

Focus on: Construction and real estate

International Business Report 2010 – Sector focus series

The Grant Thornton International Business Report (IBR) 2010 reveals that privately held businesses (PHBs) in the construction and real estate sector are markedly more confident about their economic prospects for the year; a balance¹ of +13 per cent are optimistic this year compared to -20 per cent last year. Businesses in all sectors are more optimistic this year (+24 per cent) than they were in 2008 (-16 per cent).

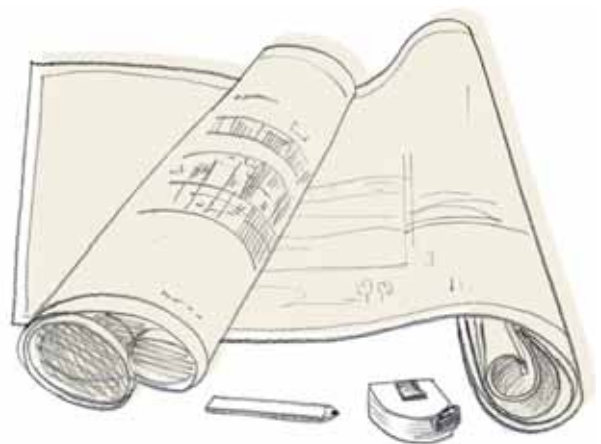
Of the ten sectors considered in the 2010 series of focuses, financial services is the most buoyant at +42 per cent; ahead of technology (+40 per cent), cleantech (+34 per cent), hospitality (+32 per cent), retail (+31 per cent), manufacturing (+25 per cent), construction and real estate (+13 per cent), food and beverage (+7 per cent), transport (+5 per cent) and healthcare (-18 per cent).

The construction and real estate sector

The construction and real estate sector has suffered as much as any part of the global economy during the downturn. Having declined by 1.8 per cent in 2008, the global construction sector is forecast to have contracted much more deeply in 2009, with mergers & acquisitions (M&A) activity retreating by around seven per cent. This comes despite massive fiscal stimulus packages – which have included substantial additional capital investment in construction – introduced by the governments of countries such as the United Kingdom (UK), United States (US), Canada and China.

Construction in many markets, including Dubai, Ireland, the US and the UK, has suffered rapid and sustained cuts in prices not experienced by other sectors; prices in the UK alone have fallen by 18 per cent in the last 12 months. The bursting of the housing market bubble in Spain – house prices had risen by over 200 per cent since 1995 – plunged the economy into a recession as house prices suffered huge corrections. Meanwhile in Ireland, the average property lost a quarter of its value between February 2007 and November 2009, and the sector shed 80,000 jobs in 2009 – or 37 per cent of the workforce.

Despite the lowering of interest rates in many economies, the real estate market has stagnated in many countries as the property bubble burst and banks tightened lending criteria. Existing house sales in the US tumbled by 16.7 per cent in December 2009 alone and prices have retreated to 2002 levels. In the UK, house prices fell by around 15 per cent in 2009, whilst in the eurozone the first annual drop in prices since 1982 was recorded in the first half of 2009. Even in economies such as India, which are less exposed to global markets, businesses in the sector have had to contend with having many unsold or unfinished projects on their books, particularly luxury residential and office space.



¹ the balance is the proportion of companies reporting they are optimistic less those reporting they are pessimistic.

