

**Strategic Realities  
Perspectives & Commentary  
4<sup>th</sup> Quarter, 2007**

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The Fourth Quarter of the year is a time when many of our client companies and friends will be creating their Strategic Plans. Here are some issues to consider as you assess the “Current Reality – Issues and Trends” portion of your plan.

**2008 Market Outlook**

“What you see is what you are going to get”, at least in 2008...and perhaps even through 2010! Unless there is a national incident or the sub prime effect on commercial lending is greater than bankers anticipate, the fine market we are experiencing should continue, especially in light of the recent Fed move.

Look at the attached data, reflecting current Building Permits and Contracts information through August, 2007, and projections of future construction activity based on national organizations’ forecasts (made before the sub prime crisis). The forecast data involves attributing the historical percentage of the national dollars to the markets shown, Houston, DFW and SA/Austin. It is surely bullish, in all these locations, through 2010. (Call us if you need more interpretation.)

Realize lots of other things could occur to change the outlook: a domestic recession; a more troubled global economy; a strong negative reaction to the new President. However, at this time, the drivers are still very positive (energy prices, employment, absorption, rental and interest rates).

**Project Financing**

Will there still be ample money, at reasonable rates, for Commercial Construction Projects in the aftermath of the sub prime meltdown? Yes, according to the head of commercial construction lending for a major bank. In a personal conversation, which occurred prior to the Federal Reserve’s rate cut, this experienced pro indicated that there will be more structure to the loans, and perhaps a slight increase in premium for the risk, but that ample money would be available, at competitive rates, for good projects.

**The Real Challenge-The Workforce**

All substantive Houston Commercial Construction Firms recognize that there truly is “A War for Talent.” It is impacting firms at all levels, both office and field. Conditions require a thoughtful, strategic response to hiring, retaining and all other compensation decisions (promotions, bonuses, annual reviews). Houston’s unemployment rate of 4.1% as of August, 2007 confirms the tight market.

Headhunters from all over the country are active in this market. They are consistently calling the employees of all established companies. Anticipate that your people will get multiple offers, and be prepared with your strategy should you need to respond. Staying close to your key employees is more critical than ever before. Don't overlook your "quiet doers," those low maintenance team members that "just get it done". Everyone needs your attention.

Look for this year's graduating classes to be courted like superstar athletes. About 80 people will come out of the Texas A&M program this year, and at the last career day well over 100 companies were active! Each graduate will get multiple offers with creative approaches to compensation; average salaries will probably escalate from record mark reached last year. Some companies are looking at grads with other degrees, agriculture for example, where the job outlook is not as bullish and the work ethic is strong.

At the craft worker level the situation is absolutely frightening. The proposed new Department of Homeland Security "No Match Letter" regulations hang over everyone's head. It appears the recent ruling on October 10<sup>th</sup> could mean these proposed regulations may not be implemented for several months, but no one expects the new requirements to totally go away. This issue has the potential to significantly reduce the number of workers available for commercial projects.

In addition, the numbers of workers in formal craft training programs, especially the basic crafts (carpentry, ironwork, etc), are near an all time low, e.g. there are 28 people in the Carpenter's Union Apprenticeship Program! When you also consider the facts that the average age of the trained construction workforce is approaching 50 years old and that over 150,000 trained workers retire each year, the outlook for an ample supply of trained or trainable workers is cloudy at best and very, very concerning.

Compare the construction employment figures in 1982 (the last real boom) at 143,400, to the current level: 190,300 reported on payrolls as of July 2007 -- up nearly 50,000! Is there that much more work? More job complexity? Or is productivity the challenge?

### **Selectivity and Strong Partnerships**

In light of an abundant market and very tight labor force, wise contractors are pursuing a much more selective strategy about the projects they pursue or accept. They are also strengthening their partnerships, certainly with their own employees and definitely with their specialty sub contractors if they are General Contractors. Smart owners and institutions are following a similar approach, selecting reputable GC's who have strong relationships with the Specialty Contractors that attract, train and retain an adequate workforce. The true restraint in this market is the capacity of the competent specialty contractors.

The strategic challenge comes over the questions, "Do you select companies or projects, or both? Will you do all the projects requested for a selected group of owners or a GC, or perform only those over a certain size?" Every contractor needs to be strategic and longer range in developing their answers.

## Other Important Issues

**Construction Materials Costs:** The impact of the housing downturn on construction costs is minimal. Expect continued escalations in materials for non-residential and heavy construction, particularly steel. The PPI for construction materials has outpaced the CPI for some time, and this trend will likely continue. Ken Simonson, National AGC Economist, predicts that construction input costs (those items typically used up, such as diesel fuel), and materials will rise 3-5% and 6-8% in 2008 and after. He expects labor cost increases to exceed 5% by the end of 2007, and 5-6% in subsequent years. Highway and Street construction costs increases will be even higher.

