EXECUTIVE INSIGHTS

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Building and Construction: Achieving Substantial Returns in a Difficult Market

It's no secret that the current U.S. building market is a treacherous place. The global economic crisis, a lack of business confidence, and tight lending conditions, have all contributed to substantial declines in both the residential and commercial sectors. Managing through these difficult times requires careful analysis and timely strategic investments.

However, there are signs of life. L.E.K. Consulting analysis shows that new and existing residential housing sales should recover in 2010, with the commercial construction market lagging behind until 2012. Provisions in the American Recovery and Reinvestment Act of 2009 may support certain segments of commercial construction and infrastructure, hastening an uptick in a few areas.

These factors present opportunities for investors, manufacturers, and distributors to make value-creating investments through consolidation and acquisitions of undervalued assets. Strategic timing and appropriate segment focus can yield strong returns, particularly in the residential sector.

L.E.K.'s research has uncovered two critical insights for the building and construction industries. The first is that the residential construction markets offer historic opportunities to invest before the market begins its upturn. The second is that commercial construction will continue to face challenges for some time to come, and while opportunities exist, there are significant risks – so make your decisions carefully.

The Residential Market: Opportunities Exist

Despite what many think, it is not necessary to time the market perfectly to achieve substantial returns. The fact is that for a number of cyclical capital intensive industries – such as building products, oil refining, chemicals, aluminum, and paper – investing anywhere near the bottom of the business cycle can substantially boost returns.

The housing market is cyclical and has a direct correlation to home building company returns, as well as the performance of all companies in the value chain. Making strategic investments now can yield strong returns as housing starts to recover. History bears this out – investing with optimal timing and leverage in the last downturn would have yielded returns of over 30% per year (see Figure 1, on page 2) across the previous cycle.

Our analysis indicates that housing fundamentals should return to their "new normal" levels over the next three years. Long-term home ownership rates will likely drop from over 69% (fueled by inexpensive mortgages and nonconforming products), to about 66%. Existing home sales and new builds should recover in 2010, although vacation and speculative homes will likely continue to lag significantly from 2005 levels because of a general destruction of household wealth during this recession.

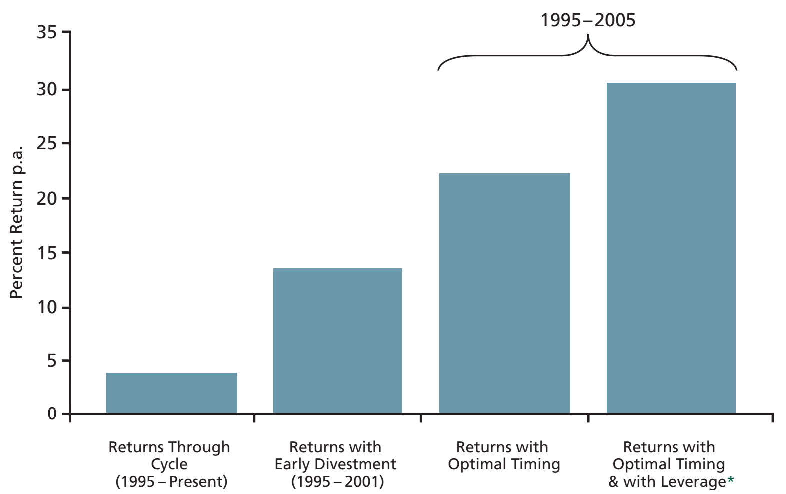
By 2012, L.E.K. forecasts sales of single-family starts should stabilize at its "new normal" of 1.0 –1.1 million units per year (versus 1.7 million in 2005).

As the housing market recovers in 2010, building and construction companies will begin to increase home production. Home builders will ramp up as demand resumes and excess inventory gradually returns to normal levels. Anticipating this, residential construction and building products companies should be positioning themselves to take advantage of this recovery.

