THE BAY DIMENSION

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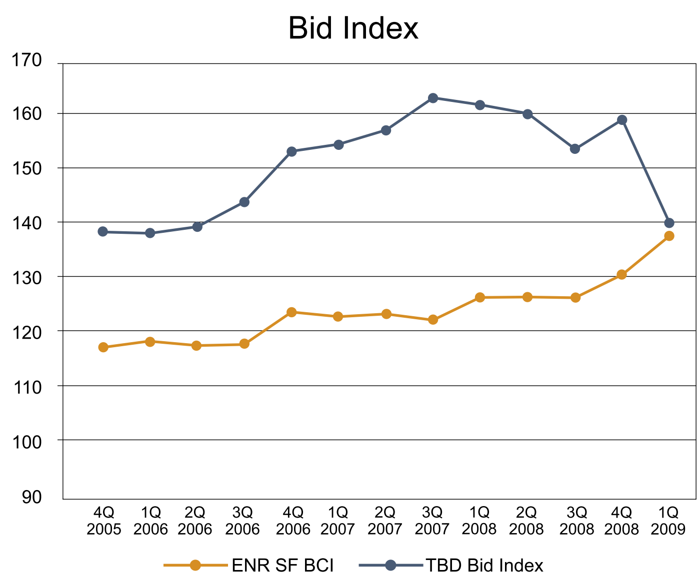
In this Edition:

Recession!

Geoff Canham, Editor

This quarter we are putting our regular articles on hold, in order to address the issues surrounding the recession.

When we started writing this article (end of November 2008) the current financial crisis had not been officially declared as a recession. However, with our Bid Index resuming its downward dive despite labor agreements pushing the ENR index up, unemployment reaching levels not seen for a couple of decades, a $700 billion rescue scheme in place to shore up the financial institutions, yet another economic stimulus package being proposed to try and get the economy moving by getting people spending, and unprecedented international cooperation in fighting the crisis, then if this wasn't a recession it was obvious we would be in real trouble when one arrives!



The popular definition of a recession is two consecutive quarters of declining growth, but by that definition some of the recessions didn't occur, such as the one in 2001. The National Bureau of Economic Research (NBER) defines a recession as "a significant decline in economic activity spread across the economy, lasting more than a few months, normally visible in real GDP growth, real personal income, employment (non-farm payrolls), industrial production, and wholesale-retail sales", and in the US we are not officially in a recession until the NBER declares that we are. That declaration was made at the beginning of December, and we had expected that the start of the recession would be set somewhere near the start of 2008, and it was officially declared as starting December 2007.

The real question is not when the recession started, but when it will end, and there is no clear consensus on that. At the time of writing (Nov 2008) the best guess seems to be that it will extend through most of 2009 at least. The stock market normally begins to recover before the economy itself does, so by the middle of the year we might be seeing a steady re-growth there. Unfortunately, the construction industry tends to grow back after the economy itself, so it might be a further year or so before we are back to a level that could be considered normal.

But the recent election had some good news for the construction industry in the number of bonds that passed for construction-related projects, including almost all the school bonds (of course, the collapse of the bond market isn't helping with these projects). However, the money being pumped into the economy in the form of bail-outs and stimulus packages has to be helping somewhere, and the incoming Obama team is proposing another stimulus package, and possibly more work on infrastructure and school projects.

The infrastructure work is good for the future, but the lead time means that it may have little impact in recovering from the recession. The potential tax rebates of a stimulus package, or straight tax reductions, are more likely to have quick effects in getting the economy moving, but add possible inflationary pressures. There seem to be no easy answers, but history shows the cycle will turn.

Market & Escalation

Gordon Beveridge

There has never, in most of our working careers, been a time where wild economic forces have produced a tidal wave of severe uncertainty surrounding the financial institutions/banks. The last four months have seen a dramatic gyration in stock values and created uncertainty and unemployment rates rising at an alarming rate.

The effects on construction have been sudden with a foreboding of what is yet to come.

Yet for clients with the money on hand to spend on construction this may be the best of times, the bidding market is as competitive as it has been for many years. Bids for medium size project are running 10-20% below the market in mid 2007. Also the price of construction related commodities has fallen off dramatically and there do not appear to be the price pressures to drive them up any time soon.

To illustrate the current situation the following are worth noting:

- Oil pricing has fallen dramatically from historic highs earlier this year.
- The Caltrans Asphalt Paving index is now 40% (Nov 08) of the July 08 level.
- The price of all building materials have fallen this year and continue to fall.
- Many projects in San Francisco/Bay Area have been halted pending improvement on the market.
- Condo projects where sales are lagging are turning into rental units.
- Medical market is still vibrant; however expect escalation to fall back to more modest inflation rates.
- Government work has become more attractive as the private sector work diminishes.

- Expect to see higher rates of unemployment in 2009 in construction.
- It's an employers market, so expect to see wage demands moderate.
- Contractors will absorb labor increases next year where profit margins will be thin.
- Overseas work has become more vital to maintain.
- Expect design fees to be much tighter as clients take advantage of the competitive market.
- Expect contract administration to be more arduous as contractors perform on slim margins.
- Expect more defaults in the construction field.

The medical market remained the exception to the general rules due to the large volume of medical work. The major general contractors and subcontractors in this field were limited and only minimal flattening of the market was evident.

We believe the last three or four months has changed all markets significantly and even the medical market is being driven down from the higher perches. Even OSHPD work will be more attractive than previously perceived.

