economics

ONCE UPON A TIME IN THE CONSTRUCTION MARKET

With apologies to Goldilocks.

BY JOHN CROSS, P.E.

ONCE UPON A TIME, there was a little girl named Goldilocks.

She went for a walk in the forest. Pretty soon, she came upon the home of three bears. She knocked and, when no one answered, she walked right in.

At the table in the kitchen, there were three construction market forecasts. Goldilocks was very interested in construction, so she read the first report.

"This market is too hot!" she exclaimed.

So, she read the second forecast.

"This market is too cold," she said.

So, she read the last forecast.

"Ahhh, this forecast is just right," she said happily, and she folded it up and put it in her pocket.

Like anyone who reads a market forecast, she decided she was feeling a little tired, so she went upstairs to the bedroom. She lay down in the first bed, but it was too hard. Then she lay in the second bed, but it was too soft. Then she lay down in the third bed, and it was just right. Goldilocks fell asleep.

As she was sleeping, the three bears came home.

"Someone's been reading my market forecast," growled the Papa Bear.

"Someone's been reading my market forecast," said the Mama Bear.

"Someone took my market forecast!" cried the Baby Bear.

They decided to look around some more and when they got upstairs to the bedroom, Papa Bear growled, "Someone's been sleeping in my bed,"

"Someone's been sleeping in my bed, too" said the Mama Bear.

"Someone's been sleeping in my bed and she's still there!" exclaimed Baby Bear.

Just then, Goldilocks woke up and saw the three bears. She screamed, "I just wanted to know what is happening in the construction market!" When she calmed down, she added, "And I really liked the forecast that was 'just right!'"

To which Papa Bear growled, "You silly child! In a bear market, you can't choose a forecast based on what you like!" And then the three bears launched into a long discussion of GDP growth, employment levels, consumer confidence, historic trends, demographic changes and the strength of the dollar.

In the midst of the discussion Goldilocks, screamed again, put her hands over her ears, jumped up, ran out of the room, down the stairs, opened the door and ran away into the forest. And she never returned to the home of the three bears and never again read a construction market forecast.

Maybe you feel a bit like Goldilocks. You like construction forecasts that are "just right" and feel like screaming and running out of the house when the details are discussed.

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Since my last economics article "How Long Will the Good Times Last?" was published in the January issue (available at **www.modernsteel.com**), I've received a number of comments from readers bemoaning the statement that we should be anticipating a downturn in construction activity. The feedback has all been centered around two thoughts: "We haven't fully recovered yet from the recession, so how could the market already be shrinking again?" and "The market isn't slowing down, because I'm seeing more bidding activity."

Regretfully, the nonresidential market is already contracting. Building construction activity in 2015 was a major disappointment, with construction starts on a square-foot basis for nonresidential and multistory residential (greater than four stories) only showing a 0.5% increase over 2014. The numbers are even more sobering when you recognize that the year-over-year change in non¬residential construction was -2% and the growth in multistory residential construction was 21%. Non-residential construction starts contracted in 2015! Certainly not what was expected.

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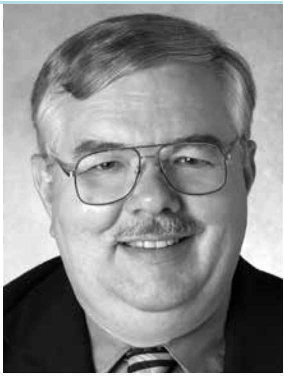