Building and Construction: Achieving Substantial Returns in a Difficult Market was written by **Robert Rourke,** Vice President and Head of L.E.K. Consulting's North American Building & Construction Practice. Please contact L.E.K. at industrial@lek.com for additional information.

Figure 1

Home Building Industry Returns^

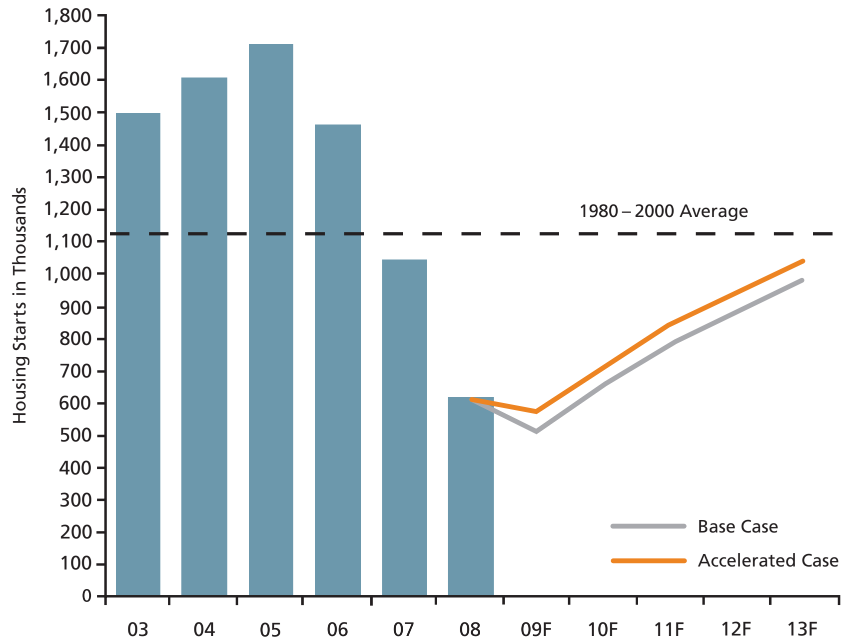


Note: ^ Based on returns from the S&P Home Builders Index of 15 largest home builders; * Assumes 50% leverage, 6.5% interest rate, 40% tax rate; Optimal returns based on investment at bottom and divestment at top of cycle

Source: Bloomberg, U.S. Census Bureau, NAHB

Figure 2

Single Family Housing Starts Forecast (2003 – 2013F)



Source: L.E.K analysis, NAHB, NAR

The Commercial Market: Choose Carefully

L.E.K. analysis has shown that two indices have strong correlations and are good predictors of the commercial market as a whole: GDP growth and the architectural buildings index.

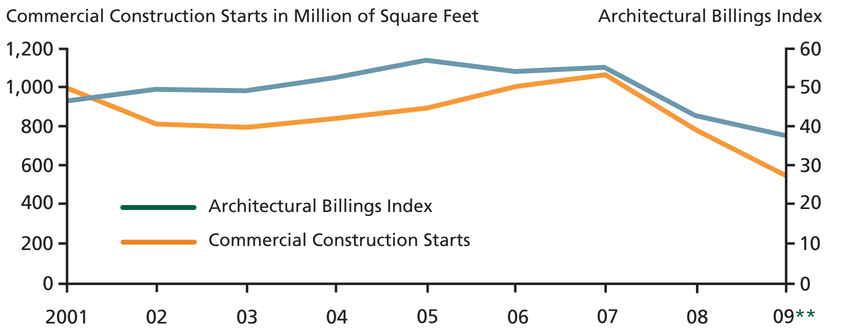
The contraction in both GDP growth and the architectural billings index reinforces the well-publicized bad news for the commercial market. However, not all segments of the commercial market are in equally bad shape. For example, retail has been one of the largest commercial construction market segments in the recent past (45% of dollars and 35% of space in 2008) outside of institutional activity. Understanding the outlook for the retail sector will yield important insight into the broader commercial market.

