

STATE OF THE U.S. CONSTRUCTION INDUSTRY

2005 / 2006

prepared by

VERTEX ENGINEERING SERVICES INC.
WILLIAM J. MCCONNELL JR., P.E.

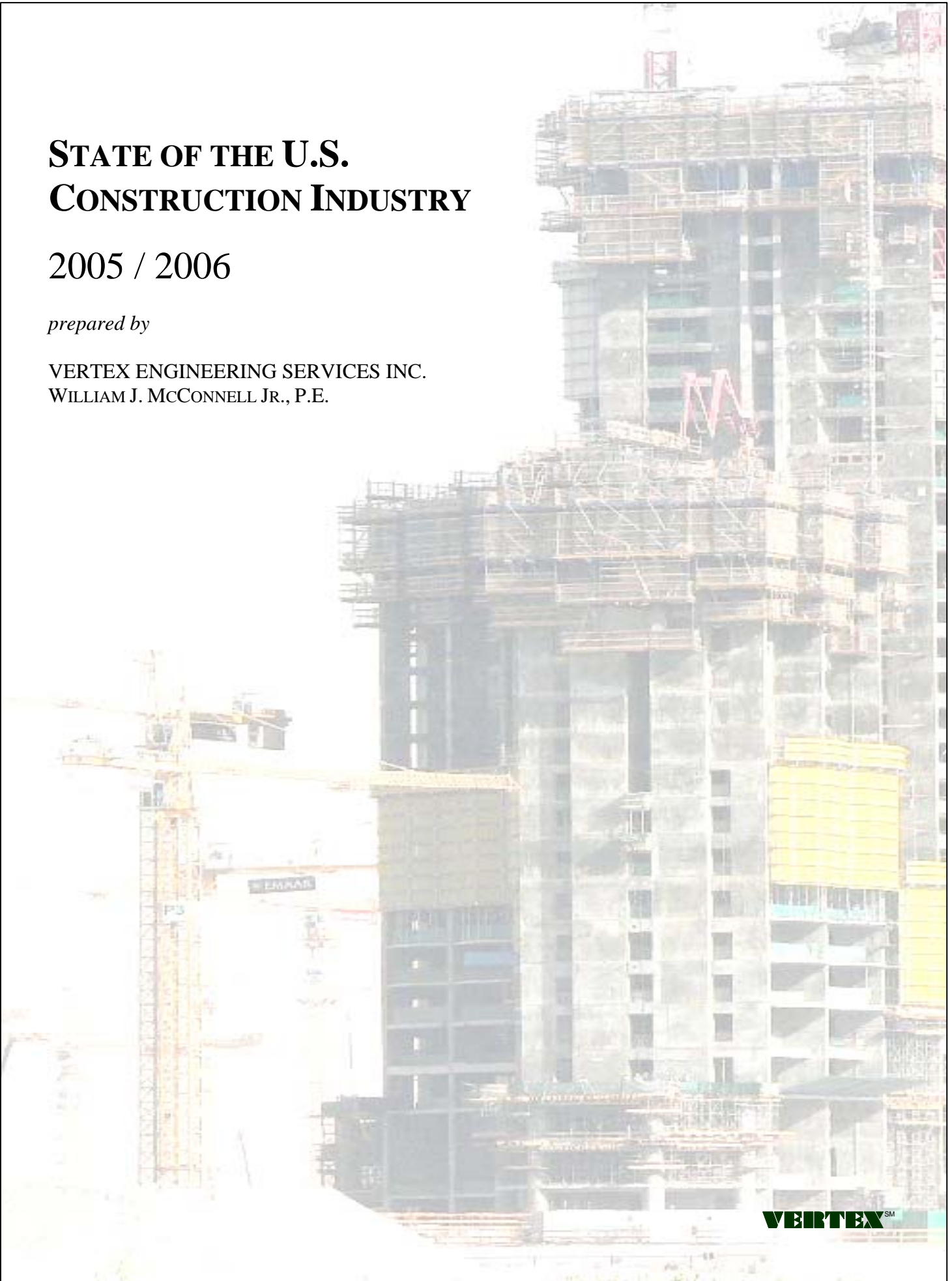


TABLE OF CONTENTS

I: Executive Summary.....2

II: State of the U.S. Economy.....4

 2005 Economic Indicator Review.....4

III: State of the U.S. Construction Industry.....7

 2005 Construction Sector Review.....7

 The Makeup of the Construction Industry.....7

 Construction Industry Key Statistics.....9

 2005 Federal Government Appropriations.....10

IV: 2006 Construction Sector Forecast.....11

 Overall Industry Forecast.....11

 Individual Sector Forecast.....11

V: Construction Material and Labor Inflation.....14

