

2011 BUILDING AND INFRASTRUCTURE CONFERENCE

March 3RD, 2011 ■ New York Athletic Club

Is The Recovery Upon Us?



CONFERENCE REPORT

Contents

Executive Summary 2

Keynote Address
Succeeding in The “New” New Home Market 3

John Burns
President and Chief Executive Officer
John Burns Real Estate Consulting, Inc.

Panel 1
Near Term M&A Outlook 7

R. Gerard Bollman, CFA
Vice President, Global Business Development
Formica Group

Donald C. Devine
President and Chief Executive Officer
American Standard Brands

S. Matthew Katz
Managing Director
FdG Associates LP

Harry A. Shaw
Vice President, Corporate Development
Owens Corning

Moderated by:
Jeffrey W. Corum
Director, Building and Infrastructure
Lincoln International

Panel 2
Growth Priorities and Challenges 11

Pascal B. Convers
Senior Vice President, Business Development
Oldcastle Materials

Peter Dachowski
President and Chief Executive Officer
CertainTeed Corporation

Fareed A. Khan
Executive Vice President, Finance and Strategy
USG Corporation

Christopher J. McGowan
Managing Director / Co-Head of Basic Industries
Madison Dearborn Partners

Amitabh Swarup
General Manager of Business Development and Strategy
Holcim (US) Inc.

Moderated by:
Rob Rourke
Vice President, Head of North America Building
and Construction Practice
L.E.K. Consulting

Endnote Address
**An update on the current transportation
construction market, recent trends and what
you can expect in 2011 and beyond** 15

Alison Premo Black
Vice President of Policy
Managing Director, Research & Education Division
American Road & Transportation Builders Association

Executive Summary

Industry professionals who attended the Lincoln International and L.E.K. Consulting Building and Infrastructure Conference in New York in March heard an upbeat long term prognosis for residential construction, and a view that there are pockets of activity in commercial construction even though overall non-residential construction activity continues to decline. Spending on infrastructure projects is under pressure as federal, state and local governments face significant budget deficits, which is impacting near term projections for spending on roads, bridges, airports and rail infrastructure.

Jim Lawson, Chairman of Lincoln International, opened the conference, indicating that when Lincoln held its first Building and Infrastructure Conference back in 2007, the market was still strong. "John Burns (President and CEO of John Burns Real Estate Consulting) was also our keynote speaker that year. He asked how many in the audience believed that the market for building products will be better next year in 2008 than it is this year? The majority of people in the room raised their hands." Mr. Burns then said that the majority was wrong because housing construction was headed for a big drop. Mr. Lawson said that the building products market had faced some very difficult times since then, but that long term dynamics were positive.

Rob Rourke, Vice President and Head of the North America Building and Construction Practice at L.E.K. Consulting, added that more individuals had registered for the 2011 conference than ever before. He said this indicated that interest in the sector was increasing. "Last year was L.E.K.'s busiest year ever in the building and construction industry and we are cautiously optimistic that there are brighter days ahead."

In his keynote address, John Burns, one of the most respected voices in the residential construction industry, said he was considerably more optimistic than the last time he spoke to the conference in 2007. He said that home builders could still feel some pain for the next few years, but that a job-led recovery is already underway, excess housing units are being depleted, residential sales are rising, the population is growing and house price affordability is the best it has been in generations.

"In four years, I think we're going to be looking at a market that is clearly trending up," Mr. Burns said. However, he said that it was important for the industry to understand the variances between different markets nationwide, and most importantly, the characteristics of the new home owner or renter who will drive the recovery.

During the first panel discussion of the day, Near Term M&A Outlook, delegates heard that in today's mergers and acquisitions market it was better to be a seller than a buyer, and that some valuations were reaching pre-recession levels as private equity firms attempted to put capital to work. Panelists agreed that despite some signs of recovery, they saw little reason to value acquisition targets more aggressively today on the promise of future growth.

The second panel, Growth Priorities and Challenges, tackled the issue of how to create growth in stubbornly flat markets. Most panelists agreed that the benefits of cost cutting are coming to an end and that it is now necessary to look at acquisitions, new products or new geographies. They also addressed how they will scale up their operations quickly enough when the long-awaited jump in demand finally arrives.