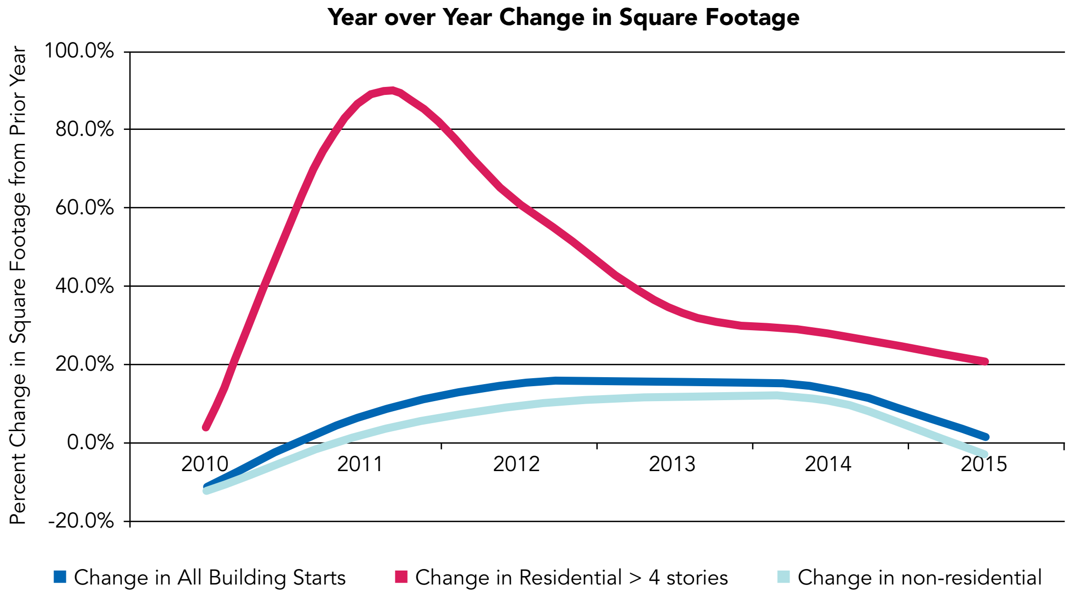

When did the downturn in nonresidential construction begin? Since July of 2015, the pace of nonresidential construction starts has fallen below that of 2014. Dodge Analytics is already reporting a 21% drop in nonresidential building construction starts on a per-dollar basis through February of this year. While it should be anticipated that these numbers will be adjusted upward and that construction levels will pick up in the summer, it is clearly an indication of a pullback in the marketplace.

But the real question for nonresidential construction is "Why is this occurring?"

I have reflected long and hard on this question and believe there may be several answers.

The first is that the growth in population and employment we are seeing is in urban rather than suburban or rural areas. This growth does not generate only new construction but also has a strong component of rehabilitation of existing structures for both nonresidential and residential use. The result is a reduction in construction starts for new structures.

Second, many new multistory residential projects include retail and light office space on the first floor or two of the structure. The old paradigm has been that nonresidential lags residential activity by 1.5 to 2 years. We have not seen that in the numbers; we should have had a sizeable increase in nonresidential starting in 2013. It didn't happen—or did it and the numbers didn't capture it because it was included in the square footage of the residential projects. Our data source does not have a separate category for mixed use, so if a project is majority residential it is categorized as residential.

Third, the changing work and consumer behavior of the millennial generation is more focused on smaller, open and shared office space and online purchasing.

I indicated in the January article that we should anticipate a 6% to 8% growth in the market in 2016. Is that still a legitimate expectation based on 2015 results? Probably, but not because of nonresidential growth. The growth will come from the multistory residential sector, not the nonresidential sector. The multistory residential sector is continuing to growth with 2016 tracking 12% above 2015.

So which bear was right: Papa Bear, Mama Bear or Baby Bear? Goldilocks may have liked Baby Bear's construction forecast of "just right," but Mama Bear's "too cold" forecast may be closer to reality. But unlike Goldilocks, we can't put our hands over our ears and run out of the house. Instead, we need to remember the lessons we learned during the last down cycle. Those engineering and fabrication firms that successfully survived the Great Recession had some common characteristics:

- They focused on niche markets where they had already established their reputation for quality work
- They valued collaboration, which resulted in the integration the expertise of structural steel fabricators early in the design life of the project
- They remained flexible in the management of their firms

The next several years are going to be interesting, and alertness will be key. So don't find a comfortable bed and fall asleep! ■