Subcontractors have started to narrow down their workforces, maintaining key staff where possible. As a result the productivity factors will go up and pricing will be driven down where possible.

The only increases will be labor wage agreements, which are already promulgated and could push labor rates in some trades up by 3-5%. Productivity increases could offset some of these increases being passed along.

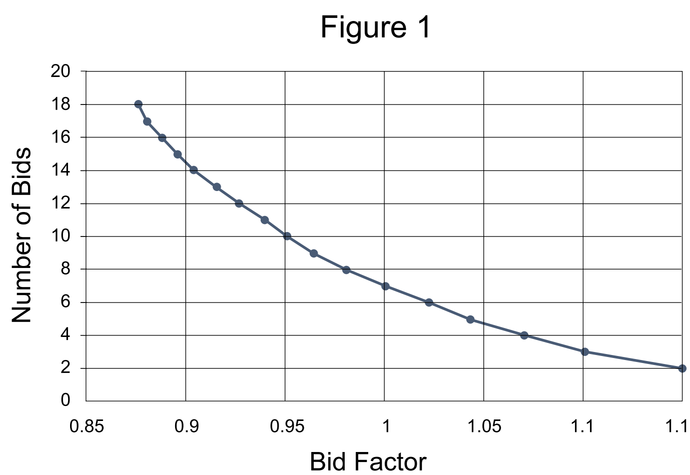
Looking at escalation going forward and communicating with contractors in the field we expect to see little escalation in the next 18 months.

Our anticipated escalation for the next few years is as follows:

	2009	2010	2011	2012
Large public sector projects	2% to 3%	2% to 3%	2% to 4%	2% to 5%
Small public sector projects	-5% to 0%	2% to 3%	2% to 4%	2% to 5%
Medical	2% to 4%	3% to 4%	4% to 5%	4% to 5%

Recession & Bid Prices

With the recession starting to affect the construction industry, the increasing competitiveness of bidding conditions is becoming more apparent. In a "normal" market (which we haven't seen for a while) one would expect around seven bona fide responses for the majority of projects. Currently however, it is not unusual to receive far more than that, and the statistical chances of receiving a competitive bid increases with the number of bidders. Figure 1 illustrates how the number of bidders affects the level at which bids may be received.



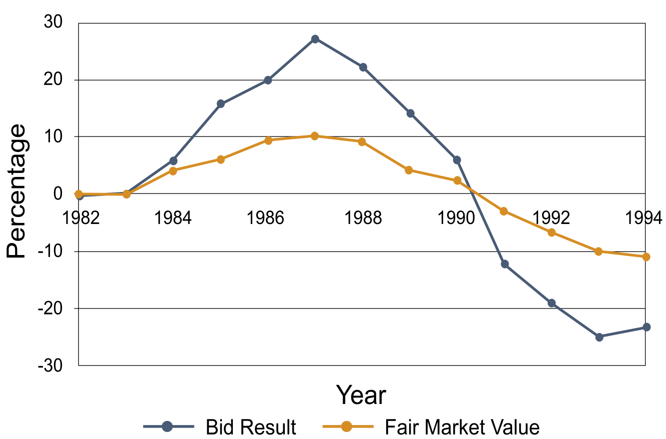
This index was prepared by Hanscomb Associates (a company that features large in the history of TBD Consultants) using a database of more than 2,000 bid results over a seven-year period. The analysis of the data revealed a distinct correlation between the number of bids received and the pre-bid estimate. While individual bids might deviate from this curve for various reasons, the index can be used as a tool for adjusting the pre-bid estimate by using the probabilities of likely price changes according to the number of bids.

The relationship between number of bidders and the competitiveness of bids is not a direct causal one, but rather the fact that both tend to be the result of the same market forces. A busy construction market will tend to mean fewer contractors are interested in bidding for a particular project, and those bidders are likely to bid high because they do not really need the work. In recessionary times, almost all contractors in the area, and some outside of the area, are likely to be chasing a project and trying to undercut each other.

What we were describing as bids in a "normal" market has also been described as the "Fair Market Value", and another study by Hanscomb Associates addressed the way actual bid results deviate from the Fair Market Value as markets moved through boom and recession.

Estimates are built up to include the labor, material, equipment, site overhead, office overhead, profit, and supplier and subcontractor discounts. Since it is hard to predict exactly what the bidding market will be at the time an estimate is prepared, they are normally developed to reflect a reasonable return to a contractor for his output, equipment and profit return, i.e. to show the Fair Market Value.

Figure 2



The Hanscomb study tracked a number of budget to bid relationships over a period of more than a decade, as the market changed. The 0% line is where prices would be if all things remained equal. The Fair Market Value line takes into account changes in material and labor costs (adjusted for escalation). The Bid Results line incorporates the effects of "predatory pricing", either aiming for the best possible price in good times, or trying to undercut the opposition in bad times.

The resulting graph (Figure 2) initially shows the same trend that the TBD Bid Index has been showing since 2003, and we can only hope that the construction market recovers a bit quicker than it did in this illustration.

The point though, is that the "right" price for a project is always the one that the market can bear, which is frequently not the same as the Fair Market Value. In good times, when contractors have as much work as they can handle, they can afford to put in high prices. When times are tough, and new projects are fewer, contractors have to bid lower to win a project, reducing profit margins and even discounting some of their overhead.

One side effect of this is that contractors have more incentive to pursue claims, to help make up for some of their reduced margins. Consequently it becomes even more essential to ensure that contract documents are complete and coordinated, to minimize the opportunity for claims.