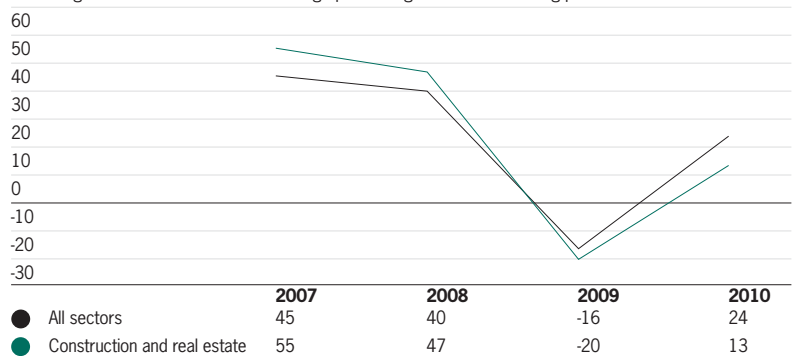
The state of the sector

Optimism/pessimism

- a balance of +13 per cent of businesses in the construction and real estate sector are optimistic about their respective countries' economic outlook this year, an increase of 33 percentage points from -20 per cent last year
- the balance of businesses in all sectors indicating optimism for the year ahead has risen by 40 per cent this year, from -16 per cent in 2009 to +24 per cent.

Figure 1: Outlook for the economy over the next 12 months: 2007-2010

Percentage balance of businesses indicating optimism against those indicating pessimism



Source: Grant Thornton IBR 2010



Fernando Beltrán
Grant Thornton, Spain

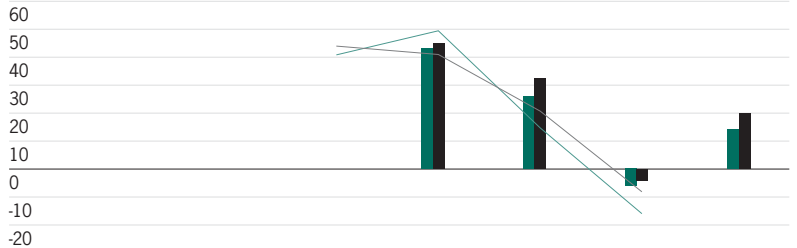
“Construction and real estate businesses in Spain have learnt some key lessons from the downturn, including the need to maintain control over business planning and budgeting, the importance of measuring risk accurately, and the need to correctly value acquisitions.”

Employment

- a balance of +14 per cent of businesses in the construction and real estate sector expect to expand the size of their workforce in 2010, below the average for all sectors of +20 per cent
- actual employment contraction reported by businesses in the sector in 2009 (-16 per cent) was even worse than expected 12 months previously (-6 per cent)
- as was the actual employment contraction reported by businesses across all sectors, -8 per cent actual compared to the expected -4 per cent.

Figure 2: Employment history: 2006-2010

Percentage balance of businesses indicating an increase against those indicating a decrease



	2006	2007	2008	2009	2010*
Expected construction and real estate	-	43	26	-6	14
Expected all sectors	-	45	33	-4	20
Actual construction and real estate	41	49	15	-16	-
Actual all sectors	44	41	21	-8	-

*actual 2010 data will be documented in IBR 2011

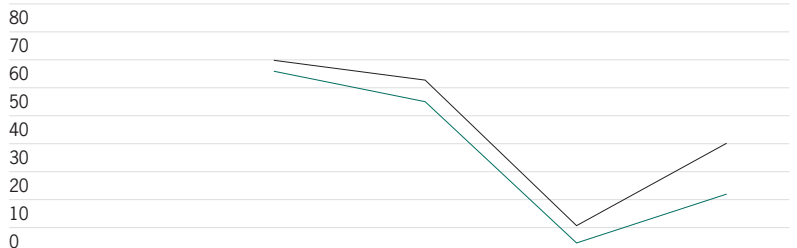
Source: Grant Thornton IBR 2010

Revenue expectations

- a balance of +22 per cent of businesses in the construction and real estate sector expect their revenue to increase across 2010, compared to +4 per cent last year
- construction and real estate businesses are the least optimistic in their revenue expectations, compared to all other sector averages
- across all sectors, revenue expectations have rebounded to +40 per cent this year, up from just +11 per cent in 2009.

