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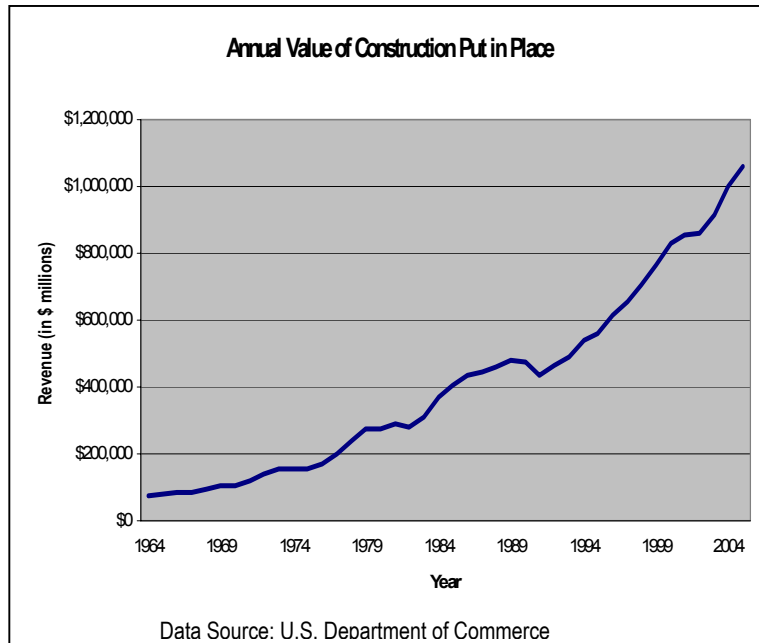
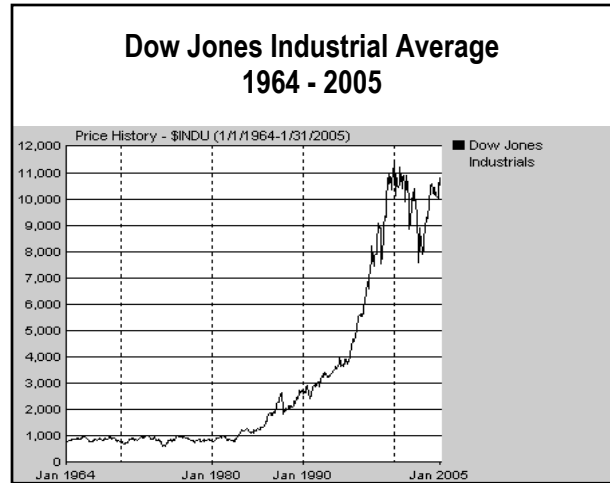
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Part I - The Current State of the United States Economy

U.S. Financial Markets vs. the U.S. Construction Economy:

Due to the sheer size of the construction industry in the United States, its health and overall strength is closely aligned with that of the overall U.S. economy. Construction spending is sensitive to interest rate fluctuations, the value of the dollar correlates with the cost of imported construction goods, and fuel prices affect the prices construction materials and equipment. In addition, international demand for commodities affects material inflation and tax revenue affects state and federal construction spending.



If you plot the Dow Jones Industrial Average (“DJIA”) against annual construction revenue, which has been tracked by the U.S. Department of Commerce since 1964, both reflect a similar growth trend. Both data series remain relatively flat through 1980, at which time there is a steep incline through 2001. In 2001 the DJIA is impacted by the September 11, 2001 terrorist attacks and the

construction curve flattens.

Between 1964 and 1984, construction spending increased by roughly \$200M. From 1984 to 2004, construction spending increased by approximately \$800M, topping the trillion-dollar mark for the first time and yielding a four-hundred percent increase over the previous twenty-year period.

Current Condition of the U.S. Financial Markets:

U.S. financial markets react very poorly to political uncertainty and tend to flourish when government has reasonable party balance. This fact largely explains the stock market rally that followed the 2004 presidential election – the Bush Administration was a known commodity. Even though Republicans retained control in the White House and majorities in both the House of Representatives and Senate, there remains a relatively equal balance in Congress, which is viewed positively by the financial markets.

