PITFALLS, RECOVERY AND OPPORTUNITIES
- case studies and lessons learned -

The GFC
When times are good there is more than enough work to go round; and, at such times, market share for the bigger boys often goes down. But, as is well charted, we (as in the entire World) have just emerged from a palpable recession and almost a re-run of the 1930s plus the near collapse of the international financial system (the GFC or Global Financial Crisis). Sure, this recession is a humdinger and we did flirt with a re-run of the 1930s. But the difference and saviour, of course, has been concerted global governmental stimulus ($US 1,799 for every man jack of us). But what was the alternative? Indeed what the stimulus bought us was survival - plus survival of the financial system - and avoidance of a father and mother of a recession (although it may not have felt like it).

Lessons learned
But there ainôt no free lunch and because it was easier on the way down - i.e. the denouement was less precipitous - so the upturn will be commensurately more muted. All developed national governments will be indebted to the rafters for a generation. State spending - capital and current - will be slashed and taxes will rise inexorably. Secondly, given the identified mistakes and excesses of the recent past (especially in banking), we will all be more regulated; and these are the challenges for any Government or Governments, newly elected or incumbent. As Rafiki in óThe Lion Kingô says: ñthe past can hurt, but the way I see it, you can either run from it of learn from itò.

- first principles: spending; legals; markets; costs; & funding
Our wonderful industry is, of course, no stranger to either a parsimonious public purse or rules and regulations ï albeit an even keener eye will need to be kept on both. Civil servants will be more powerful, too, and better paid (and thus competitors for talent). Similarly, private finance for public sector projects and asset management will become even more important; and is ignored at your peril. Dare I say it (and with no back hander), a clinical understanding of the dynamic legal framework in which we operate will be vital.

A legacy issue of the GFC, too, is that there will be a greater number of opportunities for growth in developing markets, and particularly Central and Eastern Europe. Many of them are resource and population rich, on the one hand, and beneficiaries of Western bail outs, on the other. Indeed, Global Construction Perspectives believes that many of these individual construction markets will double in size over the next 10 years.

At the micro level, few of the industryôs participants have not had the knife for both people and costs (and for a number of participants, revenue has halved). What is different this time around, however, is that the slicing has been more surgical. That is, instead of laying staff off willy-nilly, for example, the following more imaginative and effective steps have been taken:

- reduction in salaries and/or bonuses
- salary holidays

- linking salary to performance against budget
- sabbaticals
- three and four day weeks
- merging subsidiaries where possible (rather than closing them)
- rationalising premises including sale-and-lease-back plus sub-lets
- slowing payment of creditors
- abandoning employee perks
- slowing or ceasing corporate entertainment

This means that, unlike Cat Stevens, the first cut is not the deepest and the muscle of the business remains intact and ready to run the 100 metres again. Suppliers, including landlords, have also proved to be more patient about payment too ï taking the view that it is preferable to get paid eventually rather than not at all (only the banks remain intransigent if not going the other way towards the Draconian; and see later section). Employee perks have also been selflessly foregone and entertainment, both the provision of and participation in, has taken a back seat. Indeed, in the current climate prospective guests think it is better not to be seen doing so.

As a consequence, this means that we will have an older, wiser, leaner and fitter industry in the future, when the sunny uplit lands beckon once more. There can, of course, be a (financial) wobble or two at the point of inflexion. That is: you have weathered the downturn and done all the right things; you can see the orderbook beginning to thicken; but you have run out of working capital. Here there are only two choices: go to shareholders; or go to the bank (more of which later).

More broadly, public and private sector boundaries will continue to blur and the preconceptions and prejudices from days of yore will be emasculated. Learning to speak Serbo-Croat, or similar, might also be recommended.

- the special case of UK Housebuilders

UK private housing starts broadly halved between 2005 (191,000) and 2009 (82,000). In terms of the value output, this fell 42% in real terms over the same period to £10.7 billion at 2005 prices. By way of background noise, UK house prices from their most recent peak (Q4 2007) had fallen 18.6% by Q1 2009 (albeit they then rose 8.8% through Q1 of this year). The percentage changes for new houses over the same period were -17.9% (to Q2 2009) and +6.6%.

