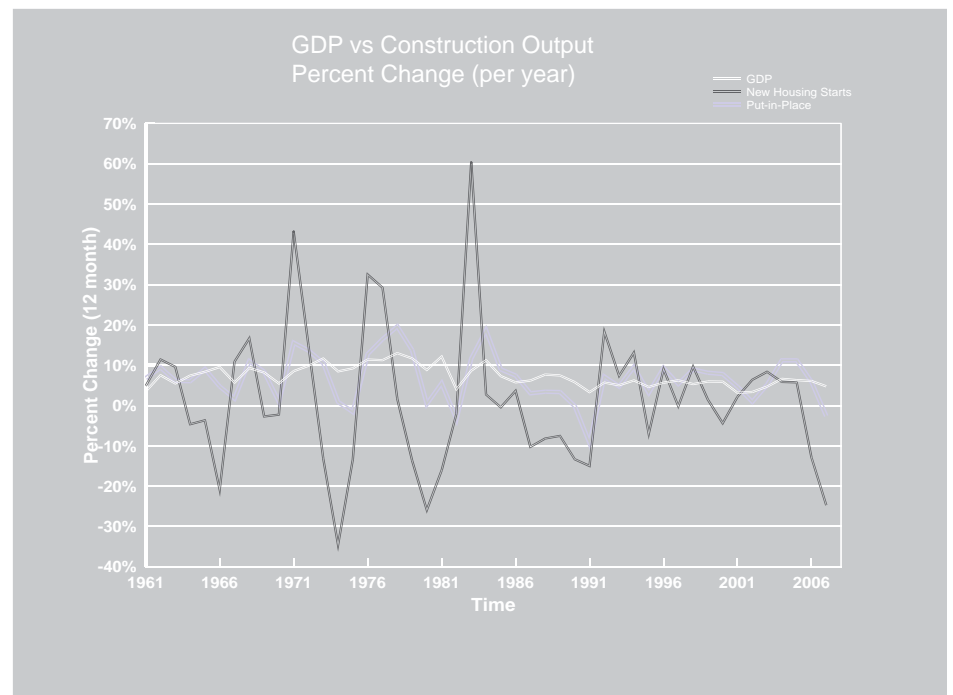


Figure 1 GDP and Total Construction Output (annual % change)

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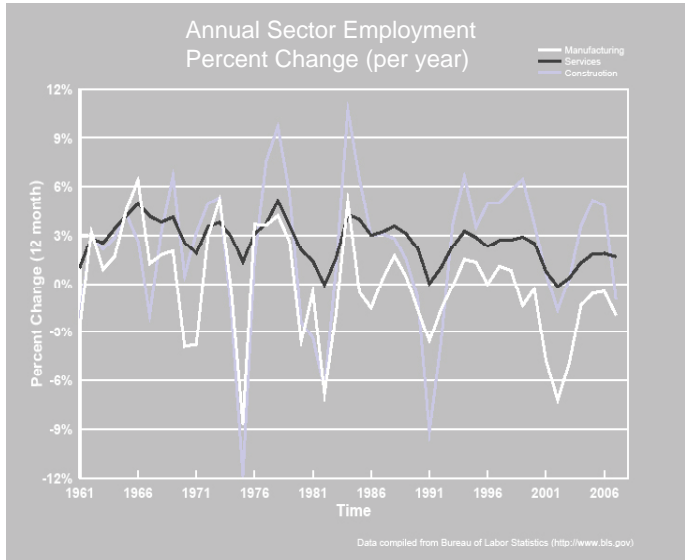


