

CONSTRUCTION COSTS TO RISE AS US ECONOMY SLOWLY COMES OUT OF RECESSION



US GDP increased at an annual rate of 2.3% in the first quarter 2011, according to figures released by the US Bureau of Economic Analysis. The figure indicated a slowdown in economic recovery following strong growth in 2010 and rises of 2.6% and 3.1% in the third and fourth quarters of 2010 respectively. The US economy has now shown seven straight quarters of growth from the property driven recession of 2008 and the expectation is that growth will register around 2.6% this year with a further increase, to 3% in 2012.

According to McGraw Hill Construction, total construction on an unadjusted basis during the first three months of 2011, was reported at \$88.0 billion, down 10% on the same period a year ago; the figure was unchanged from the previous quarter. Looking at a breakdown of the latest monthly figures, residential construction figures in March fell by 17% compared to March 2010 while non-residential fell by 14% with non-building construction (infrastructure) showing no change.

Given the above figures, many pundits believe that the US economy could be at a psychological tipping point where certain key individuals or trendsetters adopt behaviour which others follow, this creates a demand for a product which can suddenly explode as it rises in popularity.

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John Newton - Location Leader, USA

The economy

As the economy has been stagnant for two years, the analysts suggest that the economy is on a knife edge. They maintain that the trend is about to change and that economic growth will occur during 2011 for the following reasons:

- Layoffs are decreasing. Generally, a drop below 400,000 people per week filing for unemployment has historically seen acceleration in employment growth. The number of people filing for unemployment each week has been falling considerably, from 490,000 in August 2010 to 410,000 in December.
- Consumer spending is accelerating. In 2010, retail sales increased by 4.2% after falling 4.5% in 2009, and in the final six months of 2010 sales climbed at a 7.5% annual rate. This is critical because employers need to see growth in demand and have confidence that it will continue before they commit to taking on more employees.
- Temp hiring is booming. Temporary help services tend to experience employment growth sooner and faster than the rest of the economy and in the 15 months since September 2009, temporary employment has increased by nearly 500,000 jobs, by far the strongest rise in the past 20 years. With demand rising, it is expected that businesses will shift from hiring temps to hiring permanent employees in the coming year.

The real estate market

When there is a shift in employment, the impact on the real estate market can be significant. With growth forecast, the market can expect significant benefits, particularly in the office, industrial, retail and multi-family sectors.

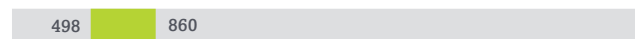
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For the first time in many years, American manufacturing is doing better than the rest of the economy. Manufacturing output fell by 15% between December 2007 and June 2009, but has since recovered two-thirds of that drop and production is now just 5% below its peak level. Factory employment too is growing, up by 1.6% compared to last year; total employment rose just 1% over the same period.

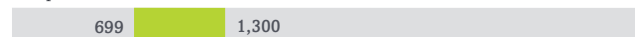
Improvements in the Industrial markets are likely to be moderate. While there is still a significant vacancy rate in the US, it is expected that demand for new build will increase rapidly particularly in areas where there has been little or no new construction over earlier years.

Indicative costs per m² in USA (US\$ per m²)

Industrial Sheds



Purpose Built Industrial Units



A/C Business Park



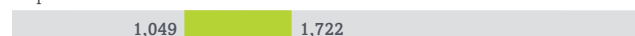
A/C High rise offices



A/C Medium rise offices



Supermarkets Shell



Shopping Centre - Mall



Leisure Centres (dry sports)



Swimming / Leisure Pools



Private Housing - estate housing



Private Housing - high quality detached



Apartments - private high quality



Apartments - luxury



Note: The costs shown above are based on the Study of International Building Costs which EC Harris carried out during the 1st quarter of 2011. The figures represent typical guideline ranges of 'built' costs that a client could expect to pay and are based on cost per m² data provided by EC Harris sources 'on the ground' in the USA.

Costs are given in US\$ per m² of gross floor area, measured to the internal face of the external walls.

Note that the figures exclude land costs, professional and legal fees, etc and taxes, which should be added to the costs in this study. There is no VAT in the USA although there are state taxes in most states, which may be imposed on construction projects.

“The US financial sector seems to be returning to health, financing remains a challenge for contractors.”

The retail sector is likely to rise significantly. The overall employment growth projected for 2011 comes in an environment of accelerating economic activity. Consumer spending is expected to rise from 2.7% in the fourth quarter of 2010 to 3.9% at the end of this year, leading to significant improvement in retail markets; this should, in turn, have a knock on effect on demand for retail space.

Rental rates on commercial offices are likely to stabilize in 2011 and may begin to rise, particularly in markets that are tighter than the national average. Overall, 2011 is likely to mark a turning point for rents in the US commercial real estate market for the nation as a whole.

International investments remain at a high. Money is continuing to flow into the US economy, particularly from the Asian markets and EC Harris are experiencing increased inquiries for due diligence from Chinese investors, who see the US market as a projected hot spot and growth area for the next five years. There are still many distressed properties and projects available on the market, which have been neglected over the last few years and consequently require major remodeling. As buyers come to the market, this will fuel the demand for construction. In addition, the larger Asian funds are still looking for deals in the hot commercial real estate markets, especially in New York; while some economic uncertainty remains, this region remains buoyant.

The economic stimulus package injected into the US economy has seen mixed results within the industry. The reliance on imported oil has been a major political talking point and the government is determined to reduce this need for imported energy. As a result, there has been a surge in alternative forms of energy.