VI: Shrinking Profit Margins.....14

 Review of Top 400 Contractors.....15

 Review of Top 600 Specialty Contractors.....15

 Review of Public Contractors.....16

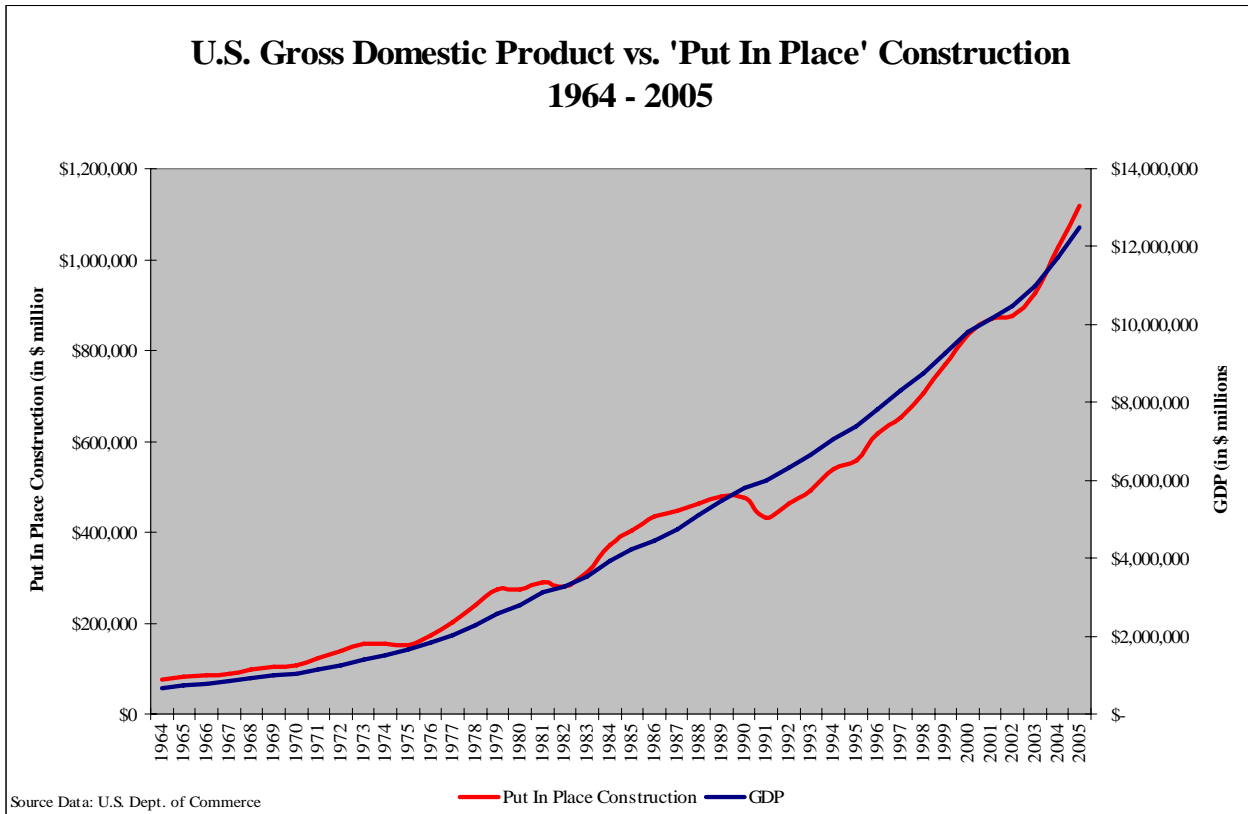
 Project Delivery Evolution.....16

VII: Tightening Surety Marketplace.....17

I. Executive Summary

Rapid construction growth continued in 2005 with the industry surpassing the trillion-dollar mark for the second consecutive year. The overall economy and construction industry have formally rebounded from the recessionary years of 2001 and 2002. The size of the U.S. construction economy is staggering when you consider it is just less than the entire gross domestic product of China, the world's seventh largest economy.