Unsurprisingly, the stock market value of the UK Housebuilding Sector collapsed from a peak of £21.4 billion at the turn of the new calendar year 2007 to a low of just £3 billion on 7 July 2008; and I will repeat that: £21.4 to £3 billion. Since then it has risen to a ópeakô of £7.8 billion on 25 August 2009 and, at the time of writing, (14 June 2010) the value was £5.8 billion.

But the housebuilders have not been sitting on their hands. In 2008 and 2009 (calendar and fiscal years), they wrote off £3.7 and £1.4 billion respectively, which resulted in a pretax loss of £2.7 billion and £1.5 billion in each year respectively. At the same time they raised £1.5 billion from their shareholders, which reduced net debt from 51% (£4.7 billion) of net assets to 31% (£2.6 billion).

Okay, it came at a price in terms of market value, but look how these businesses made their profit and loss accounts, balance sheets and shareholders work for them. What is more, only one listed housebuilder (Oakdene) has gone bust in this cycle.

- Darwinian man

In Stanley Kubrickôs ñ2001: a Space Odysseyò, a motion picture still revered 48 years after it was made, there is an indelible illustration of how we learn. Early in the film there are wonderful vistas of prehistoric earth, replete with apes and wild, predatory animals. The apes are often victims ï both of four legged creatures and their anthropoidal neighbours. But knowledge is seemingly disseminated to one ape from a mysterious ebony monolith. He learns to use a bone as a weapon for hunting food and for killing his enemies; and his fellow ótroopô members are taught/learn to do the same. For the record, the other collective noun for apes is óa shrewdnessô. No word is spoken for the first 30 minutes of the film.

For me this galvanises a number of maxims. Darwinian man was and is resourceful, otherwise we would still be living in damp caves; adversity breeds response and innovation; and population creates demand. Equally fundamental is reason, analysis and implementation i.e. figuring something out, processing what you have learned and putting it into practice. All are important but the third one is vital.

The other maxim is that competitive advantage has a short shelf life. This is true in all industries, but especially so in ours, where - while there are many patented products - there are few patented practices. There is also a risk that óprovided products or servicesô become commoditised and that any premium in pricing is either reduced or removed altogether.

We are also prone to cyclicality and the traditional way to whip the cycle is to spread your business by discipline, market and region: easy to say; hard to do (of which more later).

Competitive pressures, too, are endemic, in part reflecting ease of market entry; and so price and cost are always important (80% of a contractorô budget; for example, is typically spent on services and materials). We are also all being asked to do more for less. But quality is paramount, because structures and facilities house and ferry people. The same goes for delivery and punctiliousness (an area stoutly criticised by clients and the public at large). Again: easy to say; hard to do.

More broadly, ñwe are all salesmenò. Nor does this simply mean winning transactions, it means winning hearts and minds, doing the best job you can, looking and acting the part (right down to how you answer the telephone); being a good citizen. It also means research (often microscopic) and remorseless networking. Reputation can be a fickle bedfellow and one who can disappear in the morning accompanied by one badly delivered order.

- cash and dynamic markets

Cash as opposed to leverage (or borrowing) is King of the World and given the attrition in the price of assets, of all classes, there are bargains to be had ï if you can afford it. The opposite of this applies, too, insofar as asset owners are sitting on losses and many are in denial. This includes financial institutions which are owners (of real estate in particular) by default; dramatically so in Ireland with NAMA or the National Asset Management Agency. Corporate owners will also become more forensic about their portfolios seeking to stay longer and/or rationalise space; with which they will require help.

More broadly, a truly focused manufacturer will not directly do anything but manufacture (and even this may be in a far off land) i.e. he will outsource everything from cleaning to HR; another opportunity.

Given the constraints on public purses everywhere, PPP and PFI will gather momentum dramatically (for example the £6.2 billion PFI contract on the widening of the M25, Londonôs ring road). Similarly, duty of care from gleam-in-the eye of a facility through its construction to operation over a decade or two is now de rigueur.