Figure 2 – Annual Sector Employment - % Change

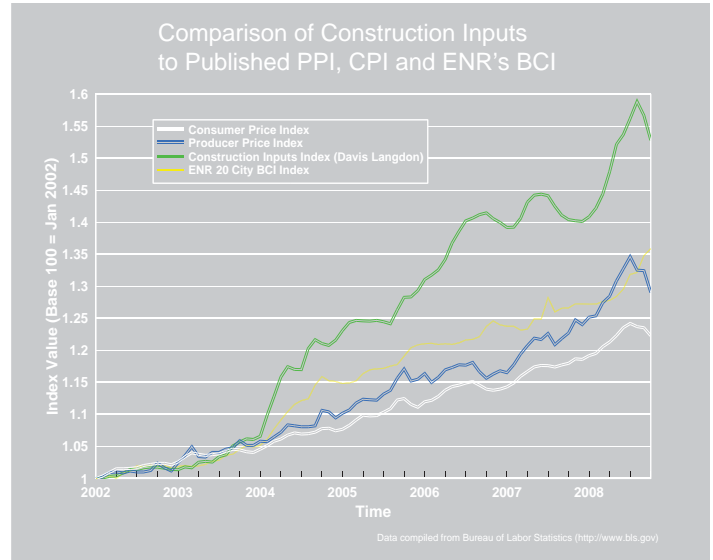


Figure 3 - Comparison of Construction inputs to published PPI, CPI, and Building Cost Index

In addition, employment in the construction industry (Figure 2) also has historically tended to respond more sharply to downturns in the economy than other market sectors such as manufacturing and service, although this has been less evident in the recent cycles.

By contrast, the recovery of output is typically much sharper in construction than for GDP overall, which points to potential problems when the industry does recover, with constrained capacity and reduced competition driving rapid re-inflation, which could potentially stifle recovery at source.

One aspect of the current economic downturn is the speed at which strong growth in demand and costs has turned into a full-scale crash – in this case driven not only by the withdrawal of investors from the property market, but also by the wider impact of the turmoil in financial markets. Another factor in the current recession is the previous instability over the rapid and unpredictable fluctuations in input prices (seen in Figure 3 above) which had led to turmoil within the industry even during a period of strong growth.

Future outlook

Recovery in the industry will happen, but it is likely to be slow, and is highly dependent on overall economic recovery, especially with regard to the credit markets. Much of the recovery will be very sector-dependent. Housing has suffered a significant drop recently, but infrastructure and public works are still remaining steady when compared to the volume of construction output as a whole. The incoming administration has proposed stimulus plans that would include significant spending on infrastructure across the country, but it is too early to say how much this might entail. Figure 4 (below) charts sector-specific construction output to total output over the past two years, based on data from the US Census Bureau. Labor costs in the US have grown steadily, but with relative stability in the past year, and this pattern is likely to continue for the coming year, despite the economic downturn. This is due mainly to the fact that contracts currently in place were negotiated in the past several years, when the economic condition was more stable. In regions with less union presence, however, these conditions would not apply and labor costs are more likely to be lower, due to an

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increased pool of available workers. Overall, labor costs are rising at about 4-5% per annum.

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 to falling prices, with escalation running from extremes of -10 to -15% in the hardest hit sectors, to a more likely range of -3 to +3% for most project types.

For markets with limited range to absorb material and risk premiums, escalation is likely to remain high. 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.

Escalation planning will be very difficult for the next two to three years as escalation becomes more reactive to external facts and thus more unpredictable. The best inflation planning will be risk planning; developing protocols to identify and manage the greatly increased risks related to construction costs inherent in the current market. Escalation risk mitigation strategies should include 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.

With the slowing economy it can be expected that the market will experience a

reduction in the number of new construction projects, as well as an increase in the number of live projects being placed on hold by owners. As a result, skilled labor should be more readily available, resulting in a decrease in contractor and subcontractor bid pricing. However, it may take some time before the current economic situation truly takes effect on trade availability, as many contractors and subcontractors had projects on their books before the economic downturn, some with project completion dates stretching into 2009 and 2010.

wards as a result of the economic downturn, and most strategic materials, especially oil, steel, copper, and lumber, are showing substantial declines in price, with an expectation that this drop in price will continue for the short term. However, the recent rapid increase in materials pricing, in some cases more than doubling in less than a year, is expected to have a lingering effect in the industry, as contractors are likely to price bids with these recent unpredictable fluctuations in mind. In addition, changes in commodities prices are not usually immediately reflected in material and in-place costs, and other

sectors of the economy, such as the decline of the auto industry in the US, are likely to play a role in determining price and availability as well.