Because of its sheer size, the construction industry is one of, if not the most integral component, of the U.S. economy. Accordingly, growth of the construction industry moves in tandem with the growth with the U.S. gross domestic product. In order to properly analyze current conditions or future forecasts, one must understand the state of the overall economy as interest rates drive private construction and federal funding drives public construction.



Residential construction, which makes up over half of the industry as a whole, was largely responsible for the rapid growth of the past three years. With rising interest rates and inflationary pressures, however, this sector will cool in 2006. Fortunately, the majority of other sectors is poised for steady growth over the next several years due to the recent passage of key federal legislation, strong corporate balance sheets, the aging population, the surge in business and leisure travel, and increased consumer spending.

Material escalation, the most publicized issue facing the construction industry over the past year, is expected to subside in 2006. Although the industry is booming from a revenue perspective, construction establishments are struggling to maintain profitability. Profit margins for general contractors, heavy contractors, and specialty contractors have all trended significantly downward over the past five years to the point where the average construction establishment is working at a near breakeven level. Poor contractor earnings have caused a record number of construction defaults, which have led to poor surety industry results since 2001.

Onerous contract forms, uncontrolled growth and extended cash flow cycles all have contributed to the shrinking profit margins. However, strict surety underwriting over the past two years has fortunately created a well-needed barrier to entry on larger construction projects. Because over ninety percent of construction establishments employ less than twenty people, the industry is extremely fragmented and making changes is a very slow process. I predict profit margins will start to rise slowly and the volume of defaults will decrease at this same pace. The surety industry has done its part and the industry will benefit.

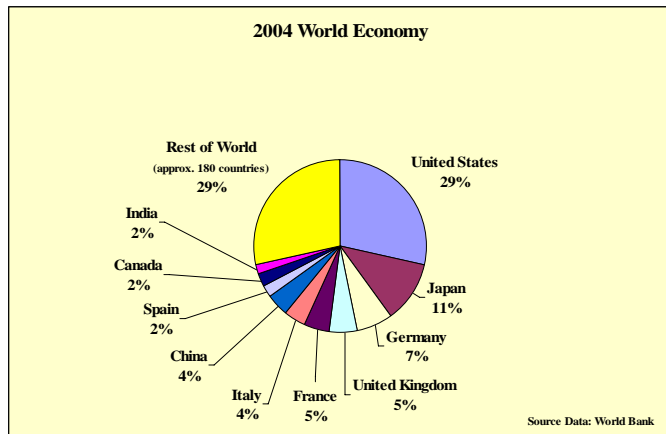
II. State of the U.S. Economy

Overall, 2005 was a good year for the U.S. economy as unemployment continued to decline and Gross Domestic Product (“GDP”) growth proved higher than historical standards. The leading economic concern was inflation as the Consumer Price Index hit its highest annual percent increase in more than a decade. Fuel prices and strong overall economic conditions triggered this increase, which led the Federal Reserve Board to raise the federal funds rate on eight separate occasions in order to slow the pace of economic growth to relieve inflationary pressures.

The greatest fiscal danger to the economy over the long-term is posed by the unfunded obligations in major entitlement programs – Social Security, Medicare and Medicaid.¹ The rising costs of these programs are tied largely to two factors: the aging of the population and the rising cost of health care. It would take \$11 trillion in today’s dollars to erase Social Security’s current unfunded obligations.