Field Marshal (later Viscount) Montgomery famously said that ñwithout infantry you can do nothingò. So it is with constructioné .and, despite its service orientation, the industry accounted for 10.9% of Western European GDP last year and nearly 12% in CEE (and double that in other international emerging markets) in a band from 7.9% (Sweden) to 15.4% (in the Czech Republic).

- scale and composition

Demand, while cyclical, is also broadly based and multi-sourced. In the UK, for example, the public sector still accounts for 34% of total construction output (down from 54% in 1955), while RMI is 44% (having been 38% in 1955 and at a peak of 49% in 1985 at the mid-point of an industry recovery). Once again, emerging markets would see a public sector comfortably in excess of 50% and the reverse for RMI. Within, these larger segments of activity there are a range of sub-sectors with varying fortunes.

For example, in the UK, in 2009, the industry had its worst year on record with an 11.5% drop in activity, in real terms. However, if you had been building schools (for the future), working on infrastructure (including Crossrail) or the 2012 Olympics you could have been forgiven for asking: what recession? Incidentally, the London 2012 Olympic facilities are on time and on budget. Being nimble, too, is important. In the UK, for example those service and product providers who had put all their eggs in the public sector basket - because it was growing and busy - are now seeing that move the other way as Government spending cuts begins to bite. There is not only less work, too, prices are being squeezed ï even where previously agreed.

- structure
Variable fortunes within one national market (sectoral and regional) underline the wisdom, I touched on earlier, of spreading your business by discipline, market and region. The only problem with the GFC, though, was that all national markets (ex-China) turned down simultaneously for the first time in nearly four score years.

Taking that as a rare exception, there is undeniable benefit to being in more than one place at the same time; and, hopefully, offering a range of services too. In order, to make this work, too, scale is important in terms of resources and finances (albeit no one in construction and real estate is ótoo big to failö). Nor should it be scale for scaleös sake.

- TKF
Nonetheless, the big are getting bigger. Look at Aecom, Balfour Beatty, CRH, Jacobs, Saint Gobain and Westfield ï and, commensurately, there remains a profusion of purveyors and boutiques at the other end of the scale. In the middle, life can be okay in the good times but it is not so easy in the bad. Yes, you can punch above your weight but you can also be kicked to death from above and knocked about from below i.e. óthe killing fieldsö. You may be in a financially vulnerable position, also, having grown quickly with debt.

Options:
- Growth by region
- Growth by product and/or discipline
- M&A
- New external investors/private equity/public to private
- Public listing, rights issues, share placing/IPO
- Status quo (not the band)

- Growth by region
In general terms, population growth pushes GDP and GDP pushes construction. The developing markets are growing disproportionately fast but the US (and even the UK) is no slouch with a projected 46% gain in population between 2007 and 2050 (to reach 469 million). My favourite emerging markets are China and India. In particular, I believe the 21st Century is Chinaös in the same way that the British dominated the 19th and the Americans the 20th. Already, China is the Worldös most populous country (1.3 billion+), the second largest global economy-elect, the fastest growing major (+9.5% on GDP this year), a benevolent neo-colonialist, friend to many of the Worldô bad boys and part-time mercantilist. Whatös more, Chinaös consumer revolution has yet to occur; and, when it does, economic growth will be underwritten. The savings rate in China is 37.9% (2008) which compares with 3.3% in the US (March 2010).

In addition, and given its wealth of natural resources, Australia is another target. Its population is growing at 2.1% per annum (as at June last year) and it is one of the Worldös most urbanised countries with an urban population of 89%. Life expectancy of Australia is also one of the Worldös highest at 79.7 years (as at 1999-2001).

- Growth by product and/or discipline
Finally, here, by discipline and/or sector, I am excited about: water; energy (new and decommissioning); transport links; and, indeed, anything regulated.