Before conference delegates broke for cocktails and networking, endnote speaker Alison Premo Black, Vice President of Policy and a Managing Director at the American Road & Transportation Builders Association, explained that delays in authorizing federal funding, a wind down in federal stimulus spending and a reduction in state and local government budgets would all reduce overall transportation infrastructure spending in 2011. However, she said that the picture varied in different regions across the country, with transportation infrastructure spending still growing in some states.



John Burns, President and CEO of John Burns Real Estate Consulting

Keynote Address

Succeeding in the “New” New Home Market

In his keynote address, Mr. Burns predicted that although the residential construction market would continue to feel some pain for the next few years, in four years the market would be back at more normal levels of construction activity. He said that the road to recovery had already begun and that fundamentals were improving, with excess housing units falling, sales rising, the population growing, and home affordability the best it has been in generations. However, he said that the industry had to understand the variances between different markets nationwide, including which regions would experience near term growth in building, and the characteristics of the new home owner or renter who will drive the recovery.

Mr. Burns began his address by stating that he wanted to give the audience lots of new information that would help them make good decisions in the residential market. He said that while the outlook for 2011 and 2012 was not great, he believed residential construction activity had bottomed and would begin a slow climb back to healthy levels. “Long term, you should have a really optimistic outlook because the U.S. Census Bureau says the population will grow by 3.2 million every year and they’ve all got to live

somewhere.” He added that in 2007, one of the mistakes made was that the industry failed to identify key consumer preferences. “My advice would be to listen to consumers and really understand their evolving needs.”

Mr. Burns said that at this same conference four years ago he was advising his clients that the market would be declining, but he was much more optimistic today due to improving industry fundamentals.



However, although the recovery was underway, the industry would not return to 1.7 million annual construction starts for six years or more. "The U.S. has never gone through a downturn like this before, but a number of regions across the country have and they took years to recover."

He pointed out that after the recession in the early 1980s, the number of housing permits issued in Houston fell significantly and took years to recover. In Southern California, where unemployment spiked up between 1991 and 1994, the number of housing permits issued did not reach 1991 levels again until 1997. "There is a notion among economists that housing leads us out of recession, but that's not the way it usually works. The economy has to be creating jobs first, which creates price appreciation, which results in more deals, which will create construction," he said.

Mr. Burns explained that homebuilding executives nationwide were reporting that recent monthly sales rates for their communities were up 26% this February compared to January, and flat to slightly down compared to the same period last year. He indicated this is a positive sign since the first-time homebuyer tax credit that expired in April 2010 had a positive impact on sales early last year. "If we compare pretty favorably to last year when we don't have a tax credit this time around, we have basically found the bottom."

The job-led recovery

He said current job growth had put the residential building and construction industry on the long road to recovery and that there are some regions nationwide that are experiencing very strong job growth, with Texas, Washington, D.C., Phoenix and Orlando adding the most jobs. However, he pointed out that there are still 1.8 million excess housing units nationwide, so two million new jobs are needed to fill that excess.

He also pointed out that although residential sales are growing, prices are still dropping nationally. He said that Phoenix and Las Vegas are now back to 1999 home prices, certain California, Florida, Boston, Denver and Minneapolis markets are at 2002 to 2003 prices, some of the best Florida markets, Washington, D.C., Charlotte and Seattle are at 2004 to 2005 prices, while the Carolinas and Texas are at 2006 levels. "This has been a very uneven correction," he said. "Would I be buying in Las Vegas because it is overcorrected? Absolutely."

Yet he explained that, while demand for construction is driven by job growth, home prices are driven by how many qualified home buyers there are versus the number of sellers. He said that today is still a buyer's market, which is why prices are still declining slightly. "Going back 30 years, we've never had more than three million homes on the market and now we've been at four million to 4.5 million homes for some time." He explained that the buyer-seller



imbalance improves as you move west across the country. "In Florida, there is more than 12 months of supply, while in California, there's only three to four months. I never thought I would stand up here and say it, but with 4.5% mortgage rates and a \$170,000 median home price, we've got the best house price affordability in generations, but with the lowest new home sales in history at the exact same time."

Great housing affordability, low sales

He went on to discuss why new home sales are low, given that the economy is growing once again and that house price affordability is very good. "Of the 200 homebuilders we surveyed, about 44% said that potential buyers have FICO scores that are too low. Another 25% said that folks did not have the down payment." He said that the third biggest problem was that consumers have too much other debt. "People are loaded up on debt right now, and that is restricting the availability of mortgages."