Figure 3: Revenue expectations: 2007-2010

Percentage balance of businesses indicating an increase against those indicating a decrease



	2007	2008	2009	2010
All sectors	70	63	11	40
Construction and real estate	66	55	4	22

Source: Grant Thornton IBR 2010



Bo Mocherniak
Grant Thornton, Canada

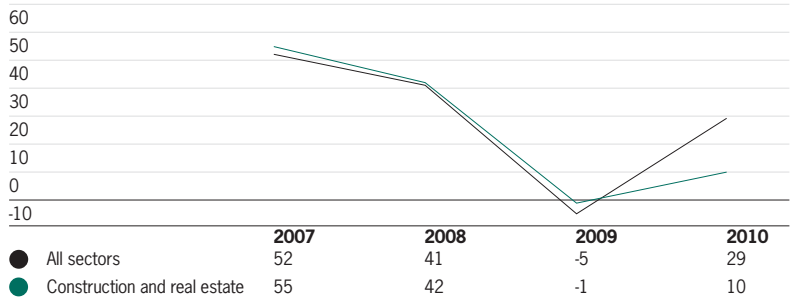
“Our government is giving us a lot of warning regarding interest rates going up in the second half of the year and how this could put in jeopardy some of the businesses that are highly leveraged; there could be a direct impact on residential housing.”

Profitability expectations

- the balance of businesses in the construction and real estate sector expecting to increase profits in 2010 is +10 per cent, an increase of 11 percentage points from last year (-1 per cent)
- construction and real estate businesses are the least optimistic in their profitability expectations, compared to all other sector averages
- the all sectors average has increased by 34 percentage points, from -5 per cent in 2009 to +29 per cent this year.

Figure 4: Profitability expectations: 2007-2010

Percentage balance of businesses indicating an increase against those indicating a decrease



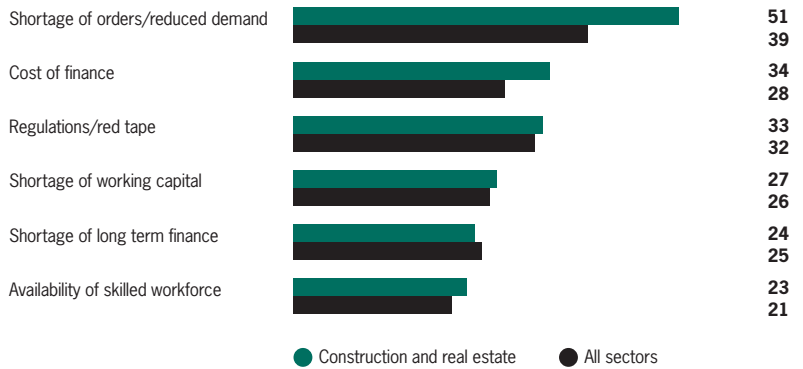
Source: Grant Thornton IBR 2010

Constraints

- a shortage of orders/reduced demand is the most pressing concern for businesses in the construction and real estate sector (51 per cent), and considerably more so than it is across all sectors (39 per cent)
- the cost of finance is cited as the second biggest constraint by businesses in the construction and real estate sector (34 per cent)
- and for the remaining constraints there are only small differences between the construction and real estate average and the all sectors average.

Figure 5: Constraints on expansion

Percentage of businesses rating constraint 4 or 5 on a scale of 1 to 5 where 1 is not a constraint and 5 is a major constraint



Source: Grant Thornton IBR 2010



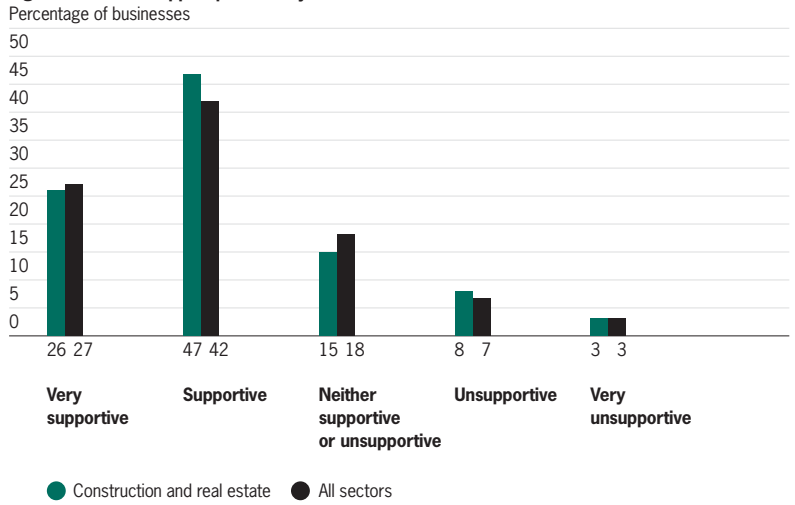
Todd Taggart
Grant Thornton, United States

