Double-dip decline in construction possible

Downtown Market Report

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The Associated Builders and Contractors recently reported that nonresidential construction spending fell another 6.9 percent in January.

The data "supports the notion that the recovery in nonresidential construction has not yet begun," the organization said, adding that "subsectors posting the largest monthly percentage losses in spending include lodging, down 20.2 percent; power, down 10.9 percent; health care, down 6.4 percent; amusement and recreation, down 6.2 percent; and office, down 5.2 percent." Feel better?
As the federal government and several large states (Illinois, New Jersey, California and Florida) grapple with budget problems, the political will to continue large deficit spending programs has evaporated. In fact, as I am writing, there is still a chance the federal government may suffer a temporary shutdown, as the funding deadline is around the corner and as yet no budget bill has been agreed upon.
In addition, major infrastructure funding programs have been turned back in Florida and New Jersey as governors grapple with funding shortfalls that have many talking about legislation to allow states to file bankruptcy. Atlanta Mayor **Kasim Reed** and the governors of Wisconsin and Ohio are struggling to find ways to dial back pensions and salaries for today's public employee union members.
All of these facts point to a slow, difficult recovery in the construction industry in 2011 and if the largest private companies don't step up to the table, it is possible that the construction economy — if not the entire economy — could suffer another dip.
According to the U.S. Census Bureau, the value of total construction put in place in 2006 topped out at $1.167 trillion. In 2010 this figure dropped to $816.5 billion and is projected at a seasonally adjusted rate of just $792 billion for 2011. Of this figure, public construction (which includes federally funded projects), ran just $255 billion (21.8 percent) in 2006 but rose to $306.5 billion (37.5 percent) in 2010. Given current political aversions to spending, it is unlikely the government will or can continue to carry so much of the load.
This is especially significant locally as Atlanta has one of the largest regional federal building concentrations outside of Washington, D.C. — with the federal government occupying more than 6.5 million square feet downtown.
Fortunately, signs exist that the private sector is beginning to emerge from its recent slumber. We are seeing a return of multifamily construction, auto industry-related construction (including auto dealerships, which had stopped dead in late 2008) and hospitality. On this note, the commercial mortgage-backed securities (CMBS) market seems to be coming back, which should serve to free up lending capacity in the primary market by allowing banks to off-load loans through securitization. This is absolutely necessary for a meaningful recovery in the private sector to take place.

According to news reports, there are as much as $50 billion in new CMBS issues coming to market in 2011, which is up from just $11.6 billion in 2010. This is a significant improvement. However, to put things in perspective, the market peaked in 2007 at $230 billion. We are unlikely to see those levels anytime soon.

The flip side of this news is that delinquency rates on these bonds are running at just over 9 percent, according to Standard & Poor's, and are projected to peak at 10 percent to 12 percent. Unfortunately for Atlanta, the Southern region has the highest rate of delinquencies at 11 percent compared with just 6.7 percent in the eastern U.S. This is not surprising given the significantly overbuilt office and retail markets in Atlanta and other Southern cities. Hopefully we are in the seventh or eighth inning of this recovery and this gradual recovery in capital markets will continue to bolster the availability of private credit.

We are eager to see this trend continue to improve. However, we fear the dreaded "double dip" could be sparked by a run-up in gasoline and diesel fuel arising from the "revolution turmoil" and leadership vacuum developing in the Middle East. Significant spikes in fuel costs serve as a tax and can significantly hamper economic growth directly and through reduced consumer confidence. Analysts indicate that a $1 rise in the barrel cost of oil translates to a 2.5-cent increase in the pump price and a $3 billion "tax" on consumers. Prices above $4 per gallon serve to significantly reduce economic growth.

When you add all this to the weakened condition of the construction industry, a lack of bank credit availability and significant material price inflation (concrete, rebar/steel, copper, etc.), and consider squeezed profit margins on new work obtained in 2010 — we fear a significant uptick in contractor failures for the next 12 to 24 months as the most vulnerable succumb to the recession. While surety loss ratios have been very favorable until now, industry statistics and historical results, unfortunately, support this expectation.