One looming uncertainty that the Bush Administration will need to address this year is the appointment of a new Chairman of the Federal Reserve, as Allen Greenspan's fourteen-year term will expire in January of 2006. "Given the power the Federal Reserve has over U.S. monetary policy, a smooth transition and solid new candidate will be vital to the confidence of U.S. and global financial markets"¹, notes Eric T. Koeplin of the Milestone Group.

Through the first quarter of 2005, the stock market has pulled back by roughly four percent as record high fuel prices, inflation concerns and mixed economic data have spurred a broad sell off. Nonetheless, with a review of key economic fundamentals, the economy appears to be reasonably healthy.

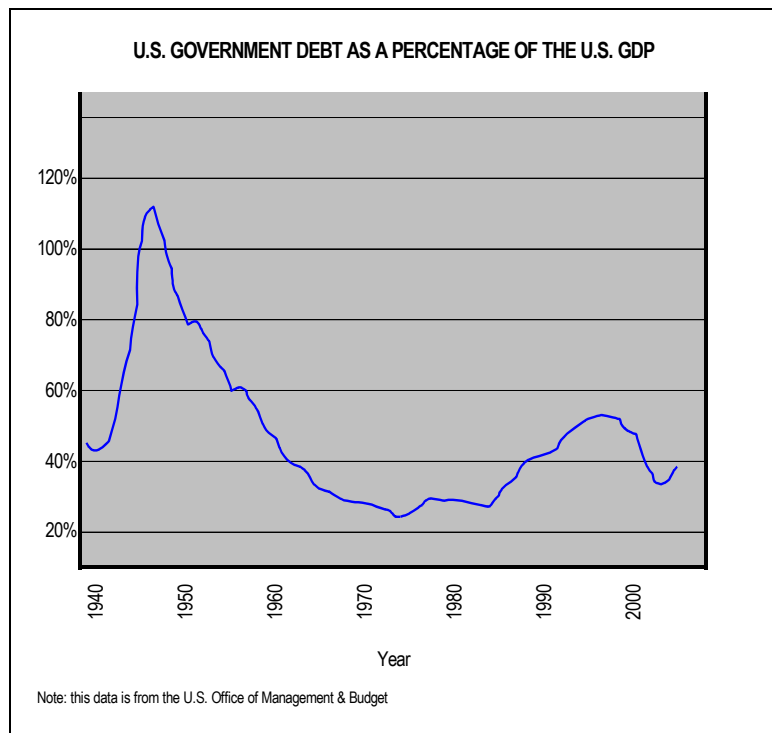
Review of Economic Fundamentals:

Budget Deficits & National Debt Levels: The U.S. budget deficit and consumer debt levels receive an enormous amount of negative media coverage, based on the sheer size of their

¹ The Milestone Group 'Financial Market Analysis – January 1, 2005', by CEO Eric Koeplin

respective figures. However, both figures are reasonably in line with historical data. As indicated in the chart below, the national debt is not disproportionately large when measured as a percentage of the Gross Domestic Product (“GDP”), and should therefore not give great cause for alarm.

In 2004, the Federal budget deficit was \$413B, considerably less than the initial projection of \$521B. \$413B represents 3.5% of the GDP. The Congressional Budget Office anticipates the deficit will be 2.5% of the GDP in 2005 and 2.6% in 2006. These are considered to be manageable levels based on historical standards. The budget surpluses of the 1990s were a function of a positive economic cycle, just as the deficits of the past few years were a result of a weak economic cycle.



Gross Domestic Product & Employment Rates: The U.S. economy has expanded rapidly over the past year with the GDP growing at an annual pace of 4%. The current unemployment rate of 5.4% is near the “full” employment rate of 5%, considered by many economists to be a function of a dynamic economy with job transition and changing industry requirements. The 5.4% rate is substantially improved from its ten year high of 6.3% recorded in June of 1994. All things considered, unemployment has not been an issue in this country since the recession of 1992, although the media and political parties tend to use it as a campaign tool.