“Businesses are finding that they can do more with less, whether through technology or other efficiencies they’ve found in their businesses, and so there is a very bleak outlook for rehiring many of the workers laid off in the US construction market.”

Support of lender

- 73 per cent of businesses in the construction and real estate sector are happy with the level of support provided by lenders, compared with 69 per cent of all businesses
- 11 per cent of businesses in the sector believe that lenders are unsupportive or very unsupportive of their business, compared to ten per cent in all sectors.

Figure 6: Level of support provided by lenders

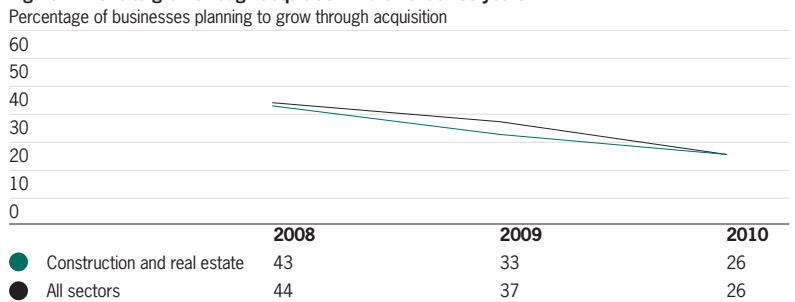


Source: Grant Thornton IBR 2010

Mergers & acquisitions

- the proportion of businesses in the construction and real estate sector planning to grow through acquisition fell by seven percentage points this year to 26 per cent
- this followed a ten per cent drop the previous year, from 43 per cent in 2008 to 33 per cent in 2009
- the all sectors average has fallen steadily over the past three years from 44 per cent in 2007 to 26 per cent this year.

Figure 7: Plans to grow through acquisition in the next three years



Source: Grant Thornton IBR 2010



Clare Hartnell
Grant Thornton, United Kingdom

“Businesses are feeling quite bitter towards the treatment that they’ve been given by the banks, but finance does not come only from banks and I think this is a key message that a lot of businesses have woken up to.”

Percentage of projects postponed

- one-quarter of businesses in the construction and real estate sector have had to postpone ten to 20 per cent of projects in the last 12 months
- a similar proportion (23 per cent) has had to postpone less than ten per cent of projects
- so around half of all construction and real estate businesses have had to postpone up to 20 per cent of projects
- whilst five per cent have cited having to postpone more than 50 per cent of projects.

Figure 8: What percentage of projects have you been forced to postpone over the last 12 months?
Percentage of businesses

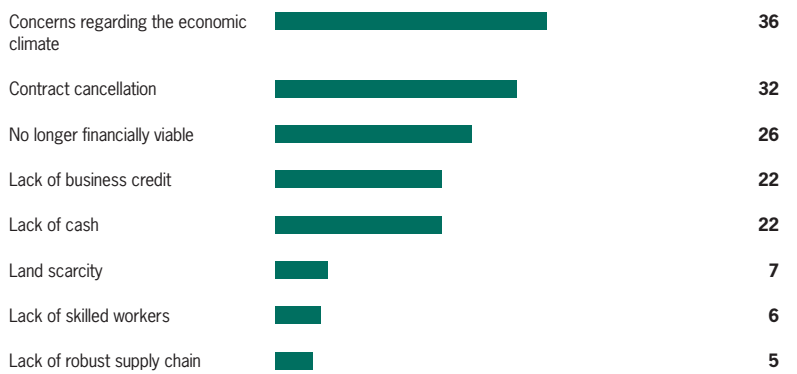


Source: Grant Thornton IBR 2010

Reasons for postponing

- concerns regarding the economic climate, cited by 36 per cent of businesses in the sector, is the main reason for postponing projects
- contract cancellation is the reason for 32 per cent of businesses in the sector
- whilst one-fifth to one-quarter cited financial difficulties, no longer financially viable (26 per cent), lack of business credit and lack of cash (both 22 per cent).