He added that it was also going to take awhile to clear excess housing stock out of the system when five million out of 55 million mortgages are currently more than 90 days delinquent or already in foreclosure. "We think that 60% of foreclosure notices have been filed and only 30% of distressed homes have been sold. Until a large percentage of these homes are sold, we're not going to be able to

take off from a construction stand point," he said. Therefore, he predicted that there could still be several more years of pain for home builders, but a bright future beyond that. "We estimate that we need 1.7 million housing units constructed every year, so we're already clearing out the excess. On average, home prices are back to 2003 levels and in four years, I think we'll be looking at a market that is trending up."

Mr. Burns said one potential issue is that the U.S. government could make things worse. He argued if the government had not rescued the banks, injected liquidity, taken some foreclosed homes off the market and slashed mortgage rates, the residential construction industry would be much worse off. However, he said that GSE reform presented a new challenge. "The government is the entire mortgage industry today. Can you blow up the entire mortgage industry at this time? I don't think that's a very good idea." However, Mr. Burns argued that the GSEs would likely be wound down slowly over time because there is no political will to take drastic action.

Mr. Burns noted that credit availability was another thing to watch closely, because under the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act, if lenders do not make a qualifying residential mortgage to consumers and a borrower defaults, the bank is liable for 5% of the principal even if a bank sells the loan. "The task force put together to assess



what a qualifying residential mortgage is can't agree, so banks are lending in a vacuum right now," he said. "As soon as the task force is done, the difficulties of refinancing mortgages will go away. This will be a game changer."

Knowing the new consumer

He then spoke about the new consumers in the market, explaining that his company had surveyed almost 10,000 consumers who had given their email address to a home builder or a land developer in the last two years. "We asked when and why they were going to buy and who would be doing the buying. We found that, for consumers, home design is slightly more important than price," he said. "Some 88% of consumers who responded think this is a good time to buy, and anticipate minimal price appreciation, but they are not finding anything to get excited about, particularly with new homes."

Mr. Burns said that 45% of respondents indicated their next home would be bigger than their current home, but pointed out that consumers needed a reason to buy now, because many have no urgency to move. He explained that survey respondents wanted the latest green technology and energy efficiency, but are not prepared to pay for it. "They are just penalizing the guys that don't have it. That's why we believe the energy-efficient products market

will grow dramatically in the next couple of years, even if construction doesn't grow at all."

He advised that it was important to know the submarkets, especially in the most competitive parts of the country. "Don't put a business plan together that says here is what we are going to do in Phoenix," he cautioned. "Look at the submarkets in Phoenix and know your consumer." He said that also meant finding out whether submarkets are attracting home owners or renters, pointing out that there are likely to be 3.3 million new renters in the next five years, partly because of the prospect of rising mortgage rates. "The rental market has been under built for 20 years, so I think there will be more apartments targeted at young folks. There are 1.5 million more 25 to 34-year-olds living with mom and dad today than there were five years ago and once they get a job, there will be a surge in household formations."

In response to an audience question, he said it would be bad news if mortgage rates rose another 2% before the market recovered, but that all signs pointed to a much improved market in four years time. He pointed out that, according to his company's own Housing Cycle Risk Index, almost the entire country is now in the invest/low risk part of the curve. He ended his speech on a high note: "Let go of what has happened in the last five years, because looking forward, there is going to be a lot of construction."



Panel 1 (l-r): R. Gerard Bollman, CFA, Vice President, Global Business Development, Formica Group; S. Matthew Katz, Managing Director, FdG Associates LP; Jeffrey W. Corum, Director, Building and Infrastructure, Lincoln International; Harry A. Shaw, Vice President, Corporate Development, Owens Corning; Donald C. Devine, President and CEO, American Standard Brands

Panel 1

Near Term M&A Outlook

On the day's first panel, panelists agreed that it was better to be a seller than a buyer in today's market and that some valuations were reaching pre-recession levels as private equity firms attempted to put capital to work. Participants talked about opportunities in the residential, commercial and international markets, and although they saw signs of recovery, panelists said they saw little reason to value acquisition targets more highly today on the promise of future growth.