Large Corporations: Corporate balance sheets are also in solid shape, with corporate debt growing 7.6% in 2004. Shareholders equity jumped 17.1% and debt to long-term capital was reduced by 4%. Non-financial corporations are holding record levels of liquid assets. According to Moody's, the ratio of liquid assets to debt on non-financial corporate balance sheets recently hit a 35-year high.

Interest Rates: Based on current stock market 'Price/Earnings' valuations, any noteworthy jump in inflation will allow for minor stock price improvement, since P/E ratios are at the high end of their historical average. The Federal Reserve has increased the Fed funds target interest rate in five successive meetings by a quarter point. It is now 2.25%. Should the Fed continue to increase rates, recessionary forces could be triggered based on overvaluations in the market.

Economic Risks: Current risks to the economy include acts of terrorism, higher inflation if growth continues to accelerate, continued interest rate hikes that lead to recession if the Fed raises rates too drastically, rising oil prices, further US dollar decline, pension deficits, and low household savings rates.

Part II – U.S. Construction Industry Tops the Trillion Dollar Mark

The U.S. Department of Commerce reported that the value of construction ‘put in place’ was up 9.2% in 2004, topping the trillion-dollar mark for the first time (\$1.0003 trillion), and representing the largest percentage increase since 1996. The Department of Commerce Construction forecasts growth to pull back to 5.8% in 2005, which is

ANNUAL VALUE OF CONSTRUCTION PUT IN PLACE in the U.S. (1964 - 2005)
 U.S. Department of Commerce

Year	Revenue (in millions)	% Increase	Year	Revenue (in millions)	% Increase	Decade	% Increase
1964	\$ 75,097	n/a	1985	\$ 403,416	9.0%	1964 - 1969	7.0%
1965	\$ 81,886	9.0%	1986	\$ 433,454	7.4%	1970s	10.3%
1966	\$ 85,753	4.7%	1987	\$ 446,643	3.0%	1980s	5.9%
1967	\$ 87,221	1.7%	1988	\$ 462,012	3.4%	1990s	5.0%
1968	\$ 96,824	11.0%	1989	\$ 477,502	3.4%	2000 - 2005	5.6%
1969	\$ 104,944	8.4%	1990	\$ 476,778	-0.2%		
1970	\$ 105,890	0.9%	1991	\$ 432,592	-9.3%		
1971	\$ 122,414	15.6%	1992	\$ 463,661	7.2%		
1972	\$ 139,126	13.7%	1993	\$ 491,033	5.9%		
1973	\$ 153,781	10.5%	1994	\$ 539,193	9.8%		
1974	\$ 155,170	0.9%	1995	\$ 557,818	3.5%		
1975	\$ 152,635	-1.6%	1996	\$ 615,900	10.4%		
1976	\$ 172,132	12.8%	1997	\$ 653,429	6.1%		
1977	\$ 200,501	16.5%	1998	\$ 705,685	8.0%		
1978	\$ 239,867	19.6%	1999	\$ 766,062	8.6%		
1979	\$ 272,873	13.8%	2000	\$ 828,768	8.2%		
1980	\$ 273,936	0.4%	2001	\$ 852,553	2.9%		
1981	\$ 289,070	5.5%	2002	\$ 860,923	1.0%		
1982	\$ 279,332	-3.4%	2003	\$ 915,700	6.4%		
1983	\$ 311,887	11.7%	2004	\$ 1,000,300	9.2%		
1984	\$ 370,190	18.7%	2005	\$ 1,057,900	5.8%		

slightly higher than the 5.5% growth rate the industry has averaged for the past twenty-five years. The construction industry grew at an average rate of 10.3% in the 1970s, 5.9% in the 1980s, 5.0% in the 1990s, and 5.6% between 2000 and 2005 (using the forecasted figures for 2005).

2004 Construction Sector Review:

2004 was an exceptional year, fueled mainly by the 14% growth in residential construction, 10% growth in health care, 8% growth in wastewater, 8% growth in office, and 8% growth in highway and street construction. Commercial construction rebounded modestly as did lodging.