Risk remains a serious concern for construction projects. Delay and cancellation of projects, even projects under construction, is a growing trend. Reduced availability and increasing cost of financing impacts not only project owners, but also contractors, who rely on financing for working capital during construction, as well as bonding and insurance companies, who rely on financing to provide their services for

construction. The recent market trouble has clearly increased risk substantially.

The impact on the financing, insurance and bonding markets is yet to be seen, but it is likely, if only in the short term, that there will be sharply reduced capacity in the construction market as bidders compete for limited finance and insurance. As a result escalation is likely to vary based on the size and/or the complexity of the project.

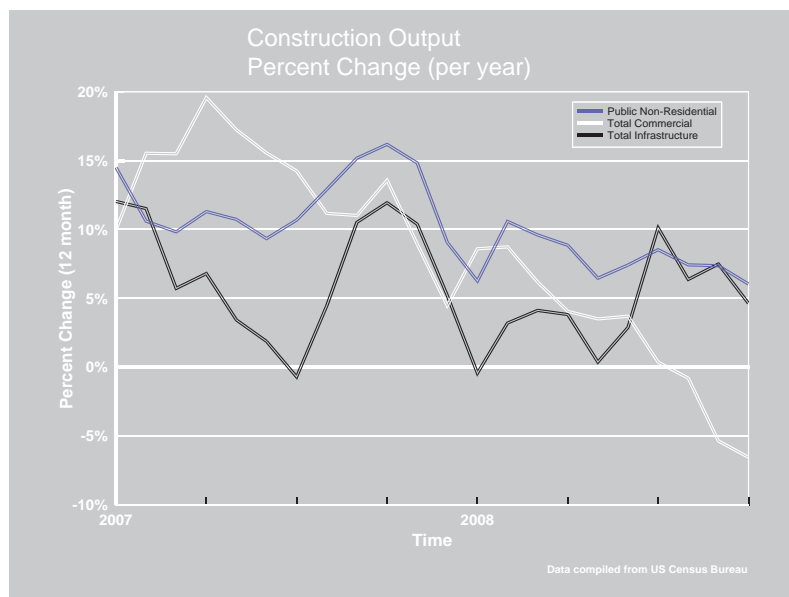


Figure 4 - New build construction output, by sector

Despite the depth of the collapse in output, particularly in the commercial, industrial, and housing sectors, it is important to also maintain some perspective with regard to the potential for prices to fall. From a construction cost escalation perspective, the recent economic news is likely to lead to better news. Just as the rapidly growing demand of the past four years led to unprecedented levels of construction escalation, falling demand is leading to decreasing escalation, and even, in some areas, deflation. Commodity prices are trending down-

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Falling prices have the potential to unlock the viability of some projects, which could in turn stimulate a revival in wider activity. Procuring construction in a falling market should provide an owner with an opportunity to secure an advantageous financial outcome. However, risks on projects increase in downturns, and owners, contractors, and all members of the project team need to approach the market in a realistic and vigilant manner. Key issues to look out for include:

