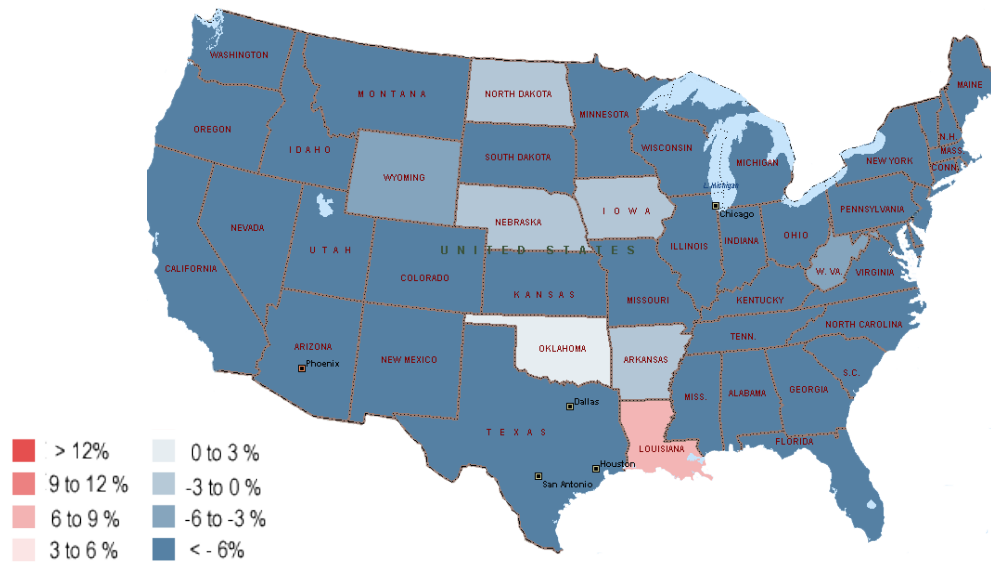


Construction Industry Market Report

First Quarter Update 2009

Percentage Change in Construction Employment
from March 2008 to 2009



Overview of the Current Construction Market

Across the nation, the overall construction market continues to show significant weakness. Construction activity has fallen dramatically in the past twelve months, in all regions of the country. Of the 50 states, only two are showing growth in activity, year on year, these being Louisiana and Oklahoma. Most states are showing double digit falls in activity, representing a total loss of almost two million construction jobs since the peak monthly employment in the summer of 2007, and over 1 million on a seasonally adjusted basis. This reduction in activity is leading to greatly increased competition among bidders and putting pricing pressure on projects. In many areas, cost trends have become negative, leading to moderate to strong construction price deflation.

It is likely that this weakness will continue through the end of 2009 and well into 2010, and that any recovery in activity will be sluggish. The deflationary pressure will abate, however, as the pool of suppliers and contractors shrinks to align with the reduced demand, both as a result of reduced capacity and business failures. As the market capacity reduces, even modest rises in demand for construction could lead to inflationary pressure in the mid-term. Broader global recovery could also lead to inflationary pressure on construction materials, particularly strategic commodities.

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 2010 to 2011, where much depends on the severity of the current recession and 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 alternatives 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 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.

The current financial crisis and recession are also putting unprecedented strain on the construction market, most particularly in the area of contractor financing and working capital. Many contractors are experiencing 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.

The financial stress on contractors is creating a high likelihood of contractor and subcontractor failure during the course of projects, particularly on projects experiencing high levels of competition among bidders. This means that projects should plan for such eventualities. Bonding and Sub-Guard insurances will provide some of this coverage, but they can lead to delays, which could in turn create further failures in the project team.

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.

Impact of the Financial Crisis and the Recession on the Construction Market

The financial crisis and the recession are two connected, but distinct challenges to construction. The financial crisis is creating severe constraints on the availability of capital at all levels through the economy, including project funders, insurers, and contractors. The recession is sharply reducing demand for construction services and products. This will initially create significant residual capacity in the market, but over time, as capacity is reduced, will lead to reduced availability of labor, materials and contractors. Both the financial crisis and the recession increase the risk inherent in the construction market, increasing the costs associated with risk.