Education, the second largest construction component next to residential, remained relatively flat along with transportation, power, water supply, recreation and communication. Manufacturing was down slightly, as was public safety and religious related construction.

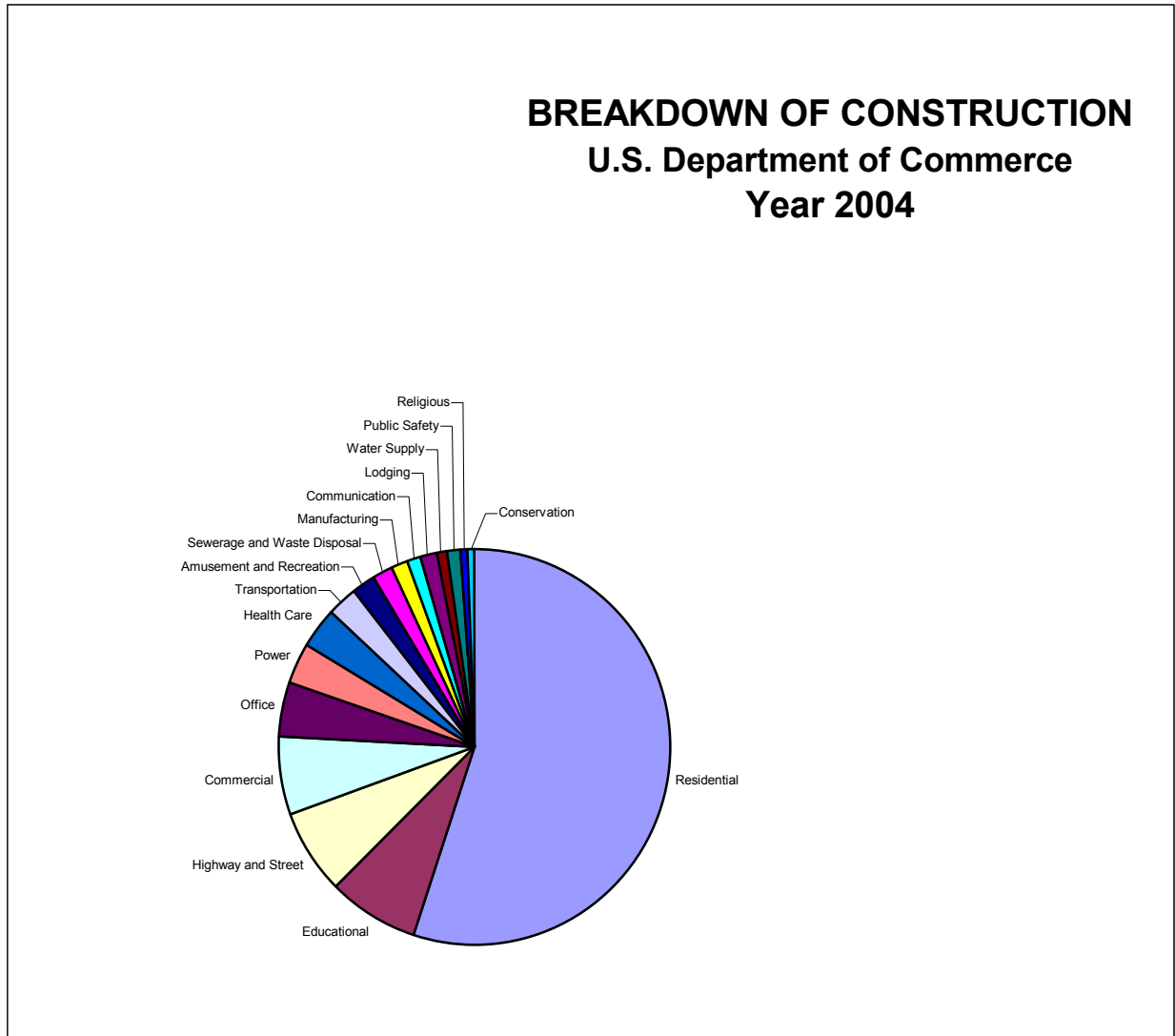
Office construction suffered four years of steady declines prior to 2004. The most active regions for office construction growth included Washington D.C., New York City, Atlanta, Phoenix, Dallas and Chicago. The largest six individual office starts in 2004 were the 1.) Freedom Tower in New York City (\$800M), followed by 2.) One Bryant Park in New York City (\$635M), 3.) New York Times Headquarters in New York City (\$400M), 4.) Department of Transportation headquarters in Washington D.C. (\$189M), 5.) Wells Fargo Mortgage Complex in Des Moines (\$160M) and 6.) the Washington Mutual Expansion in Seattle (\$120M).