Since 1982, decreases in consumer savings rates (and the associated increases in consumer spending) has driven a long-term trend of adding retailing square feet throughout the U.S. With falling asset values in the economic downturn, the bottom 50% of households (by median income) have on average a negative net worth on paper – and these same households control about 30% of consumer expenditures. This has a material implication for retail recovery.

As a result, retail square footage per capita is now nearly 40% more than 1982 and almost twice that of Europe. With the recent trend toward increased savings rates of consumers, coupled with a de-leveraging of household debt and an outlook for slow economic growth, it will be some time before the excess retailing capacity is worked off – exacerbated by the continued consumer shift toward

Figure 3

Commercial Construction Starts and Architectural Billings Index*
(2001–2008)



Note: *Number of projects being designed; ** Commercial Construction Start data is a forecast for the year, architectural Billings Index '09 data YTD data – Jan. through Mar. '09

Source: U.S. Census Bureau, Bureau of Economic Analysis, International Monetary Fund, McGraw Hill Construction Outlook, L.E.K. analysis

e-commerce activity. This will place downward pressure on lease rates for existing properties – thereby reducing the economic incentives for builders to pursue new developments.

While retail is but one of the end markets of commercial construction activity, the fundamentals driving the other sectors are not enough to offset this downward pressure:

- Office construction activity generally lags employment.
- Hotel and lodging follow the business cycle – and while that industry is certainly feeling pain right now as business travel, occupancy rates and room rates are all down – the fundamentals in those sectors suggest that the acute oversupply problems of residential construction and commercial retail are less pronounced here.

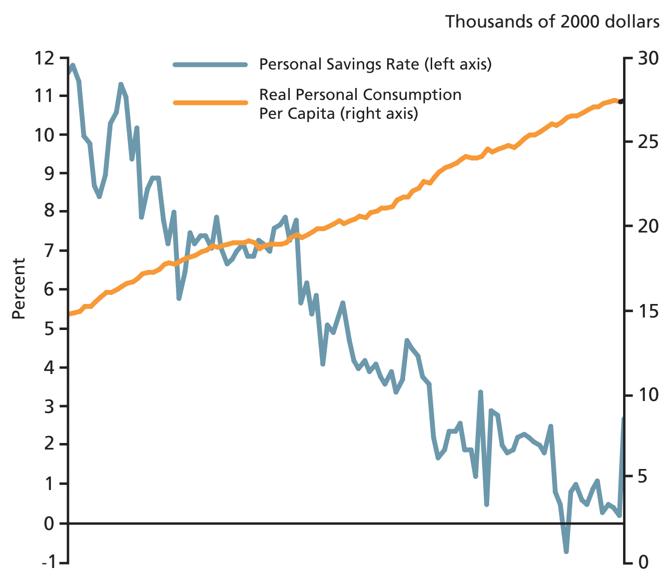
Furthermore, the ability to refinance much of the CMBs and CDOs coming due in the next 18 months – given the tightness of the credit markets, falling occupancy rates and lower rent rates – will prove to be very challenging for the industry as a whole and will further complicate the timing and will speed of a recovery. Therefore, we believe the commercial construction activity is likely to experience downward pressure for two to three more years before showing improvement.

Summary

There is not a single simplifying set of recommendations that has universal application to all the various segments of the building products industry. The priorities for commercial construction players are no doubt different than the opportunities facing residential and remodeling OEMs. Likewise, your

Figure 4

U.S. Household Savings Rate* vs. Real Personal Consumer Expenditure Per Capita
(1982–2008)