Some 2.4 billion people live in ñwater-stressedò countries such as China, according to a 2009 report by the Pacific Institute, an Oakland, California-based non-profit scientific research group. Water scarcity and pollution reduce Chinaôs GDP by about 2.3 %, the World Bank said in a 2007 report. ñWater will become the next big power, not only in China but the whole Worldò said Li Haifeng, VP at sewage treatment company Beijing Enterprises Water Group. ñWars may start over the scarcity of waterò. Water demand in the next two decades will double in India to 1.5 trillion cubic metres and rise 32% in China to 818 billion cubic metres, according to the 2030 Water Resources Group, a research collaboration between the World Bank, management consulting firm McKinsey and industrial water users such as Coca-Cola. That will produce returns of 12% or more from investments in companies which treat or process water, said Arnaud Bisschop, who oversees $3.27 billion investments in the Water Fund run by a unit of Pictet in Geneva.

Chinaôs 1.33 billion people each have 2,117 cubic metres of water available per year, compared with 1,614 cubic metres in India and as much as 9,943 cubic metres in the US, according to the Food and Agriculture Organisation of the UN. The 1.2 billion people in India, where farmers use 80% of available water, will exhaust their fresh water supplies by 2050 at the current rate, the World Bank estimates.

China, with 20% of the Worldôs population and 7% of its fresh water, has contaminated 70% of its rivers and lakes, while half the cities have polluted groundwater, according to the World Bank. By 2030 China will have a supply shortfall of 201 billion cubic metres unless the government takes steps to control demand, according to McKinsey. ñChina can solve this problem in a way that creates economic value as opposed to economic cost. There is tremendous, though largely untapped, opportunity to meet Chinaôs enormous need for water resources by focusing on better managing demandò. Investments in technologies to ease Chinaôs water deficit are expected to reap Yuan 131 billion ($19 billion) in profit a year, according to the McKinsey report in April.

- M&A
The mergers and acquisitions climate has turned sharply positive when compared with this time last year. Corporates who are well-funded, can see the incipient recovery in the majority of the Worldôs economies and are seeking to take advantage of depressed asset prices. Balfour Beatty is buying everything big and small that it can lay its hands on, including Parsons Brinckerhoff in the US. Then, in the Spring, VT Group bid (now lapsed) for Mouchel; and, in a move reminiscent of the 1980ôs corporate PacMan, this was followed by Babcock bidding for and successfully taking over VT.

An alternative strategy theory is that of simply taking out competitors/capacity. If you have the cash (or can borrow), as a corporate and you assume that growth per se may be benign - buying up oneôs competitors makes sense. Most obviously it removes a competitor (*sic*) which helps your growth and may even improve market pricing.

Similarly, there will inevitably be cost reductions that can be wrought. Sadly, such rationalisation tends to happen on a wide scale when everyone is feeling good about business, the economy, themselves. Indeed, from a value creation point of view (the acquirer) it should happen when the going is tough and may even be a rescue (the acquired).

Although, M&A includes the ñMò word, they are rare it is more often than not ñAò or ñacquisitionsò which prevail. In reality, too, even a meeting of equals involves one party taking the other over, even when there is no premium paid and the transaction is share based. Cynically, too, the quip amongst investment bankers is that mergers are often like two drunks supporting each other. In the UK, the most significant recent merger was that of Taylor Woodrow and George Wimpey to form Taylor Wimpey, which actually made a lot of sense; and it has created short term value even though the UK housing market has been pretty dreadful.

Reverse takeovers occur when a smaller rival merges with a larger one (which is most probably ailing). Typically, the smaller of the two assumes majority management of the enlarged business, even though the larger unit may officially óacquireô the smaller one

Finally, I have already touched on óbeing acquiredô and there can be significant attractions for the seller. In the current market, it may be the route to/price of survival. However, in better times it can be an exit for existing - maybe family or elderly - shareholders. In these cases, the premium for that £1 of assets is the reward for brand, market position, risk and development over time (see below).

- New external investors/private equity/public to private
There is also an abundance of private equity and venture capital money burning holes in various tailored pockets i.e. there is much more cash than there are ideas. This comes at a price, of course, which may run to four or five times the original investment; but it can also be a perfect match of need and capacity. In many cases, private equity investors are skilled financial managers of business or similarly well connected with prospective customers; and both can be very useful. The vendorõs ownership would be diluted, inevitably, but better to have, say, 40% of something in three to five years than 100% of nothing, should a business fail. Inevitably, too, there needs to be an exit route for the investor(s) and this can really only take two forms: flotation on a public market; or a trade sale.