PANELISTS: R. Gerard Bollman, CFA, Vice President, Global Business Development, Formica Group
Donald C. Devine, President and CEO, American Standard Brands
S. Matthew Katz, Managing Director, FdG Associates LP
Harry A. Shaw, Vice President, Corporate Development, Owens Corning

MODERATOR: Jeffrey W. Corum, Director, Building and Infrastructure, Lincoln International

Jeff Corum of Lincoln International began by asking the panelists about their outlook for non-residential construction in 2011 and 2012. Matt Katz of FdG Associates said he thought that activity was increasing in higher education, healthcare, some transportation markets, power and utilities

and commercial retrofit. However, he said that K-12 activity had stopped in most areas and that federal activity had slowed down significantly. "It will be a good year for a small number of firms that operate in specific niches but for the majority, it is going to be very challenging in 2011." Gerry Bollman of



Donald C. Devine, American Standard Brands



R. Gerard Bollman, Formica Group

Formica Group agreed that healthcare, multi-family and remodeling in retail were exhibiting signs of life, while K-12 and hospitality were very quiet. "The one bright spot in government activity has been the military," he said. Don Devine of American Standard Brands pointed out that given the long lead time for commercial construction, 2011 will reflect decisions made one to three years ago, when there was excess capacity and little money available, which would cause activity to drop further. He added that state and local government cuts in school and infrastructure spending would also negatively affect 2012 construction activity.

Mr. Corum then asked the panelists whether last year's healthier M&A market for building and infrastructure companies would continue. Mr. Katz said that it was a great time to be a seller, particularly if your business did well in 2008 and 2009, but a very difficult time to be a buyer. He said that companies with numbers that are flat or modestly up are seeing valuations at pre-recession levels, given the immense amount of private equity capital buyers are trying to put to work. He explained that FdG Associates exited one business last December and the transaction went well. "I can't imagine seeing higher multiples at any time," he said. "It was a great business that had performed well, but there was just so much demand."

Harry Shaw of Owens Corning agreed that although uncertainty about the pace of recovery was holding back activity, when Owens Corning disposed of a business last December, he saw a much better tenor in the market. "I also think that banks are ready to finance private equity and corporates," he said. "As people seek to grow, we think it's going to be off to the races."

Mr. Bollman said that Formica had not made any North American acquisitions for the last couple of years because valuations have been too high, but had been looking more actively in Asia and Europe. He said one of the challenges in Asia is the multiples expected for businesses given the significant growth in the region. Europe though is a different story. "In Europe, we could see some interesting valuations. The market there has been very tough and some European economies are behind ours."

Mr. Devine said that American Standard Brands had made two acquisitions last year, Decorative Panels and Safety Tubs. He said more industry consolidation was necessary because, contrary to expectations, few companies had exited the business during the downturn, resulting in a lot of capacity. "Every company believes that if it has survived this long, why should it give you the upside?" he said. "Financial markets have also been very accommodating, which has enabled many building products companies to defer the day of reckoning."



The legitimacy of higher valuations

Mr. Corum noted that many Lincoln International clients with significantly reduced EBITDA levels thought their profits would rebound in the next one to three years and thus he asked the panelists whether they would give any credit to potential target companies for future increases in profits.

All of the panelists said that they looked at current levels of profitability and would not pay extra for a future recovery story, particularly when, as Mr. Devine pointed out, all companies are having to bear increased input costs. "The price of copper has already exceeded where it was in the summer of 2008. Oil is at \$100 a barrel. There has been enormous pressure inside the value chain to push through commodity price inflation and that's building as we speak today." However, he said that was not possible in such a flat market place, where big buyers such as Home Depot and Lowe's have enormous pricing power. "Home Depot and Lowe's have been able to increase their gross profit margin each year from 2006 to 2010 through the downturn. Being a big buyer during a downturn leads to enormous pricing power."

Mr. Bollman said that the only time Formica would consider paying for the promise of recovery was if the company felt that it could bring value to a transaction that others could not, for example, by leveraging the

global reach of its business or taking products to new markets. Mr. Shaw noted that the trading multiple given to Owens Corning in the equity markets gives the company a certain amount of discipline. Mr. Katz said that FdG Associates also tried to remain disciplined as they evaluate acquisition opportunities. "It doesn't matter what we think, though, because plenty of firms seem perfectly willing to pretend that it's 2007 and pay a very full price," he said. "It's been very frustrating for those of us who have tried to remain disciplined to see that there's a feeding frenzy for assets that have performed well." He suggested that there was a disconnect between the empirical evidence about the economic recovery and what people intuitively feel.