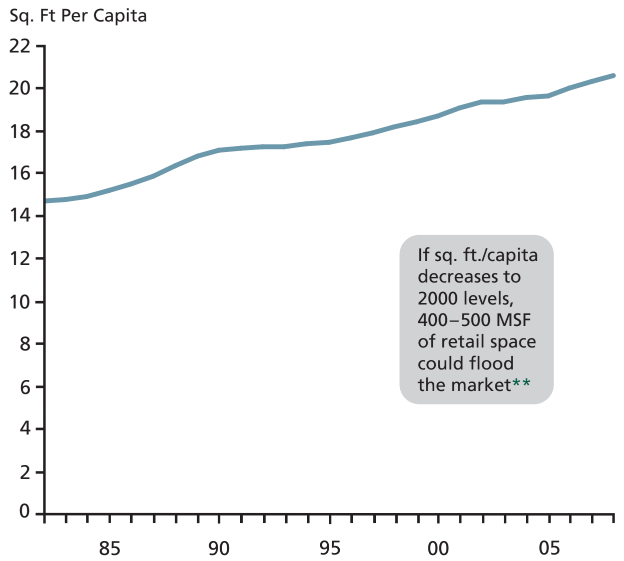


Note: *As percentage of disposable personal income,

Source: Bureau of Economic Analysis, L.E.K. analysis

Figure 5

U.S. Retail Square Feet Per Capita
(1982–2008)

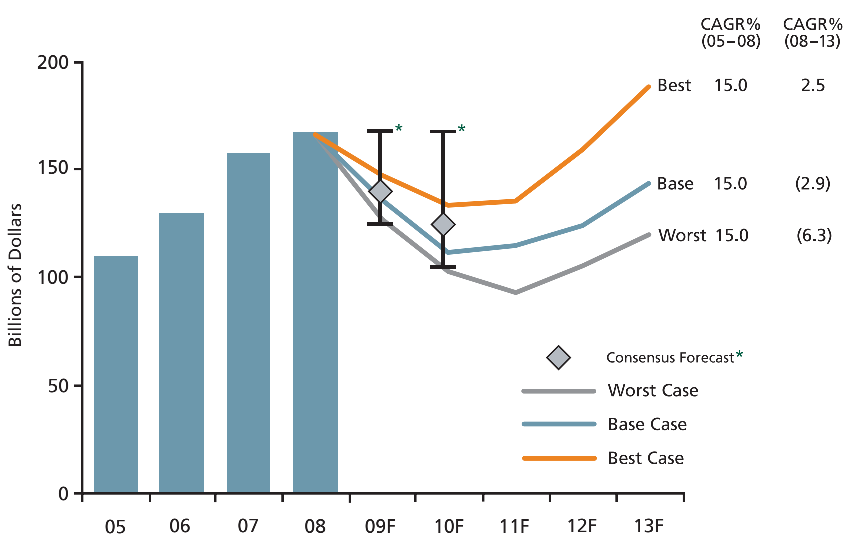


** Based on projected 2010 population and 18.7 sq. ft./capita

Source: Bureau of Economic Analysis, L.E.K. analysis

Figure 6

Total Private Commercial Construction Spend^



Note: ^ Includes the Office, Lodging and Commercial/Industrial segments of U.S. Census Private Nonresidential Construction put in place; * Based on AIA growth forecast ranges for '09 & '10; compiled from McGraw Hill, Moody's, FMI, Reed Construction and Global Insight, H1 2009

Source: U.S. Census Bureau, McGraw Hill, AIA.org, L.E.K analysis

position in the value chain will no doubt drive and inform a unique set of priorities. However, what is clear is that the landscape has changed dramatically over the recent years – and that it will continue to evolve along new dimensions in the coming months as well. Companies that capitalize on the resultant uncertainty – or timidity – of their competitors will outperform the market, improve competitive position, and create tremendous value.

Now is the time to be bold with these important decisions.

L.E.K. has tremendous experience in helping companies in the building products industry tackle these very challenges and realize superior returns. We have worked on more than 200 projects related to these topics on a global basis over the past five years. We would welcome the opportunity to help your organization capitalize on the current market conditions and accelerate your future profitable growth.

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