The credit market tightening has impacted project financing, contractor working capital financing, bonding and insurance. Both the cost and availability of credit and insurance have been affected. Even in situations where projects are stable enough that project financing will not be an issue once the project is authorized and funded, contractor financing will still be a cost factor. As contractors and subcontractors experience difficulty in obtaining adequate insurance, bonding or working capital, the pool of available bidders decreases, and the level of competition decreases, leading to increased construction costs. Where bidders are able to obtain financing and financial instruments, these are likely to be significantly more expensive and restrictive, further increasing the cost.

The shortage of credit and working capital is becoming a major factor for bidders. This is typical in recessions, but with the added financial pressure, this is a greater factor than usual. We are seeing bidders preferentially bid projects where there are assurances of prompt pay, or early retention release. Conversely, bidders are reluctant to bid on projects without such assurances, or where owners have a reputation for slow payment, poor change order management, or delayed approval of work. This is translating into marked differences in bid pricing, with lower bids on the projects with more attractive cash flow management.

In addition to the cost and availability of financing, risk is also a major factor. Bidders will need to carry larger reserves to manage the uncertainty of their financial position. There is a risk that they will lose financing, insurance or bonding, or that costs will increase prohibitively during the project. The bidders will have to carry this risk in their bid pricing, as they would any other risk.

The recession has led to significant reduction in demand for construction services, and has increased the pool of available contractors. This is beginning to translate into lower bid pricing as bidders reduce their margins and compete more aggressively for the available work. This reduction is most evident in smaller, simpler projects, where we are seeing bid cost reductions in the range of 10% to 15%. These reductions are less evident in the larger projects, or in challenging, complex, or risky projects. A disadvantage of the reduced margins in bids is that bidders have less risk management capacity. In past recessions, we have seen increased contractor and subcontractor failure rates as bidders are less able to survive. This means that owners need to carry higher project contingencies to manage the cost impact of subcontractor weakness or failure, recognizing that bonding or sub-guard insurances will not cover the full cost of such problems.

Overall, the outlook for construction is quite poor. While there are indications that the credit markets are beginning to stabilize, if not improve, and that the recession may be stabilizing, these are at best tentative. There are as yet few signs of any imminent improvement. Escalation is likely to be much lower than in recent years, but the level of activity is also likely to be much lower, and there is the possibility of business failure 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. The recently passed government stimulus package includes large sums for “shovel-ready” projects, but even this is unlikely to be a major contributor to overall volume in either the short or long term.

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 decline 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 reasonable 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 current recession is driving capacity out of the construction sector with failures or shrinkage in contractors, subs and suppliers,

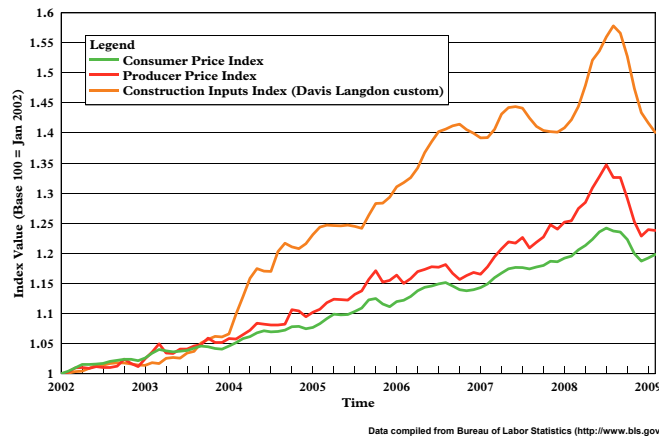
such that even a small growth in demand could overtax the surviving resources.

The uncertainty of both the movement of the factors and the extent of their influence means that the range of possible outcomes of inflation is large.