Mr. Corum said that financing sources seem to be back in the industry, and asked the panel their views on the current financing markets for building products companies. Mr. Devine said that American Standard Brands recently completed a significant financing and they found that financing sources are very interested in the building products industry. Mr. Shaw said that the financing available for transactions had rebounded to levels that allowed private equity firms to compete with strategics for deals, setting a floor on value.



Harry A. Shaw, Owens Corning

The international outlook

Mr. Corum then asked the panel about international opportunities. Mr. Bollman pointed out that during the downturn in North America, Asia has continued to grow at double digits, while Europe is still a mixed bag. "We don't see, for example, Spain recovering anytime soon. If we were more exposed to France, Germany and some of the healthier markets, we probably would be more optimistic," he said. In Asia, he said that although it is relatively easy to find top line growth, finding profitable growth is a challenge. "We are looking to do acquisitions there, but multiples are incredibly high, and there is significant competition." He said that Formica Group was particularly interested in China and India, but given the inherent growth in these markets, it may make more sense to build factories there instead.

Lastly, Mr. Corum asked the panel for their views on the residential construction market in 2011 and 2012. Mr. Devine and Mr. Bollman agreed that residential construction remained weak and the recovery will be slow, although both thought that prospects for remodeling were good, as long as house prices do not depreciate further. "If consumers are confident that their dollars will not be diluted, they will invest in their properties, and thus remodeling activity could increase significantly when home prices stop falling," said Mr. Devine. Mr. Bollman also said that one bright

spot has been the multi-family segment. Mr. Katz added that there were opportunities for businesses operating in areas helped by governmental support, such as the replacement window industry. "The government is helping by throwing money at the window industry through the credits. People can only put up with drafty windows for so long if they are contemplating being in their home for another five to 10 years."

A member of the audience asked how the panel would compare opportunities with private equity-owned companies to opportunities with publicly traded companies. Mr. Shaw said that they offer a value creation opportunity at Owens Corning as a shareholder, in addition to mobility and the opportunity to run larger businesses. Another audience member asked what could change the panel's general forecast of slow growth to no growth over the next few years. Mr. Devine said the most important thing is that employment would have to materially improve which could then potentially lead to home price appreciation.



Panel 2 (l-r): Rob Rourke, Vice President, Head of North America Building and Construction Practice, L.E.K. Consulting; Fareed A. Khan, Executive Vice President, Finance and Strategy, USG Corporation; Amitabh Swarup, General Manager of Business Development and Strategy, Holcim (US) Inc.; Christopher J. McGowan, Managing Director / Co-Head of Basic Industries, Madison Dearborn Partners; Pascal B. Convers, Senior Vice President, Business Development, Oldcastle Materials; Peter Dachowski, President and CEO, CertainTeed Corporation

Panel 2

Growth Priorities and Challenges

Most of the panelists agreed that the benefits of cost cutting are coming to an end and that acquisitions, new products or new geographies are now necessary to drive growth. They discussed whether big box retailers would be able to further capitalize on the enhanced market share that they have built during the recession and addressed how they will scale up their operations when the long-awaited jump in demand finally arrives.

- PANELISTS:** Pascal B. Convers, Senior Vice President, Business Development, Oldcastle Materials
Peter Dachowski, President and CEO, CertainTeed Corporation
Fareed A. Khan, Executive Vice President, Finance and Strategy, USG Corporation
Christopher J. McGowan, Managing Director / Co-Head of Basic Industries, Madison Dearborn Partners
Amitabh Swarup, General Manager of Business Development and Strategy, Holcim (US) Inc.
- MODERATOR:** Rob Rourke, Vice President, Head of North America Building and Construction Practice, L.E.K. Consulting



Pascal B. Convers, Oldcastle Materials

Rob Rourke of L.E.K. Consulting began by asking the panel about growth opportunities over the next few years. Peter Dachowski of CertainTeed Corporation said that although the company focused on specialized distribution, it has begun an important relationship with Lowe's, partly to get more access to the remodeling market. CertainTeed has also looked more closely at growth in Canada, since Canada is currently approximately 25% of the U.S. construction market. He also said that CertainTeed was investing in solar energy, which the company believes will be a big market in the future in addition to being a good fit with CertainTeed's roofing business.