U.S. Dept. of Commerce - Winners / Losers in 2004
 (billions of current \$)

Type of Construction	2003	2004	% Change
			03 to 04
Residential	482.9	550.5	14
Health Care	29.9	32.9	10
Highway and Street	62.9	67.9	8
Office	41.5	44.8	8
Sewerage and Waste Disposal	13.7	14.8	8
Lodging	11.1	11.8	6.3
Conservation and Development	4	4.2	5
Commercial	62.3	64.8	4
Power	33.2	33.9	2.1
Water Supply	10.4	10.6	1.9
Transportation	25.3	25.6	1.2
Educational	74.2	74.9	0.9
Amusement and Recreation	20	20	0
Communication	12.5	12.5	0
Manufacturing	14.3	14.2	-0.7
Public Safety	9	8.7	-3.3
Religious	8.5	8.2	-3.5
Total Construction	915.7	1000.3	9.2

The Makeup of the Construction Industry:

U.S. construction is largely driven by its \$550 billion residential component, which makes up 55% of the industry as a whole. Residential construction's sensitivity to interest rates explains the constant focus of attention to this issue, as any substantive increases could significantly reduce the industry's 'put in place' figures. Provided that interest rates don't rise too sharply, I anticipate residential construction will continue to grow modestly through 2009 as 'baby boomers' continue to purchase retirement and second homes.

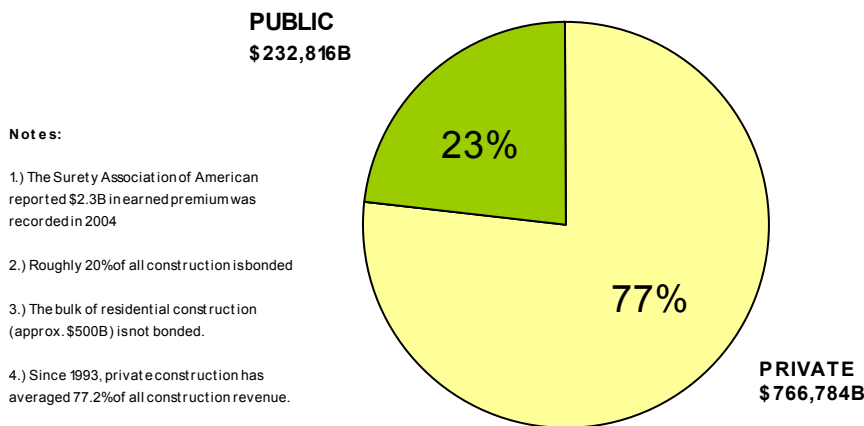


Other large and influential sectors include education (7%), highway and street (7%), commercial (6%), office (4%), power (3%), health care (3%), and transportation (3%). All other sectors have less than a two percent market share.

Due to the dominant market share held by residential construction, private construction revenue is overwhelmingly larger than public construction revenue. According to the Department of Commerce's figures, private construction has averaged a 77.2% market share since 1993. 2004 was no different with 77% of all revenue dedicated towards private construction (\$767 billion) and only 23% towards public construction (\$233 billion). As the bulk of residential and private

work is unbonded, contract surety bonds cover only about 23% of all construction. According to the Surety Association of America, approximately \$2.3 billion in premiums was earned in 2004. Assuming sureties charge an average of 1% for payment and performance bonds, the total value of underwritten construction in 2004 was \$230 billion, nearly the exact amount of public construction put in place (\$232 billion).