- There could be the growth equivalent of a 'soft landing', where demand increases at a pace that supply can keep up with. In this case inflation should be moderate and manageable, within the range of 3 – 5% per annum in the next five years.
- It is also possible that the recession will remain persistent and intractable, and that structural deflation sets in, essentially becoming a depression. That would give another year or two of falling prices, say -5%, then stagnation - between -2% and +2%.
- A third possibility is a very uneven 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.
- The last scenario is that the markets recover strongly, with a rapid return to demand for construction services, and in two to three years construction activity returns to the levels seen in 2006/2007, in which case, inflation could return to the very high levels seen in the past few years.

Of these scenarios, the most likely is the uneven slow recovery. 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 and CPI**



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. Prior to five years ago, this risk was relatively manageable. Even in prior periods of high inflation, inflation was relatively steady, and bidders could have some degree of confidence in the overall trend. In the past five years, however, 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.

In recent years, several materials have experienced dramatic increases over very short periods of time; in some cases, such as steel, copper and oil, doubling over a period of less than six months. As a consequence, even when prices are actually falling, bidders will tend to price higher, in the possibility that prices could move sharply upwards again during the course of the project. This tendency is offset to some degree by competition, but if all bidders are cautious, there will still be some residual risk pricing in the overall price.

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, rising sharply through the first half of 2008, then decreasing almost as sharply during the latter part of the year and on into 2009; now the indexes are back down to the levels of early 2008. While the indexes show broad trends, the underlying data show the variability at individual material levels, some of which have shown price variations of a factor of two, both up and down, in the past year. These fluctuations are most challenging at the subcontractor level, since these bids are heavily focused on only a few materials.

Direct Costs (cont'd.)

Labor

Labor costs will continue to rise, since labor agreements run over two to three years and some of these agreements, particularly those made in the recent strong market, have significant increases remaining in the coming one to two years. This is likely to have more impact in areas where union wages are required; in areas with lower union membership, there is the possibility that labor costs could fall slightly as workers accept lower rates to reflect lower demand for construction services. There are even indications that some unions are accepting renegotiation of labor agreements to reflect the weakness in the market, but so far these are isolated occurrences.

The indications are that, over the next two to three years, input costs will continue to experience deflationary pressure. Strategic commodity prices should stabilize as supply adjusts to falling demand. In some cases prices may rise moderately, but, absent a strong resurgence in global economic activity, it is unlikely that they will rise significantly. The lower commodity prices should eventually work through the supply chain, allowing for lower construction material prices over the next few years. Labor rates are likely to remain flat, with the possibility of small increases or decreases in individual trades.

Overall, input costs are likely to continue to fall in the range of 3 to 10% per annum for the next one to two years, and then recover weakly in the following two years.

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.

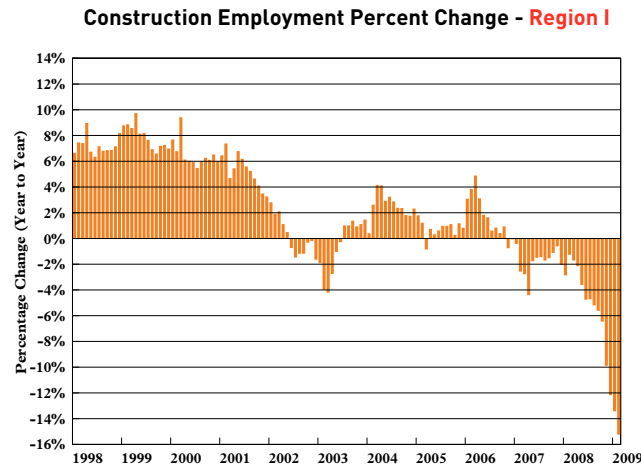
Within both these pools, there will be aberrations as bidders seek to gauge the competition for any given project. This could lead to localized significant bid overages or savings on individual projects.

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, targeted reductions in bonding requirements.

Region I – Connecticut, Maine, Massachusetts, New Hampshire, Rhode Island, Vermont

The decrease in growth in Region 1 has more than doubled over the past six months, mirroring a trend seen in much of the rest of the country. None of the states is showing any improvement in growth, and in fact Vermont and Connecticut are now the second and third weakest states in the country in terms of construction employment, both with declines over 20%.