Figure 9: Which of the following reasons have forced you to postpone these projects?
Percentage of businesses



Source: Grant Thornton IBR 2010



David Jones
Walker, Chandio & Co, India

“Population growth complemented by a rise in income opportunities can well-translate into a diverse, deep, dynamic and yet sustainable real estate market. Affordable housing can become a potential growth driver for the Indian real estate sector, both in the near and long term. However, this would require significant support at national policy level by Government whereas the proposed changes to the regulatory environment, as they relate to real estate, are not in this direction.”

Outlook for the sector

Businesses in the construction and real estate sector are expected to have to do much more with much less this year, as access to funds for new development remains low and vacancy rates remain high. Investment is likely to remain weak, meaning the focus will shift to efficiencies. UK construction is expected to continue to shrink, despite improving performance in infrastructure and housing, but early forecasts for the US show double-digit gains across the year.

In the eurozone, limited private investment and public sector deficits may hold back growth in Europe, although recent data shows an increase in activity and offer some more encouragement for the next 12 months. In the developing world, especially the two Asian powerhouses of India and China, strong government and power sector spending, coupled with stable materials prices, are expected to underpin a year of stable growth in the construction sector.

Real estate markets remain weak and further declines are expected over the next 12 months, as high levels of unemployment force through sales at reduced value. In the US and the UK house prices may fall by more than ten per cent over the year, whilst the decline in Dubai could be triple that. In India, tighter bank lending should pull supply back to fit in more closely with demand but may mean further delays in projects under construction, whilst vacancy rates and rental values – both which contracted sharply in the downturn – should continue to improve slowly.



Colin Feely
Grant Thornton, Ireland

“There are signs that the market is bottoming out at present, however, the sector remains in a state of flux, it is difficult to see when the tide will turn. We wouldn’t anticipate any huge change, certainly over the next 12 months or so.”

Sector's perspective

Civil engineering firm based in Ireland employing around 300 staff.

Lessons learned from the downturn

“Primarily, large budget deficits in Ireland mean many large infrastructure projects have had to be put on hold, so we have had to be flexible in our approach, and consider diversification into other areas of construction such as the fledgling green construction sector. In addition, we have been put in the unfortunate position of having to let some staff go, although as far as possible we have tried to keep people on by providing specialised training in preparation for the upturn. Finally, access to credit has retracted sharply; banks were throwing money at the sector in general before but they are now taking much longer to make funding decisions.”

Major risks for the year ahead

“There is a lack of vibrancy and optimism in the sector currently; if the recovery had truly kicked in we should be seeing projects coming for the latter half of the year coming out now, but the sector is flat. Further, the lack of projects means we have seen competition increase dramatically over the past 18 months; we are being undercut by other businesses to such a degree that they cannot be making a profit – they are taking the work simply to keep turning over.”

Planning for the future

“The so-called “race for the bottom” where businesses undercut competition just to get the contract is unsustainable so we are focusing on sticking to realistic pricing in areas of specialism. Moreover, the lull in business presents an opportunity to train staff in specialist areas that will help support our competitiveness through the upturn and beyond.”

Positive changes in the sector

“The adverse weather conditions brought on by the severe winter we’ve had in Ireland means there is a lot of capital-intensive work that needs to be done to roads and bridges and the like. These projects pay for themselves in the long-run and those in charge of budgets will realise soon that now is a good time to get value for money.”

“We are being undercut by other businesses to such a degree that they cannot be making a profit – they are taking the work simply to keep turning over.”