The residential sector remains depressed with property prices in some locations up to 60% below the peak they reached in 2006; nationally around 23% of homeowners owe more on their mortgage than their property is worth. The S&P/Case-Shiller index of home prices in 20 American cities fell by 3.3% in the year to February after reaching an all-time low in January.

Following on from the financial crisis within the banking sector, the major banks are starting to revisit projects that were shelved prior to this crisis. Obviously, the banks are number crunching with slightly guarded eyes, but the signs are that markets in which the banks do not normally invest are opening up.

The banks are, in addition, looking at their own property portfolios and seeking advice with particular emphasis on their asset registers. EC Harris have received a number of enquiries from the banks for assistance with compiling portfolios at the same time as preparing life cycle costs for the properties which suggests that the banks are looking to retain their assets and increase their value with a systematic approach to maintenance and replacement. Following on from this, the banks are also becoming increasingly conscious of their running costs and we are seeing a greater awareness of sustainable building techniques.

The Northeast and Midwest enjoyed relatively strong economic performances in 2010 with New York and Massachusetts increasing by 5.1% and 4.2%, respectively. At the other end of the scale Florida's economy grew just 1.4%, and Nevada's continued to shrink. Employment trends reflect the economic performance in the different regions with labour markets relatively strong in the Northeast and improving rapidly across the Rust Belt.

When looking at US construction data, it is important to realize the vastness of the Country. What is happening on the East Coast can be very different from the mid states and the West Coast. Similarly, the North and South divide has very different economic drivers. Each region has different cost parameters and it is quite difficult to evaluate a country overview with such diverse factors affecting the cost drivers. In addition, the construction industry is highly localised in the United States and as a result, the pricing behaviour of contractors is related to a combination of local factors affecting the ability of the contractor to source resources in their local market as well as industry wide conditions relating to the US.

However, there are certain drivers that, while having different effects in different regions, have a common influence on construction demand and consequently cost. One key element is the climate, the extremes of which can throw up a number of cost penalties. It has been estimated that the tornado and storm losses which brought havoc across 9 states in Central USA could reach US\$6.5 billion. Meanwhile, following on from record snowfall in the west during January and February, and flooding in the North East in April, the damage caused by the Mississippi floods across 6 states has been estimated at US\$4 - 5 billion.

Economy and construction - USA at a glance

	2010	2011	2012
Economy generally			
GDP growth (%)	2.9%	2.6%	3.0%
Consumer price inflation (y-o-y %)	2.0%	2.8%	2.0%
Producer Price inflation (y-o-y %)	5.9%	5.8%	
Average wage Inflation (y-o-y %)	2.2%	2.0%	
Unemployment rates (%)	9.4%	8.8%	8.1%
GDP per Capita	\$47,300	\$49,100	\$51,100
Retail Sales growth (y-o-y %)		6.0%	
Private Consumption (y-o-y %)	2.8%	4.5%	5.3%
Government Consumption (y-o-y %)	2.6%	2.3%	3.4%
Exports (y-o-y %)	11.7%	9.0%	8.6%
Imports (y-o-y %)	18.65	11.7%	8.2%
Industrial Production Growth (y-o-y %)	5.8%	4.3%	5.0%
Interest rates (3 months)(%)		0.2%	
Construction Industry			
Construction Tender Prices	3.6%	1.3%	
Labour Rates %		2.5%	

Commercial real estate trends

Commercial real estate has seen three phases in recent years; a period of growth between 2006 and 2008, when rents more or less doubled due to growth of the IT sector, expansion of local and international corporations and a limited supply of higher specification office space. This period of growth was followed, in 2008 - 2009, by a sharp drop in demand, due to the economic slowdown which saw an oversupply of office space and lease rentals falling by 25-50%, compared to the 2006 rates.

From 2009 onwards, there has been a good supply of commercial office space available across cities with demand still slow. As a result, rents are likely to be kept in check within the short-to-medium term until demand catches up with supply.

Effects of funding constraints

Even though the financial sector seems to be returning to health, financing remains a challenge for contractors. The depth and the duration of the recession have severely strained contractor working capital. In many respects, the market is now entering the most dangerous time for bidders; in the early portion of the recession, bidders were likely to be cash-rich as revenues from earlier projects exceeded current costs.

As the situation recovers, bidders change to a position of having little or no cash revenue arising from current projects, just as they are looking to increase activity. In addition, the recession has weakened the financial and the balance sheet positions for contractors, just as banks are increasing the stability requirements for business working on capital loans, making it harder for contractors to maintain their loan capacity. It is likely that this will lead to classical undercapitalisation, leading to contractor failure in some cases. Caveat emptor.

Overall material prices are likely to show quite some volatility as supply and demand rebalance. Despite strong increases in worldwide commodity prices which have seen major increases in steel and oil prices, figures from the Bureau of Labor indicate that materials prices for a number of key materials were still falling earlier this year, readymix prices in April were down by 1% compared to a year earlier while cement and brick prices were both down by 4%. After a long period of declining rates, wages in the construction sector have started to pick up with average rates in April approx 2.5% higher than a year ago.

It is evident that the US economy is slowly coming out of a major recession. As a consequence, construction costs are likely to rise as demand for buildings increases. The increase in commodity prices together with suppliers' attempts to raise the fuel surcharges are inevitably going to influence the construction cost index. Interest rates should remain at an all time low for 2011 which should also fuel the construction industry and help the industry to regain its position as a major force in the US.

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