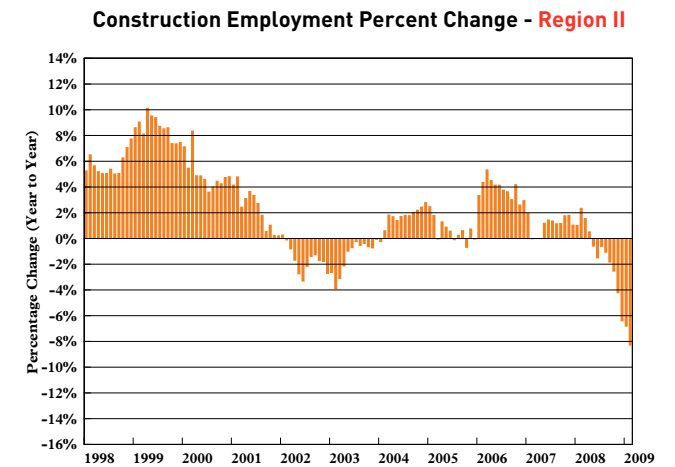
The overall economic picture in the region is generally poor. There is weak job growth and a limited prospect for growth in demand for construction services, in the short term. In the longer term, the states in the southern portion of the region have stronger growth prospects.



Region II – New Jersey, New York, Virgin Islands, Puerto Rico

The construction industry in Region II has continued to contract, although not to the extent seen in most of the rest of the country. Much of this has been due to New York, which had managed to maintain some growth through most of 2008, only slipping into negative during the past few months.

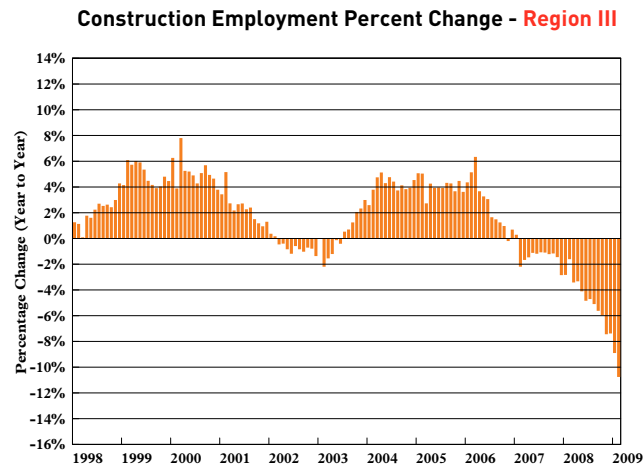
In the short term, the region is likely to see continued shrinking of construction activity, but perhaps to a lesser extent than the surrounding regions, and than the country as a whole. It may also be one of the regions that recovers the quickest, due to the long term economic strength of the region.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



Region III – Delaware, District of Columbia, Maryland, Pennsylvania, Virginia, West Virginia

Construction activity in the region continues to slow, with DC, like New York, now showing decreasing activity.

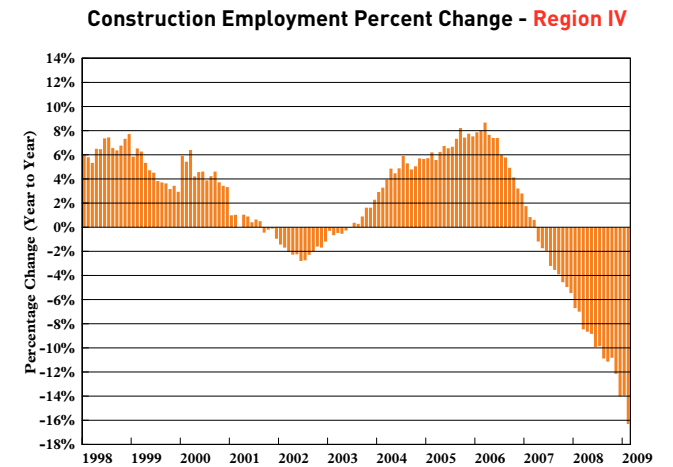
The long term economic picture in the region is relatively strong. The DC region is set to receive significant stimulus funding, and there is likely to be steady job growth and reasonable prospects for continued long-term demand for construction services. In the short term, however, the region is likely 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 IV – Alabama, Florida, Georgia, Kentucky, Mississippi, North Carolina, South Carolina, Tennessee

Region IV is contracting rapidly. The formerly strong states of Tennessee and Kentucky have turned sharply negative, and the region is second only to Region IX in total percentage reduction, and leads in total number of jobs lost at almost one quarter million.