Fareed Khan of USG Corporation said he didn't see any major recovery in the next 12 to 18 months and that USG was still running the business as though it is in a protracted downturn. USG has taken advantage of improving financing markets to add some liquidity to their balance sheet through a high-yield bond refinancing last fall. He added that, when the recovery arrived, the company would be scaled up in a very different way. "We are very focused on core business profitability by getting the most out of the plant network we have now without having to bring back idle capacity," he said.

Chris McGowan of Madison Dearborn Partners, which owns Boise Cascade, said that Boise Cascade has worked extremely hard to reengineer its manufacturing operations to restore profitability there, and that it

had grown its distribution business organically by adding locations and new products as the competition had been retrenching. He said that although the company was also looking for tuck-in distribution and manufacturing acquisitions, he was not banking on a near term recovery.

Pascal Convers said that the U.S. Materials Division of Oldcastle Materials had acquired 20 companies last year and would probably buy another 20 to 30 this year. "We are ramping up and looking for good bolt-on opportunities," he said. "It's a good time to buy in our industry. We do see competition from private equity firms, but strategic buyers are not doing much in the U.S. right now."

Amitabh Swarup said that Holcim had taken significant cost out of the business, and now were turning their attention to acquisitions. He said that prices have come down, although not as much as the company would like. "We are also looking at joint venturing in a few different markets, but these are not easily accomplished in this industry," he said.

Mr. Rourke asked whether the panelists were changing their geographic focus, given the lack of U.S. growth. Mr. McGowan said that Boise Cascade was doing well in Canada and that China was also on the radar screen as an export market. Mr. Khan said that USG already has a joint venture in China and the Middle East and is very interested in international markets, even though



it does not have much capital to devote to current acquisitions as the company is focused on becoming investment-grade for the next cycle.

Mr. Dachowski explained that Saint-Gobain, the parent company of CertainTeed, is focused on the BRIC quartet of countries. He said that the group had been very successful in Brazil, India and Russia, even though Saint-Gobain's entry into Russia was just a decade ago. "China initially offered top line growth and all sorts of problems and losses, but our business is now profitable there too," he said. He mentioned other interesting countries. "Turkey is also an attractive market," he said. "The lion's share of our discretionary capital investment in acquisitions is going to emerging countries." Mr. Convers said that Oldcastle Materials was also interested in increasing its emerging market exposure from 15% to from 25% to 30%. However, both he and Mr. Swarup said they were still very bullish about long term growth opportunities in the U.S.

Market share of big box retailers

Mr. Rourke mentioned that big box retailers had increased their market share during the recession. He asked whether professional contractors would move their business from home centers and start buying from traditional channels again as the economy improved or whether there would be more consolidation among those channels.

Mr. McGowan said that as Boise Cascade is both a one-step and a two-step distributor in the supply chain, it pays close attention to this. "Overall, the industry lost about 1,200 retail locations during the downturn. Simply by being in business, being in stock, and floating responsible levels of credit to the trade, we have been able to take a tremendous amount of market share." However, he said that with the spike in prices of commodities, price was also becoming a significant driver and some competitors are also offering non-standard credit terms.

Mr. Dachowski agreed that the market was getting increasingly price sensitive. "A major specialized distributor of ceilings and insulation said to me last week that one of his longest standing customers had asked him for a \$300 adjustment on a \$100,000 job. The distributor said that three years ago, if an estimate had been \$3,000 high, the conversation would never have taken place." He added that lower-priced channels, in search of new customers, are



Rob Rourke, L.E.K. Consulting



Christopher J. McGowan, Madison Dearborn Partners

invading new segments of the industry and predicted that the landscape could evolve to look quite different. However he argued that although big box retailers have taken market share, especially in certain categories such as plumbing, the big two are not adding many new stores.

An audience member asked Mr. Swarup about activity from private equity firms. He responded that private equity money is important in his industry, particularly since strategic buyers are not as willing to compete on valuation at the moment, and that Blackstone has been one of the most active funds in the industry through its ownership of Summit Materials. "Four or five years ago, valuations were quite high and firms were rewarded for flipping businesses in two or three years," he said. "I think that today valuations are a bit more reasonable." Mr. McGowan said that Madison Dearborn is looking for companies with strong market share and pricing power, which was especially important given volatility in raw materials prices. However, he said he would shy away from markets where there was excess capacity within the supply chain as that could mean a choppy road to recovery.