“In the current climate, the major risk facing us is fraud.”

Lanco Infratech Ltd – India

Lanco Infratech is one of the fastest growing Integrated Infrastructure Enterprises of India, with annual revenues of £1.3bn.

Lessons learned from the downturn

“The downturn was the result of over-confidence and the gross misjudgements of a few institutions, confined within certain geographic boundaries, and as such, the longer term impacts especially in a country such as India have proved not to be too severe. However, we decided that it is better to wait for the sector and economy in general to stabilise before making any major decisions so we have had to be patient and exercise caution in this regard.”

Major risks for the year ahead

“In the current climate, the major risk facing us is fraud; dealing with any party without having sufficient information of their debt and finance, management practices, and capability of crisis adaptability could be severely problematic. In addition, irrational changes in priorities caused by short-term social and political requirements could be an influential factor in the marketplace.”

Planning for the future

“We are having to be very selective in terms of bidding for contracts and have committed to calculating all the risks associated with a tender before proceeding. Moreover, even with ever-changing political priorities, the importance of certain sectors such as energy, public health and infrastructure will not diminish and we have therefore planned to move our business forward in these areas.”

Positive changes in the sector

“Consumption is a natural behaviour in human society; the temporary derailment of the Indian economy – which was growing very rapidly – is perhaps a blessing in disguise as consumption will return but perhaps at more sustainable levels than seen previously. Further, in a country such as India where consumption is growing so fast, investment in any sector will be beneficial both in the short and longer term.”



View from Grant Thornton

Lessons learned from the downturn

- **importance of contingency planning:** business models seem to have been based on the premise that the construction and real estate market would continue to boom; there needs to be a greater focus on the what if scenarios
- **improving flexibility:** flexibility in long-term lease negotiations can be beneficial from both the landlord and tenant perspectives
- **importance of core activity:** in real estate, whilst some of the larger entertainment projects have been shelved, the focus has returned to core leasing activities
- **sourcing alternative finance:** the ability to refinance was taken as a given by many firms, but more stringent lending conditions mean alternative measures of improving cash flow, such as securing finance from the Middle East or Asia, need to be considered
- **management of risk:** businesses should control planning and budgeting better
- **importance of a reasonable loan-to-value:** reduce financing risk through a more reasonable proportion of debt compared to equity value.



Major risks for the year ahead

- **reduced access to finance:** tough stance taken by banks on which businesses they are willing to support shows no sign of abating in near future
- **retention of key staff:** some businesses may find it hard to retain key staff if opportunities present themselves in other sectors of the economy which recover faster than construction and real estate
- **interest rate rises:** this could put highly-leveraged businesses' survival, let alone long-term growth prospects, in jeopardy, as well as directly impacting on the residential housing market
- **contract price pressures:** increased competition for contracts will mean greater pressures on margins in the sector.



Planning for the future

- **cost control:** many businesses are simply looking to survive and expansion plans have been shelved
- **improving efficiencies:** businesses have lost staff but maintained revenue levels due to increased use of technology, and are generally making efficiency savings
- **increased regulation:** governments, especially in the developing world, are producing more stringent regulations for developers
- **environmental issues:** the 'green issue' may have slipped slightly due to the economic downturn but there are lots of tax breaks and other incentives to encourage development properties that are environmentally friendly; it is also a useful marketing tool.



Positive changes in the sector

- **consolidation:** solid businesses who have controlled risk and protected their workers are likely to survive despite short-term revenue constraints, whilst weaker businesses will fold or be acquired, resulting in stronger levels of competition in the sector
- **transparency:** consumers, especially in the developing world, will be able to see much more clearly the risks of investments they make
- **increasing levels of investment:** investors are waiting for the market to 'bottom out' but once confidence returns there is money available
- **more robust lending:** banks have been too eager to lend without doing necessary background checks, but more stringent rules will benefit the sector in the long-term
- **restructuring:** many businesses will need to restructure themselves to survive the downturn but will emerge stronger for it.