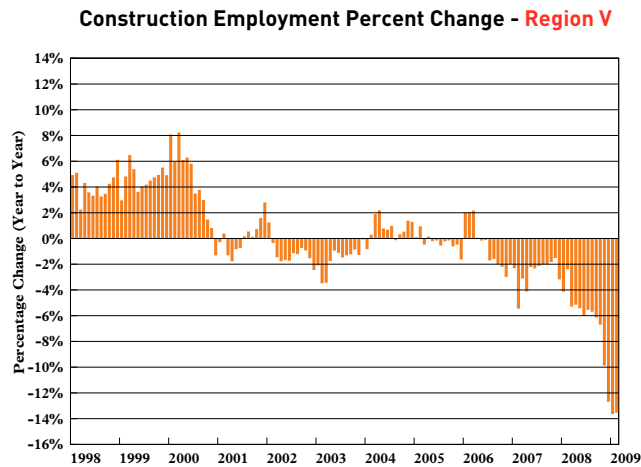
The economic prospects are similarly poor. The Atlantic states have experienced significant overbuilding, particularly in residential and hospitality construction. The backlog will take time to eliminate, and with these sectors being among the most impacted by the current recession, these sectors are 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 V – Illinois, Indiana, Michigan, Minnesota, Ohio, Wisconsin

Region V remains one of the weakest overall construction markets in the country. While the region is not among the ones with the greatest decline in activity, it is distinctive in experiencing steep declines that were not preceded by high levels of growth. 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 six months.

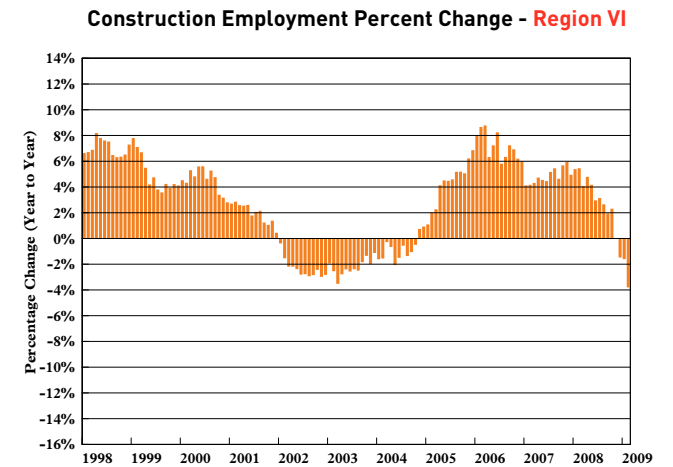
The overall economies in the region remain very vulnerable, with low employment growth and low economic activity. The region has been severely impacted by the current economic conditions, and there is little sign of a pick up in demand for construction in the region over the next two to four years.



Region VI – Arkansas, Louisiana, New Mexico, Oklahoma, Texas

Region VI has the distinction of having the only two states in the country – Louisiana and Oklahoma – which are still showing any positive growth. 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 relative modest at nearly 7%, when compared to the rest of the country.

The region also has relatively good economic prospects, both in the short and mid term, although the region 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 VII – Iowa, Kansas, Missouri, Nebraska