Preparing for the upturn

The panel was also asked by an audience member whether the industry was ready for a quick upturn from a human resources standpoint. Mr. Khan said that USG

will worry about recruiting new talent when the upturn comes. "You see other sectors of the economy already recovering, so we might be the last out of the gate," he said. "So far we haven't lost much talent, and we are moving people around more and creating more interesting roles, but it's been a grueling four years."

Lastly a member of the audience asked how companies will manage an increase in capacity when demand improves. Mr. McGowan said that customers of Boise Cascade, looking at all the capacity that had been removed from the industry, keep asking how the company will deal with a jump in demand when it arrives. "It's true that in the industry as a whole, supply at some point will not be able to keep up with demand," he said. "That will give lots of pricing power and make some companies more profitable at 800,000 housing starts than they were previously at 1.2 million." He added that distribution is likely to be easier to scale, but manufacturing is more difficult. "I think we are going to see greatly increasing product prices be the leading indicator of when we should start expanding capacity." Mr. Khan warned that although pricing declines of raw materials created margin expansion on the way down, the reverse would be true as the market recovered. "It's the opposite story on the way up and getting cash to rebuild inventory will be a challenge. This could cause more consolidation," he said.



Alison Premo Black, Vice President of Policy, Managing Director, Research & Education Division, American Road & Transportation Builders Association

Endnote Address

An update on the current transportation construction market, recent trends and what you can expect in 2011 and beyond

Ms. Black of the American Road & Transportation Builders Association, a 102-year-old federation that provides custom research on a federal, state, local and county level, explained that transportation infrastructure spending would fall in 2011 due to delays in the reauthorization of federal funding, a wind down in federal stimulus spending, and budget cuts by state and local governments. However, she said that the picture was very different across the country, and that in some states, transportation infrastructure spending was still growing.

Ms. Black began her speech by saying she expected the downturn in transportation infrastructure spending that began in 2010 to continue in 2011. She said there were three key reasons: a prolonged debate on the multi-year reauthorization of the federal highway transit bill, the fact that stimulus spending from the American Reinvestment and Recovery Act is coming to an end, and cuts in state and local spending.

“In particular, the pull back by state and local governments is making a real difference in the overall market outlook for the next few years,” she said.

Ms. Black explained that Congress typically reauthorizes the Surface Transportation Bill to set federal spending levels for highway, bridge and transit construction over a six year period.



She said one of the key reasons for continuing delays over passage of a new bill has been the unwillingness of Congress to generate new revenues to pay for it. "Right now, the money coming into the trust fund from the gas tax will not support current spending levels," Black said. "Congress must decide whether to raise revenue, from the gas tax or elsewhere; borrow money from the general fund, as they have done for the last two years; or cut the program. There has been no political will to take any of these actions."

Ms. Black said the allocation of this federal money was a critical driver to the whole sector, not only because it formed a big portion of overall transportation infrastructure spending outright, but also having a big impact on how much individual states spent themselves. "Some 44% of highway capital spending is federal reimbursements to states for ongoing work, while the states spend 32% with local municipalities contributing the remaining 24%. The federal spending also requires a 20% state match, so when you factor that in, federal investment is driving about half of the highway and bridge construction market," she said.

The role of stimulus funding

Ms. Black also discussed the federal stimulus law's transportation investments, pointing out that, "Really

it was the lifeline of our industry over the past year, but essentially that money has now been spent." She explained that a total of over \$18 billion has already been paid out to contractors. "There's a common misconception that much more stimulus spending was allocated to infrastructure, but only \$27.5 billion of the total \$787 billion in the stimulus went to highways and bridges. That's a pretty small piece." She said the other common misperception was that the money has not been spent, when in fact around \$5.5 billion was spent in 2009, a further \$11 billion was spent in 2010 and \$1.5 billion in early 2011. "While it didn't create lots of new jobs, it certainly saved many." She explained that was because most of that cash, some \$13.5 billion, had gone towards shorter term pavement improvements, rather than new construction projects, and because a number of states dramatically scaled back their highway and bridge programs. "Typically, for pavement improvements, companies can move crews around. It is not like a new construction or bridge project where a company will hire because it is a longer term project. Our quarterly contractor survey shows us that around 60% of companies are working at 75% of capacity or below, which means that companies have a lot of room to absorb this extra short term work."