Public to private (and Dell, the computer manufacturer, is the latest to at least mention it) has also been frequent if not popular. Being publicly listed comes with its burden of rules and regulations (more every year), cost and accountability; and, for some business it becomes too much. For example, the typical average time that a medium-sized, listed company CEO spends on investor relations per year is around 60 days.

- Public listing, rights issues, share placing/IPOs
Most developed equity markets are up around 50% from their lows in March 2009 ï excluding Spain but including Ireland. For example, the FTSE 100 is up 48% since then

(to 5,188.70 at the time of writing), while the S&P 500 is up 60% (to 1,091.6) since its nadir in the Spring of last year.

The Initial Public Offer or IPO market is also stirring and will soon take-off again, not least because there is a lot of private equity investment which will need to find an exit. Being publicly listed, though, comes with its own set of stress and strains (as previously noted). But it also is the only sustained medium where £1 of assets is valued at more than a £1. Take Balfour Beatty or CRH as examples, their market values are 1.7 and 1.4 times greater than their net assets; and in happier days they were double these ratios at peak share prices. You can also use the public markets to raise capital through rights issues and placing ï and your ópaperô is a currency when it comers to acquisitions.

By example, too, a number of household names in the UK building and construction have gone bust over the past two years. This list includes contractor William Verry which had been established in 1832 but was not publicly listed. I believe that the majority of these household name bankruptcies would have been avoided had they been publicly listed.

While on this subject, the banks in the UK, in my experience are not being too kind to private companies seeking debt. Personal guarantees of PGs are now de rigueur and I was with one client - and a successful business - recently who was seeking a £150,000 overdraft from a major UK bank (which limits the list of possibles). My client did not want to provide a PG, so the banker said ñdeposit £150,000 with me and I will provide an overdraft of £150,000ò. I was so flabbergasted that I asked him to repeat it; and he said: ñdeposit £150,000 with me and I will provide an overdraft of £150,000ò. Youôre right: whatôs the point? And this from a bank which had been bailed out by the British taxpayer. It is wrong and immoral; and it puts ósand in the gearsô of commerce.

- Status Quo
This is always an option i.e. maintaining the existing condition and, I guess that if you are generating sufficient cash from a business, which is not growing significantly - and you are not either avaricious or ambitious - then it may work. Nonetheless it is very difficult to remain static in a dynamic world/market place. But, to be fair, the eponymous rock and roll band is, at the very least, a lesson in longevity.

Turning specifically to the UK, last year saw the biggest percentage fall on record (-11.5%). This year will be down again followed by very modest growth in 2011 and 2012. Indeed, in 2012 the level of activity will still only be the same as in 2002 (just over £98 billion in real terms at 2005 prices). This may mean that the period 2003-08, when output peaked at £111 billion, was the aberration and <u>this</u> is normal life. If that is the case, competitive pressure will continue to intensify, customers will harden and the premium pricing of the past five years or so will become a memory. In busy times, purveyors of construction services and products can ask for and win higher prices. Clients and customers need the work done and are also more profitable, at this time. But the opposite is also true and are we to endure years of commodity-pricing? If so, this will drive down the top line, drive down margins and cash and, ultimately, some firms out of business.

Glass half full?
The World Bank published its Global Economic Prospects this month and emphasised that market nervousness concerning the fiscal positions of several of Europeøs most prosperous countries poses a new challenge for the World economy. This arises as the recovery morphs into a more mature phase during which the influence of rebound factors (such as fiscal stimulus) fades and when GDP gains will depend increasingly on private investment and consumption. ñAssuming that measures in place prevent any market nervousness from slowing the normalisation of bank lending and that a default or restructuring of European sovereign debt is avoided, global GDP is projected to increase by 3.3% in 2010 and 2011, and by 3.5% in 2012. Similarly, reflecting stronger productivity growth and less-pronounced headwinds than in high income countries, GDP in developing countries is expected to grow by 6.2, 6.0, and 6.0% in 2010, 2011 and 2012 respectively. This is more than twice as fast as in high income countries, where growth is projected to strengthen from 2.3% this year to 2.7% in 2012.