Public vs. Private Construction - 2004



Construction as a Percentage of the Gross Domestic Product:

The Bureau of Economic Affairs' recently completed its Gross Domestic Product breakdown for 2002. This document listed construction consumption at \$464 billion. Accounting for the additional construction spending hidden in other categories (mainly related to private sectors), construction was the eighth largest GDP component. If you were to carry the \$1 trillion figure provided by the Department of Commerce, it would be the fourth largest GDP component, following only (1) Wholesale and Retail Trade; (2) Manufacturing, and; (3) Real Estate and Rental / Leasing. To state it mildly, construction is a massive industry directly linked to the domestic and global economy.

2005 Federal Government Appropriations:

Congress met on November 16, 2004 to discuss nine unfinished appropriations bills including the \$388.4 billion “Omnibus Package” that included the bulk of proposed non-defense agency funding. This bill was finalized in early 2005 and calls for a 3% increase for transportation agencies, 0% increase for building agencies, and 19% decline for water and environmental agencies. The most penalized individual agency is the Bureau of Prisons, whose funding was cut by over 53%. The funding allocated through this bill will likely translate into additional construction consumption in 2005 through 2008.

2005 Construction Industry Forecast:

Construction economists feel 2005 will break the 2004 record for overall construction volume². The Department of Commerce estimates nearly every construction sector, with the exception of ‘Water Supply’ (likely due to the reduced federal funding in the Omnibus package), will show positive growth. Although residential construction is forecasted to increase by 7.5%, the other sectors will likely play a slightly more substantial role in construction growth. In addition, state budgets are returning to a surplus situation, after years of financial crisis, and are also fueling the optimism of the 2005 public markets³.

U.S. Dept. of Commerce - Forecast for 2005
(billions of current \$)

Type of Construction	2004	2005	% Change
			04 to 05
Sewerage and Waste Disposal	32.9	35.5	7.9
Residential	550.5	592	7.5
Highway and Street	44.8	47.5	6
Public Safety	4.2	4.4	4.8
Communication	14.8	15.5	4.7
Manufacturing	10.6	11.1	4.7
Office	64.8	67.4	4
Amusement and Recreation	67.9	70.6	4
Commercial	8.7	9	3.5
Health Care	11.8	12.2	3.4
Lodging	74.9	77.2	3.1
Educational	33.9	34.9	3
Religious	14.2	14.6	2.8
Power	20	20.4	2
Conservation and Development	8.2	8.3	1.2
Transportation	12.5	12.5	0
Water Supply	25.6	24.8	-3.1
Total Construction	1000.3	1057.9	5.8

² ENR November 15, 2004 article “Forecast 2005” by Tim Grogan

³ Ibid

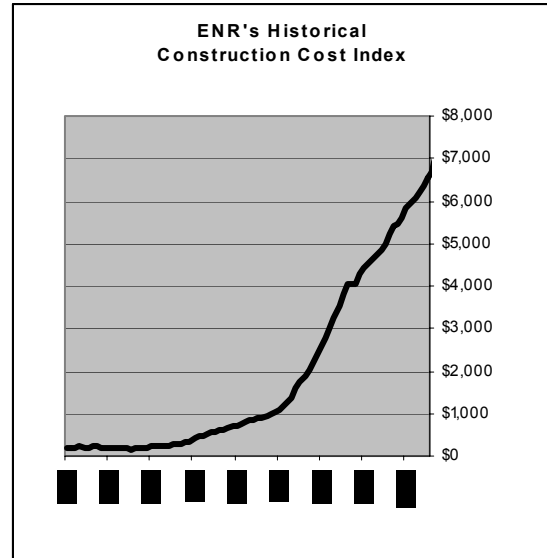
“Construction growth has been running ahead of that of the overall economy since 2001 and this year (2004) will break the trillion-dollar barrier for the first time”, notes Department of Commerce’s economist Patrick MacAuley. “There is a strong link between water and sewer construction and the housing and there is a lot of catch-up work that has to be done.”⁴ It is also anticipated that the fastest growing segment will be health care due to aging population of baby boomers. The construction sector with the least optimism for growth over the next five years is mass transportation.