2005 Economic Indicator Review:

- GDP Growth:** The U.S. economy dominates the world marketplace with a staggering thirty percent market share (\$12.5 trillion US GDP vs. \$42 trillion world GDP). Although India has nearly four times the population of the U.S., the U.S. construction economy is nearly double India’s entire economy. China, whose growth over the past several years has been impressive, and whose population is over four times that of the U.S., is still only a fraction of the U.S. economy. Economists forecast China’s economy will eclipse the US economy over the next twenty-five years and India’s economy will nearly match the size of the U.S. economy².



Over the past century, real GDP growth has averaged 3%. The Bureau of Economic Analysis reports real GDP growth of 3.5 percent in 2005. This figure is down from 4.2 percent in 2004 but substantially higher than the recessionary years of 2001 through 2003. “The slowdown in GDP growth in 2005 mainly reflected a downturn in inventory investment, a slowdown in consumer spending, and a slowdown in federal government

¹ Joshua Bolten, Director, Office of Management and Budget, Mid-Session Review, July 13, 2005

² Goldman Sachs’ Global Economics Paper No. 99

spending.”³ Imports, which are a deduction for the calculation of GDP, increased in 2005.

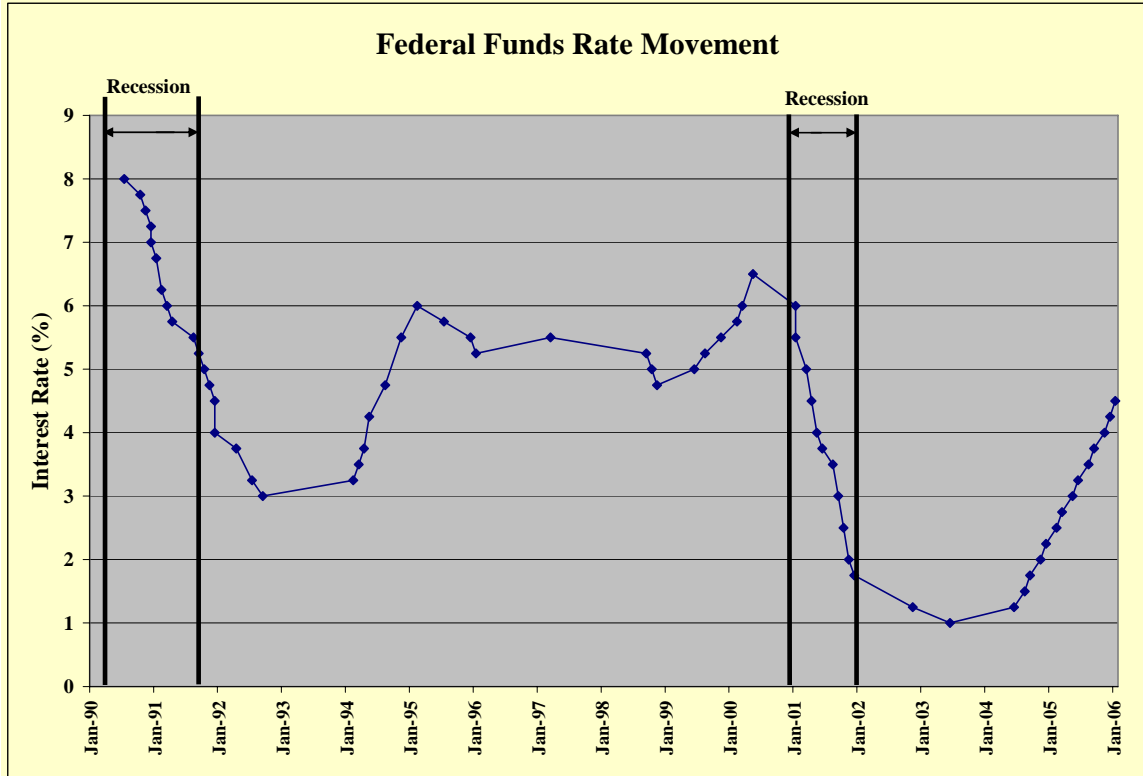
- Unemployment: The civilian labor force in the U.S. is approximately 150 million and unemployment has been steadily declining for two years. Currently unemployment stands at just over 7 million, or 4.7 percent. Many economists consider unemployment under 5% as “full” employment due to the dynamic economy with job transition and changing industry requirements.
- Productivity: The US Department of Labor calculates productivity through output, which measures the total value of production including inventory accumulation, minus imports. Productivity has been steadily increasing over the past fifteen years. The Bureau of Labor Statistics predicts output will grow at this same rate over the next seven years, even though the workforce will grow at a slower pace.⁴
- Trade: According to the U.S. Census Bureau, the 2005 trade deficit of \$725.8 billion surpassed the record set in 2004 of \$617.6 billion. The largest component of this deficit is petroleum, representing \$229.2 billion. Interestingly, exports in 2005 also set a record. The largest trade deficit with a country is China (\$201.6 billion).
- National Debt: The U.S. National Debt is \$8.209 trillion as of February 7, 2006. Since September of 2005, the debt is increasing at an average of \$2.14 billion per day⁵.
- Budget Deficit: According to the Congressional Budget Office, the 2005 budget deficit of \$493.6 billion was the third largest in history (next to 2003 & 2004). Since 1962, there have only been two years when the budget was balanced, 1999 and 2000. The budget deficit in 2006 is estimated at \$516 billion.
- Inflation / Federal Funds Rate: The Consumer Price Index increased by 3.4% in 2005, the largest increase in more than a decade. Higher oil prices boosted retail prices of a broad range of consumer energy products and, as a result, continued to hold up the rate of overall consumer price inflation in the first half of 2005⁶. Due to continuing economic expansion for households and firms, and some upward pressure on inflation, the Federal Open Market Committee (FOMC) continued to raise the federal funds rate eight separate times in 2005, increasing the rate from 2.50% to 4.25%. Federal Reserve Chairman Alan Greenspan’s fourteen-year term expired in 2005 leading to the appointment of Dr. Ben S. Bernanke. It is anticipated that Dr. Bernanke will continue to follow the economic policies of Mr. Greenspan.