- The timing of the downturn – The forecast for continued decrease in prices is based on an expectation that the reduction in new project opportunities will translate directly into an aggressive pricing strategy by contractors. Different sectors and trades will have different workload profiles, however, and as a result, the extent of cost reductions will vary:
 - Infrastructure has been short of work for a number of years and rapid growth, as proposed by the incoming administration, is likely to face capacity constraint and continuing inflation.
 - Contractors with a significant public sector workload secured via frameworks will have greater confidence in their pipeline than those who have focused on commercial projects.
 - Different trades have contrasting workload pipelines due to the timing of activities on project programs. Mechanical and electrical specialists and their supply chain, for example, are not currently as hungry for work as front loaded trades such as piling or concrete works, and prices may not soften for a further 6 months.
 - Continued volatility in currency and commodity markets could affect a contractor's ability to fix or reduce prices. Alternatively these risks could be packaged in such a way as to transfer risk to the client.
- The extent of inflation built into the client's baseline estimate – Prices are anticipated to fall from a highpoint of 2nd quarter 2008 and estimates produced before this date may not reflect the full level of cost escalation which has taken place.
- The stability of the contractor and their supply chain – Highly competitive pricing, reduced turnover and increasing fixed costs such as debt are all likely to put pressure on the financial stability of companies at all levels of the supply chain. An increased focus on the workload, resources and financial health of key supply chain members will help to mitigate, but will not remove the risk of company failure.
- The effect of the choice of contract on project recovery scenarios – Consideration of the potential for contractor failure may also affect the selection of procurement routes – particularly where clients are dependent on short-term project finance. Design and build is very attractive to clients as a means of risk transfer, but in the event of main contractor failure, the unpicking of the contract can create a complex set of problems related to warranties or access to subcontractors.
- Maintenance of competitive pressure – In a falling market any project which offers a respite from competitive pressure will be welcome to bidders, but will not secure the full benefits of competition. Two step negotiated procurement will continue to have a place in procurement strategy, but if clients wish to secure a lowest price of entry to ensure affordability, direct competition is likely to be necessary.
- The emergence of adversarial relationships – One of the reasons for moving away from single stage competitive bidding has been as a positive response to the inefficiencies associated with sequential working and adversarial project culture. The fact that more owners are willing to contemplate a return to traditional procurement suggests that more collaborative approaches have

not always delivered the expected benefits. When making use of more competitive bidding strategies, owners must make sure to appropriately manage risk, by selecting qualified bidders, and establishing appropriate contingencies. Actions to take to obtain secure project outcomes.

A key theme for project owners in the current market turmoil is that the successful adoption of a competitive procurement strategy, in order to secure lower costs, will depend on active steps by the owner and the project team to ensure that the contractor is in a position to provide a realistic and binding bid and that contractors' bidding costs are minimized. The key steps are outlined below. Without action in these areas, contractors' work could be disrupted, unnecessary costs could be incurred, and owners could be severely disadvantaged in their efforts to secure a low exit price on their contracts.

- Keep bidder lists reasonably short to keep bidding costs low and to encourage serious, competitive bidding.
- Allow enough time for design work to be completed and signed off before proceeding to discussions with contractors.

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- Define a procurement strategy that balances the owner's need to establish quality standards with the contractor's ability to drive in value and manage their risk exposure, through the allocation of design responsibility and the selection and management of the supply chain.
- Minimize project risk for both project owner and the contractor through packaging strategy, design and specification, coordination, and the clear definition of critical performance requirements.
- Establish clear design signoff and change management system, to be agreed to by all members of the project team, including contractor and owner.
- Evaluate the financial health of the proposed contractors and their supply chain. Ensure that robust and properly funded performance bonds and guarantees are in place. Regularly monitor the financial health of the selected project team.
- Sign the construction contract ahead of commencement of works on site. Do not rely on letters of intent.
- Invest in well managed information exchange tools. Ensure that these tools are properly managed and used as the single source of project information.
- Build adequate risk allowances into overall project budgets.

difficulty maintaining adequate cash flow for operations, and none have the resources to manage significant expansion of working capital. For this reason, bidders are having to be very careful in selection of projects, with a strong preference towards projects with good quality cash flows. Generally this comes from owner commitments or reputations for assured project financing, prompt payment and early release of retention. Owners who act responsibly and proceed into contracts with well designed schemes and a carefully selected contractor team will have to work hard, but should secure value. However, for those project teams that proceed on the basis of information standards and management styles that were the norm during the recent upswing, the next several years could provide some nasty surprises.

CONCLUSION

The current financial crisis and recession are putting unprecedented strain on the construction market. The reduction in construction activity is leading to increasing competition among bidders and lower escalation pressure on projects; in many projects, cost trends have become negative, leading to moderate construction price deflation. The issue of contractor financing and working capital is one of the biggest causes of concern. Many contractors are experiencing