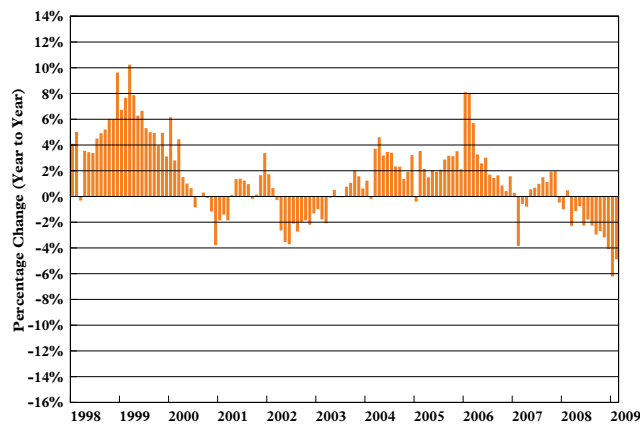
All the states in region VII are in very mild decline. This region is not one given to rapid changes in activity. It did not participate in the boom of the past four years, and it is likely that the slowdown will be similarly modest, as will be any coming recovery.

Region VIII – Colorado, Montana, North Dakota, South Dakota, Utah, Wyoming

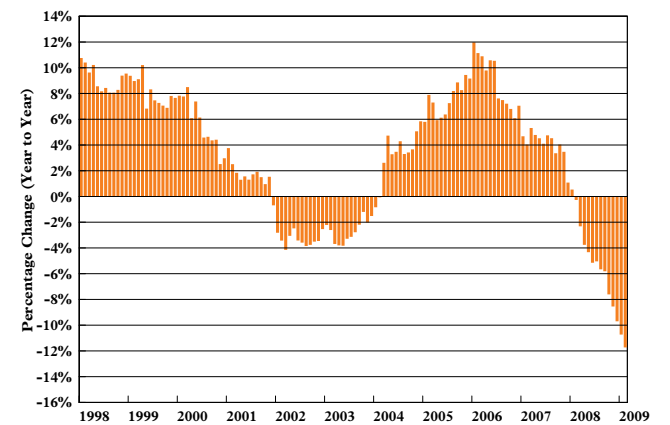
Activity in Region VIII has continued to slow, but at a steady pace, unlike some regions where decline appears to be accelerating. Wyoming and the Dakotas are still the stronger states in the region, at declines of 2 to 6%. Colorado, Utah and Montana are declining more sharply.

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.

Construction Employment Percent Change - Region VII



Construction Employment Percent Change - Region VIII



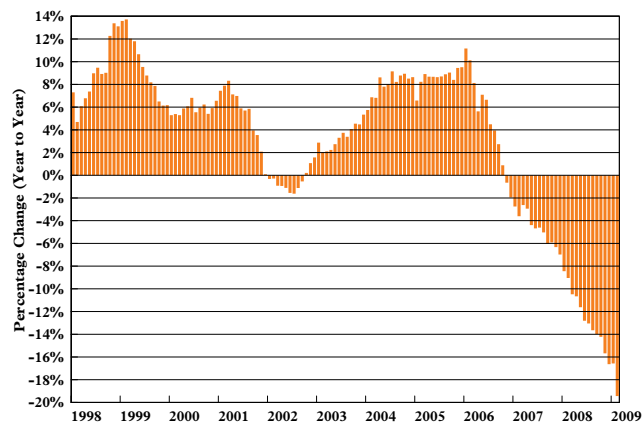
Region IX – Arizona, California, Hawaii, Nevada

This region is the hardest hit region in percentage terms, and the second hardest hit in total job losses at almost one quarter million in the past year. It includes three of the hardest hit states. Arizona, at over 26% decline, is the national leader, while California and Nevada are 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, but to a lesser degree.

The sharp slowdown in activity has led to substantial excess capacity, particularly in the residential and smaller non-residential sectors, although most sectors have some excess capacity. This has led to some very competitive bidding, with large bid responses, and some very low bids, erasing much of the escalation in the past two years.

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. Many state projects have been cancelled or put on hold, even some in construction. 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.

Construction Employment Percent Change - Region IX



Region X – Alaska, Idaho, Oregon, Washington

The rate of decline in construction activity in Region X has doubled in the past year, now reaching over 12% per annum. Washington, by far the largest construction employer in the region, is showing the least decline, at about 12% per annum, while Oregon and Idaho are contracting at a faster rate, at over 15% per annum.

Long term economic prospects in the region remain strong, but recovery in the region may be some years away.

Construction Employment Percent Change - Region X