³ Growth Slows in Fourth Quarter, Ralph Stewart, Bureau of Economic Analysis, January 27, 2005

⁴ Industry Output and Employment Projections to 2012, Jay Berman, The Bureau of Labor Statistics, February 4, 2004, Vol. 127, No. 2

⁵ www.brillig.com/debt_clock

⁶ July 2005 Monetary Policy Report submitted by The Federal Reserve Board. The federal funds rate is the interest rate at which depository institutions lend balances at the Federal Reserve to other depository institutions overnight.



- Corporate Balance Sheets:** Profits of S&P 500 companies have risen drastically over the past three years. Earnings per share in 2005 are estimated to be a record \$71.47, up from \$58.55 in 2004, and \$48.74 in 2003. Earnings per share in 2001 and 2002 were \$24.69 and \$27.59, respectively.
- Value of the Dollar:** The value of the dollar rebounded in 2005, particularly against the Yen and moderately against the Euro and Pound. Between 2001 and 2004, the US dollar lost considerable ground to all of these currencies. Because of the weak dollar, the cost of imports was more expensive however there was a slight gain in exports for this same reason.

III. State of the U.S. Construction Industry

The U.S. Department of Commerce reported the value of ‘put in place’ construction was up 9.0% in 2005, topping the trillion-dollar mark for the second consecutive year (\$1.12 trillion). The 9.0% growth rate is down from 11.1% in 2004, which represented the industry’s largest increase since 1984. The 2005 figure, however, is well above the average growth for the 2000s (6.49%), 1990s (5.05%), and 1980s (5.92%).

Growth is expected to slow in 2006 due in large part to reductions in residential spending.