**Labor Costs:** Two global Human Resources firms (The Hay Group and Hewitt Associates) expect base salaries to increase between 3.8% and 4.1% in 2008, with additional compensation coming from bonuses and incentives because of the critical need to hire and retain staff. Hewitt's study also shows higher wage increase projections for various cities (4.6% for Houston).

While Health Insurance premium growth rates have slowed nationwide to 6.1% in 2007 (vs. 7.1% in 2006), the growth has still outpaced inflation. A recent national study shows the average percentage increase for premiums was 6.3% in the South Region, which includes Texas.

**Green Building:** This is no longer a trend; it is now a main stream spec item by both public and private owners. Contractors need LEED Certified people on their payrolls.

**Building Information Modeling (BIM):** This is still fairly new but growing in acceptance as a valuable approach to projects. Future focused companies are learning all they can. Some companies feel the internal benefits from it are great enough to not wait for client requests. The GSA has announced that new buildings designed through its Public Buildings Service use BIM in the design stage. Watch for more BIM to be required in the future.

**City/County Matters:** Since Andy Icken (formerly of Friendswood Development and the Texas Medical Center) took over the city's developmental services, people are reporting continuous improvement. Many people are now posturing for key City and County Races in the coming years. Mayor White will be easily re-elected next month; he will move on because of term limits at the end of 2009. It appears, at this time, that either current City Controller Annise Parker or former Kemah Mayor and Managing Partner of a major law firm, Bill King, are the leading candidates to replace White. The Harris County Judge race in 2008 should be quite interesting. Incumbent Republican, Ed Emmett, is being challenged both by Democrat David Minberg, an apartment developer and contractor, and Republican Charles Bacarisse, current County Clerk. And, the zoning issue has surfaced again in light of the inner-city high rise development. Houston voters last turned it down in 1993.

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Kiley Advisors supports CEO's, Senior Executives and Boards of Commercial Construction Firms and Associations with their Leadership and Strategy Responsibilities. We also organize and facilitate Strategic Planning Sessions and Leadership Retreats, and we conduct workshops on the Principles of "Good to Great" for Construction Firms. We speak on the Houston Market Outlook; Leadership Characteristics of Successful Builders; Current Challenges with the Construction Workforce and Generations in the Workplace.

**ATTACHMENT  
KILEY ADVISORS – STRATEGIC REALITIES – OCTOBER, 2007**

**CITY OF HOUSTON PERMITS - YTD through August 2007**

	<b>Aug-07</b>	<b>Aug-06</b>	<b>% change</b>
Residential	1,468,717,567	1,391,995,509	5.5%
NonResidential	2,343,740,129	1,771,711,896	32.3%
<b>Total</b>	<b>3,812,457,696</b>	<b>3,163,707,405</b>	<b>20.5%</b>

**McGRAW HILL CONTRACTS HOUSTON MSA - YTD through August 2007**

	<b>Aug-07</b>	<b>Aug-06</b>	<b>% Change</b>
Residential	6,399,404,000	6,772,077,000	-5.5%
NonResidential	2,798,468,000	2,758,901,000	1.4%
<b>Total</b>	<b>9,197,872,000</b>	<b>9,530,978,000</b>	<b>-3.5%</b>

**Contracts Year-End Projection at Current rate:**

Residential	\$9.6 Billion	<i>(This reflects homebuilding market outside COH)</i>
NonResidential	\$4.2 Billion	
<b>Total:</b>	<b>\$13.8 Billion</b>	

**PROJECTED NONRESIDENTIAL CONSTRUCTION MARKETS FOR SELECTED TEXAS MSA'S**

	<b>2006</b>	<b>2007</b>	<b>2008</b>	<b>2009 + 2010</b>
<b>Houston MSA</b>				
<b>TOTAL NR Construction</b>	3,656,436,000 <b>\$3.7 B</b>	3,989,420,500 <b>\$4 B</b>	4,329,131,000 <b>\$4.3 B</b>	9,716,619,000 <b>\$9.7 B</b>
<b>Dallas/FW/Arlington MSA</b>				
<b>TOTAL NR Construction</b>	5,927,275,200 <b>\$5.9 B</b>	6,467,060,600 <b>\$6.5 B</b>	7,017,749,200 <b>\$7 B</b>	15,751,150,800 <b>\$15.8 B</b>
<b>San Antonio &amp; Austin MSA</b>				
<b>TOTAL NR Construction</b>	4,041,324,000 <b>\$4 B</b>	4,409,359,500 <b>\$4.4 B</b>	4,784,829,000 <b>\$4.8 B</b>	10,739,421,000 <b>\$10.7 B</b>