Nevertheless, she said that work on bridges has actually been gaining market share over the last decade. "States tend to use their federal funds for these big investment projects, and as they tend to be



multi-year projects, states are not pulling back," she said. "This work is ongoing." She pointed out that contract awards for bridge work have also been at record levels in 2009 and 2010, so the prospects for this market were good, particularly considering the need. "Some 25% of the nation's 600,000 bridges are structurally deficient or functionally obsolete, so a lot of work will be continuing in the bridge sector."

A contraction in state spending

Ms. Black said that the contraction in state spending was really apparent in highway and pavement work, now that stimulus funds had worked their way through the system. "This is where states that are facing economic challenges started pulling back on projects, particularly last year," she said. She explained that in 2007 and 2008 total spending by states, including federal funds, was on average about \$50 billion per year, but only climbed to \$51.6 billion in 2010. She said that 2010 spending should have been significantly higher, given the level of federal stimulus spending. "Had states maintained the same level of spending, the cumulative difference between 2009 and what we expect the market to be in 2011 would be between \$20 billion and \$23 billion. Stimulus spending has not had a very big impact, because state and local governments have pulled back their own spending by almost the same amount."

She stated that the association's overall highway and bridge investment spending forecast for 2011 showed a downturn of 4.4%, absent any significant new federal, state or local spending, and was also forecasting very modest growth after that for the next few years. "Our market forecast, an econometric model, assumes status quo federal funding. Currently we don't have any type of reauthorization proposal that is going to significantly ramp up funding and we expect modest economic growth, which will help state and local government spending," she said. "We're assuming that inflation and material prices remain at 2% year on year, so nothing too dramatic."

She pointed out that the association's latest quarterly survey also showed that around 50% of contractors are expecting continued recessionary conditions or at best sluggish growth in transportation construction. She noted that the forecast did not include private investment, although she said this represented a very small portion of overall spending. "We are supportive of public private partnerships and they will be a very important factor in financing transportation infrastructure in the future, but not every project meets these investment requirements. They are not the silver bullet that closes the spending gap."

She said that, under this forecast, state and local spending was expected to be \$38.7 billion in 2011. "If you look at our forecast, state and local spending is expected to increase as the economy recovers

and federal spending declines.” However, she pointed out that while state revenues are expected to improve again this year, she did not expect a big rebound in state or local spending in the next year or two. “We do know that about 15 states have cut spending from their general fund for transportation,” she said, adding that although a state’s general fund typically only accounted for about 10% of its highway spending, it is an indication that states are struggling in this economic environment.

The lesson of past recessions

However, Ms. Black explained that there were other contributing factors to the sector downturn in 2010 and 2011. She pointed out that, unlike the general construction market, highway and bridge construction tends to be very stable because the level of federal and state funding is usually steady. However, she said that when a recession drags on for three years or more, as occurred in the early 1970s, states start to cut or delay their capital spending. “What got us out of that tailspin was a federal gas tax increase in 1983 under President Reagan,” she said. “We’re watching very carefully to check that we are not at the beginning of a tailspin like that now.”

She explained that the large downturn in general construction during the most recent recession has also had a big impact on transportation construction. “A lot of businesses that are typically focused on vertical construction have entered the transportation construction market because there has been some spending in that area, so there’s a very high level of competition right now.” She pointed out that has led to many bids coming in well below estimate. “In Texas last year, for example, the difference between engineer estimates of what they were planning to spend on projects and the lowest bids they received was \$700 million,” she said. “This is great from a taxpayer’s perspective, but it does mean that contractors are having a very challenging time.”

Ms. Black pointed out that the situation varied dramatically state by state. “There were 22 states where highway and bridge contract awards were up last year and probably about 17 states have shown

decent contract growth over the last few years,” she said. “Florida has used public private partnerships to its advantage and shown growth for the last few years. North Carolina is also doing very well.” She also cited the example of Texas, where she said some creative financing and concessions had really supported the market. “Their market has been going gang busters over the last few years,” she said.

An audience member asked about the current political climate in Washington, D.C. and what it means for transportation investment. Ms. Black noted that while some members of Congress are focusing more on spending cuts in a variety of different areas, including transportation infrastructure spending, President Obama and other members have identified infrastructure as one of the keys to “winning the future.” Add it all up and it makes for interesting political theater in the coming months.

2011 BUILDING AND INFRASTRUCTURE CONFERENCE

March 3RD, 2011 ■ New York Athletic Club

Is The Recovery Upon Us?