Public spending, however, is forecasted to increase due to recent legislation that has freed up infrastructure improvements. The industry as a whole continues to be dominated by private residential construction, which makes up nearly sixty percent of the market, followed by sixteen other components as shown in the table above.

| 2005 Construction Sector Review | | | | | |
|--|------------|--------------|--------------|----------------|----------|
| U.S. Dept. of Commerce (millions of dollars) | | | | | |
| Type of Construction | 2003 | 2004 | 2005 | Percent Change | |
| | | | | 03 to 04 | 04 to 05 |
| Total Construction | \$ 925,069 | \$ 1,027,738 | \$ 1,119,764 | 11.1% | 9.0% |
| Residential | \$ 482,398 | \$ 569,983 | \$ 632,815 | 18.2% | 11.0% |
| Lodging | \$ 10,934 | \$ 12,017 | \$ 12,026 | 9.9% | 0.1% |
| Office | \$ 41,757 | \$ 45,082 | \$ 46,322 | 8.0% | 2.8% |
| Commercial | \$ 62,104 | \$ 66,586 | \$ 71,751 | 7.2% | 7.8% |
| Health Care | \$ 30,866 | \$ 34,122 | \$ 36,661 | 10.5% | 7.4% |
| Educational | \$ 69,974 | \$ 72,267 | \$ 76,972 | 3.3% | 6.5% |
| Religious | \$ 8,569 | \$ 8,087 | \$ 7,572 | -5.6% | -6.4% |
| Public Safety | \$ 9,403 | \$ 9,083 | \$ 9,897 | -3.4% | 9.0% |
| Amusement and Recreation | \$ 20,049 | \$ 19,860 | \$ 19,012 | -0.9% | -4.3% |
| Transportation | \$ 25,795 | \$ 26,863 | \$ 27,149 | 4.1% | 1.1% |
| Communication | \$ 12,814 | \$ 13,530 | \$ 14,284 | 5.6% | 5.6% |
| Power | \$ 39,570 | \$ 34,607 | \$ 33,942 | -12.5% | -1.9% |
| Highway and Street | \$ 59,304 | \$ 60,475 | \$ 67,095 | 2.0% | 10.9% |
| Sewerage and Waste Disposal | \$ 14,643 | \$ 15,660 | \$ 17,838 | 6.9% | 13.9% |
| Water Supply | \$ 11,031 | \$ 10,949 | \$ 12,227 | -0.7% | 11.7% |
| Conservation and Development | \$ 4,329 | \$ 4,899 | \$ 5,372 | 13.2% | 9.7% |
| Manufacturing | \$ 21,529 | \$ 23,671 | \$ 28,829 | 9.9% | 21.8% |

2005 Construction Sector Review:

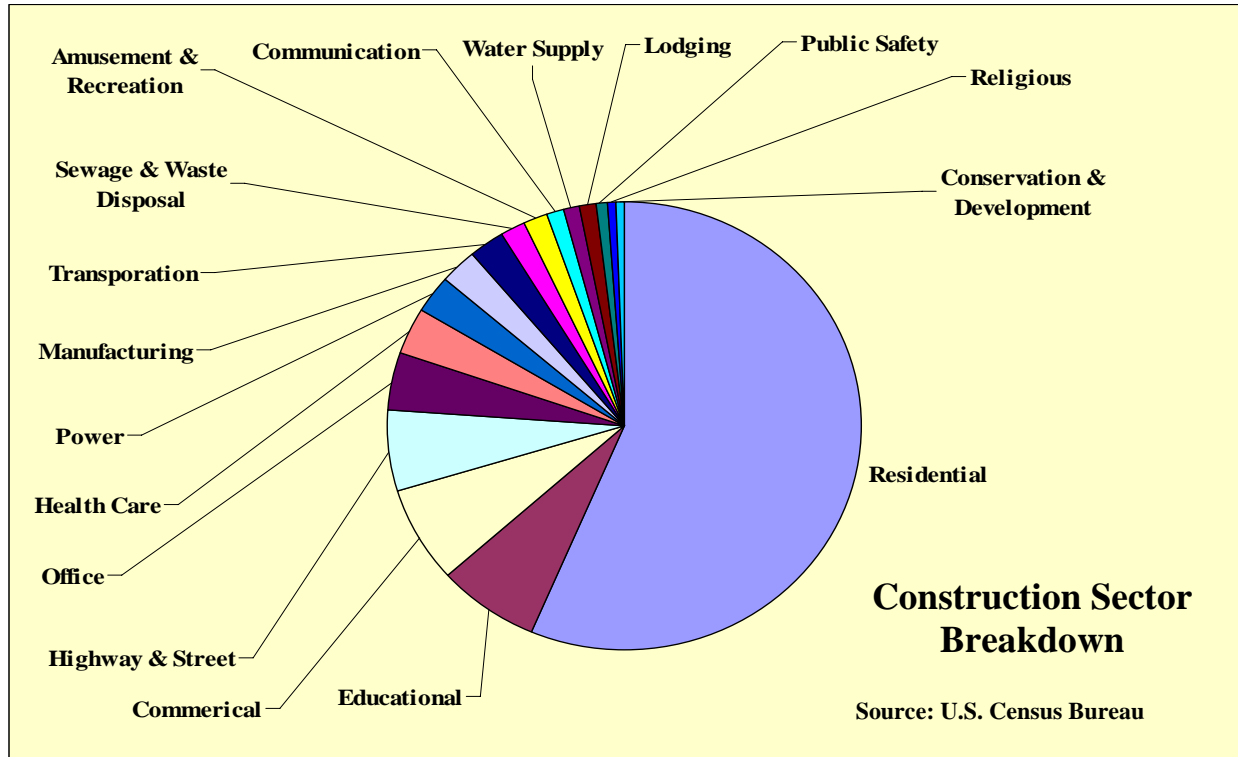
Exceptional growth continued in 2005 fueled mainly by the continued expansion of residential construction, which was up 11%, and secondarily by the growth in following major sectors: Educational (up 6.5%); Manufacturing (up 21.8%); Health Care (up 7.4%); and Highway & Street (up 10.9%). Other minor sectors that performed well include Sewerage and Waste Disposal (up 13.9%) and Water Supply (up 11.7%).