⁴ Ibid

Part III – Issues Facing the Construction Industry

2004 Inflation:

Last year's ENR construction cost index ("CCI"), which takes into consideration both labor and material prices, increased by 6%, the largest annual increase since 1986. Tim Grogan, economist for ENR, notes, "The moderate inflation rates experienced by the construction industry for much of the 1990s through 2003 may go down in economic text books as a fluke made possible by the rare combination of cheap imports, energy and money combined with a relatively weak global economy. Those conditions are now changing."⁵



Considering the index is weighted more heavily towards labor, and average wages increased by only 4.1% in 2004, the major reason for the increase is the 20% material inflation sustained in 2004. Material prices have surged for a number of reasons including:

- The strong demand overseas and the weak dollar are preventing imports from stepping in to cap domestic price increases for items such as processed cement. This led to its largest price increase in over a decade;
- Oil prices are at record highs;

⁵ December 20, 2004 ENR article, "New 'Rules' Favor Inflation"

- The Federal Reserve Board is has been raising interest rates;
- The emergence of China, India and other Asian countries as economic powerhouses has shaken up global supply and demand, pushing up commodity prices and skewing international freight cost.
- China has already grown to become the world's largest consumer of industrial metals such as steel and copper, and is second only to the U.S. in oil consumption. Years of excess capacity of copper and other metals have been exhausted by this increased global demand;
- The escalating steel prices opened the door for double digit price increases for other materials, including lumber, plywood, copper, stainless steel, gypsum wallboard, ductile iron pipe and PVC pipe.

Year	Index	% Increase
1984	\$ 1,602	n/a
1985	\$ 1,611	1%
1986	\$ 1,644	2%
1987	\$ 1,701	3%
1988	\$ 1,685	-1%
1989	\$ 1,708	1%
1990	\$ 1,700	0%
1991	\$ 1,712	1%
1992	\$ 1,788	4%
1993	\$ 1,995	12%
1994	\$ 2,029	2%
1995	\$ 1,974	-3%
1996	\$ 2,072	5%
1997	\$ 2,195	6%
1998	\$ 2,165	-1%
1999	\$ 2,192	1%
2000	\$ 2,127	-3%
2001	\$ 2,056	-3%
2002	\$ 1,992	-3%
2003	\$ 2,011	1%
2004	\$ 2,420	20%
1985 - 1989	1.20%	Partial
1990s	2.7	
2000 - 2004	2.4	Partial

The Association of Equipment Manufacturers reported equipment prices shot up 6%, which is six times the annual average increase over the past four years. Manufactures are blaming high steel costs for these increases.

2005 Inflation:

Through the first quarter of 2005, the CCI is up by three percent and appears well on its way to top the 6% level, which will likely set a new twenty-year high. Per the Construction Labor Research Council, a 3.9% increase in labor costs is expected in 2005⁶. In order to help mitigate

⁶ Figures are calculated through a review of trade union's collective bargaining agreements.

this alarming increase, U.S. Department of Commerce recently approved a measure to reduce by half the tariff on Canadian lumber imports. This will reduce the cost of lumber by roughly 8% over the next two years.

Material	% Change (03 to 04)
Aggregates	3.8
Asphalt Paving Mixture	3.6
Bricks	2.3
Cement	7
Copper, Pipe and Tube	21.8
Diesel Fuel	64.7
Ductile Iron	13.7
Fabricated Steel, Bldg.	20.6
Glass, flat	-1.5
Gypsum Products	19.7
Insulation	11.8
Lumber, Softwood	18.7
Paint	3.7
Pipe & Pipe Fitting	26.8
Plywood	-7.2
Ready Mix Concrete	8.2
Sheet Metal	13.8
Wire & Cable	14.6

Data Source: ENR

Steel price escalation, however, will likely continue, as the demand for structural steel will rise to accommodate the increase in nonresidential construction, including office buildings and industrial work. Combining this with the weak dollar, a ten percent increase in steel prices is forecasted by the Department of Commerce.