Hung in the UK
In the UK we have a ðhungö parliament (which means not single political party has a majority). My Granny used to say only pictures, meat and young men can be hung; but not all of them well. When it comes to UK politics, though, there has, historically, been no such consideration of degree or quality: a hung parliament is a pejorative. Not so in continental Europe where they call them coalitions and many have worked very well; and in Germany they are the norm.

I liken previous resistance, to the introduction of all day drinking in bars and pubs (rather than shutting in the afternoon) and appointing a foreigner as the England Football Manager. Many thought it would never happen in the UK and many thought it was a bad idea. The drinking speaks for itself; but did you know that the Italian, Fabio Capello - prior to the current tournament - has the best percentage of games won by any England manager ï ever (at 77.35%); and the best goal difference (2.05)?

And, so we have duly abandoned convention and popular misconception with formation of a Conservative-Liberal Coalition; and given the problems in our economy arenøt two head better than one? Particularly as in our own industry, bust follows boom ï regardless of which party is in power. So the real challenge here is economic management; not political management. That said, the UKøs budget deficit in 2010-11 is expected to be £155 billion or 10.5% of GDP ï the worst since the Second World War and one which puts us right up there with the PIGS: Portugal, Ireland, Greece and Spain ï where the range is 9.4 to 13.6%. Perhaps this acronym should become UKPIGS or PIGSUK (note, too, that US could be added to the mix, as its public borrowing position is similarly bad at $1.5 trillion or 10.6%).

Life after death
In a bright start, too, the new ócoalitionö has established a new budget watchdog ï the wonderfully named óOffice for Budget Responsibilityö or OBR, which sits just on the correct side of George Orwelløs lexicon. Also imaginative, is the choice of its head man in Sir Alan Budd ï the firebrand economist who at 72 years old has seen it all. In any

event, there first initiative, unsurprisingly, was to downgrade the economic forecasts of the previous administration. The economy will grow more slowly after this year than the previous Labour Government expected but State borrowing will fall a bit faster than originally thought partly due to recent higher tax receipts. The OBR, created shortly after the coalition took office last month, said the economy should grow 1.3% this year, in line with previous forecasts, but growth would only rise to 2.6% in 2011. Labour had forecast 3 to 3.5% next year. Rather endearingly too, Sir Alan stressed the uncertainty surrounding any economic forecasts. ñAll ... forecasts will be wrong, though some will be more wrong than others. Itøs our best shot at an impossible taskò.

But there is life after death. For example, Sweden transformed a budget deficit of 11.2% of GDP in 1993 to a surplus of 1.2% in 1998, while Canada reduced from 9.1% of GDP in 1992 to 2.9% in 2000. Similarly, the UK moved from a budget deficit of 8.0% of GDP in 1993 to a budget surplus of 3.7% in 2000. Sweden mostly cut current spending, while Canada racked up total spending cuts of 20%. Finally, in the UK, public spending as a percentage of GDP fell from 44% to 36% 1993 through 2000.

Taking this a step further, the OBR says that the British Governmentøs budget deficit is expected to fall from £155 billion or 10.5% of GDP in the fiscal year 2010-11 to 3.9% by 2014-15.

The elephant in the (UK) room

It should also be remembered that the UK Government bailed out the UK banks to the extent that it owns one outright (Northern Rock) 82% of another (Royal Bank of Scotland or RBS) and 41% of a third (Lloyds). This cost the Government - or more correctly the British taxpayers - £90 billion. At todayøs prices, for RBS and Lloyds (and a shadow valuation for Northern Rock) the Government would get nearly half of that back ï i.e. at the time of writing (14.06.2010) £41 billion; and eventually a whole lot more.

In fact, the belief is that the amount of cash raised will be much more than that generated by Mrs Thatcherøs Conservative Government mass privatisation of State assets in the 1980s and 1990s. So we may be hung ï but we are not drawn and quartered. The sunny uplit lands will return; as they always do.

Tony Williams
Building Value
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www.buildingvalueltd.com

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