Sectors with poor performance include: Religious (down 6.4%); Amusement and Recreation (down 4.3%); and Power (down 1.9%). Sectors that remained flat include: Lodging (up 0.1%); Office (up 2.8%); and Transportation (up 1.1%)

The Makeup of the Construction Industry:

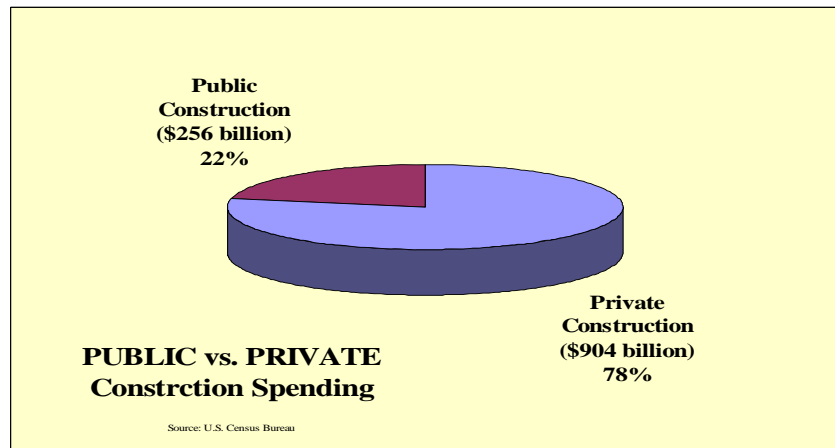
The U.S. Department of Commerce breaks down the construction industry into seventeen sectors, by far the largest being Residential construction, which makes up 56.5% (\$632 billion), of the industry as a whole. Residential construction’s sensitively to interest rates explains the

constant focus of attention to this issue, as any substantive increases could significantly reduce the industry's 'put in place' figures. Based on the eight increases in the federal funds rate in 2005, the residential market is already showing signs of slowing.



Other large and influential sectors include Education (7%), Commercial (6.7%), Highway and Street (6.0%), Office (4.2%), Health Care (3.2%), power (2.8%), manufacturing (2.5%), and transportation (2.4%). All other sectors have less than a two percent market share.

Due to the dominant market share residential construction holds, private construction is overwhelmingly larger than public construction. Pursuant to the Department of Commerce's figures, private construction has made up on average 77% of the construction industry since 1993. 2005 was no different with 78% of all construction remaining private (\$873 billion) and 22% public (\$246 billion).