According to the Portland Cement Association, cement consumption in 2005 will increase another 3%, which will keep markets tight due to the regional shortage of process cement. ENR predicts that cement prices will increase another 4.5%.

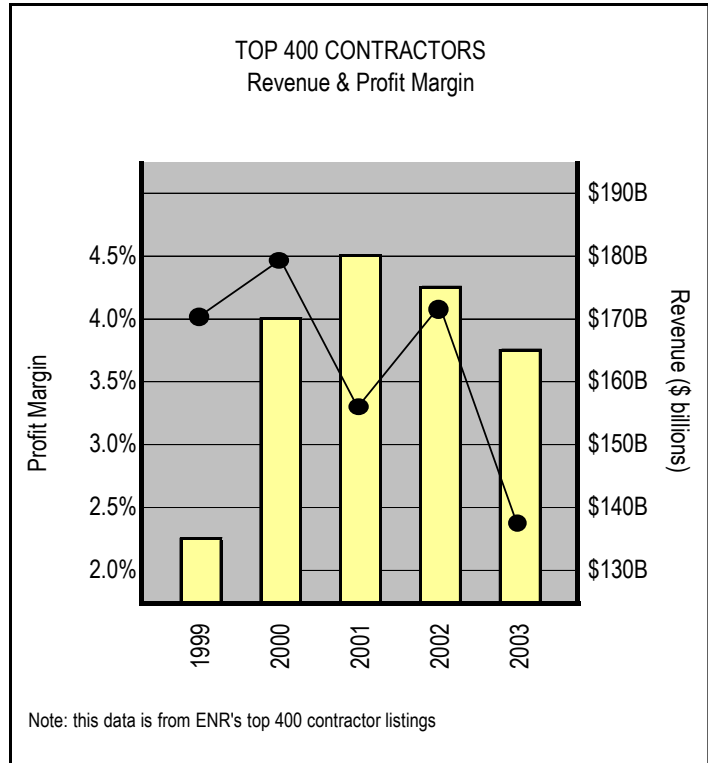
Regarding oil prices, geological depletion concerns are of concern because no new oil reserves of significance have been located in the past forty years and production current reserves has peaked. Oil industry analysts feel energy prices will continue to rise in the future.

Dwindling Profit Margin:

The top four hundred contractors in the U.S. manage approximately twenty percent of domestic construction. Using financial data offered by these contractors as an index for all construction contractors, it is evident the industry has a major problem with profitability. Average profit margins in 2003 were reported to be 2.3%, which is approximately half of that listed from the

previous four years⁷. The 2004 financial data due to be released in May of 2005 will likely reflect further declines in profit due to the inflationary issued noted above. According to R.S. Means, general contractors bid projects using an average anticipated profit margin of 3 to 5%. Considering the risks involved with construction, this leaves no margin for error. Highly capitalized subcontractors operating in niche markets are one of the only remaining examples where double-digit profit margins are achievable. Competition in these niches is often reduced due to high barriers to entry, such as bonding and technical knowledge.

In the 1980s, large general contractors and owners started a shift from lump sum contracts to construction management contracts, which had considerably less risk and lower fees to contractors. In addition, the majority of large general contractors reduced their self-performed work, choosing instead to outsource most or all labor. This pivotal transition changed construction from a blue-collar industry to a white-collar industry.



In the mid 1990s, however, owners embarked on a slow transfer of risk back to prime contractors. Guaranteed Maximum Price (GMP) contracts, which often have provisions for hefty delay damages, became more prevalent. Warranty requirements also became more stringent, creating yet more risk to contractors. Finally, owners began to transfer design risks to contractors through design / build contracts. Although contractors have taken on greater risk, profits usually remained constant or were even reduced.

⁷ ENR "The Top 400 Contractor" issues from 1999 to 2004

The continuing trend of shrinking profit and increased risk is obviously not a sound business model. Over the next three years, I anticipate a number of large contractors will pull out of high-risk markets and focus attention on specific regions where profits, albeit low, are achievable without unnecessarily high risk. Nonetheless, I expect to see a high number of large construction defaults, at least until profit margins return to a reasonable level.