As the bulk of residential and private work is not bonded, contract surety bonds cover

less than 25% of all construction. According to the Surety Association of America, approximately \$4.1 billion in premiums were earned in 2004. Assuming sureties charge an average of 1.5% for payment and performance bonds, the total value of underwritten construction in 2005 was \$273 billion, just over the total public construction market (\$246 billion).

Construction Industry Key Statistics:

- According to the U.S. Department of Labor, construction employs about 5.4% of all workers, and accounts for 9.8% of all work establishments. Construction employment has risen from 5.2 million in 1995 to a high level of 7.0 million in 2004, surpassing a previous high achieved in 2001.
- In 2004 there were approximately 818,000 construction establishments in the U.S., with the majority of them extremely small. 65% of construction establishments employ less than four workers, 26.4% employ between five and nineteen workers, 7.6% employ between twenty and ninety-nine workers and only 0.8% establishments employ more than one hundred workers.
- Construction employment is distributed as follows: 64% work for Specialty Contractors, 23% work for Building Contractors and 13% work for Heavy and Civil Contractors.
- In 2004, the unemployment rate of persons employed in construction was 8.4%, several points higher than the overall unemployment rate of 5.5% in 2004.
- Over the next ten years, construction employment is the only goods-producing sector that is projected to grow.
- In 2004, there were 1,224 fatal construction related injuries. The incident rate was 6.4 per 100 full-time workers in construction, well above the 4.8 per 100 full-time workers in all private industry.

| Industry Statistics | |
|---|-------------|
| U.S. Department of Labor | |
| Statistic | 2004 Figure |
| U.S. Construction Employment | 7 million |
| Construction Establishments in the U.S. | 818,000 |
| Percent of establishments with less than 20 employees | 91% |
| Percent of workers employed by Specialty Contractors (subs) | 64% |
| Percent of workers employed by Building Contractors | 23% |
| Percentage of workers employed by Heavy Civil Contractors | 13% |
| Number of construction related fatalities | 1,224 |

- The value of ‘Put In Place’ construction represented 9.0 percent of the GDP in 2005 (\$1.12 trillion vs. \$12.49 trillion). This figure is up from 8.8 percent in 2004, which means the construction economy is growing faster than the economy as a whole (as seen on the graph in the Executive Summary).
- Since 1980, the construction industry has represented between seven and ten percent of the U.S. economy. In the 1960s and 1970s, the construction economy made up between ten and twelve percent of the economy as a whole.

2005 Federal Government Appropriations:

2005 was a great year for construction legislation as four bills were passed that will ensure a substantial increase in federal funding for highway and bridge projects, power projects, hurricane relief projects and Gulf Coast redevelopment. Congress passed the “SAFETEA-LU” (Safe, Accountable, Flexible, Efficient Transportation Equity Act: A Legacy for Users) bill in 2005, which sets in place five years of federal transportation funding. The bill guarantees \$286.5 billion in funding through 2009, which represents a 38% jump over the preceding six-year statute, the 1998 Transportation Equity Act for the 21st Century (“TEA-21”).

Congress also passed one of the most comprehensive energy bills since 1992 (“Energy Policy”). The bill pushes construction in nuclear power, clean coal technology, renewable energy and transmission. Lastly, Congress provided \$29 billion in disaster relief aid for hurricane damage and \$8.7 billion in tax breaks for new Gulf Coast structures (Gulf Opportunity Zone Act).

IV - 2006 Construction Sector Forecast:

Overall Industry Forecast:

Construction growth will slow in 2006 due to rising interest rates and inflation that negatively affect Residential Construction. Overall, the construction economy will outpace the overall economy by a factor of approximately two (7.6% vs. 3.5%), as has been the case since 2003.

Several nonresidential sectors will achieve significant growth due to recent legislation, strong corporate earnings, aging population, increased business travel, rising employment, overall weak dollar (drives manufacturing back to the

U.S.), and increased consumer spending patterns. The winners this year will likely be Commercial, Health Care, Highway & Street and Manufacturing.

| Type of Construction | 2004 | 2005 | Forecast 2006 | Percent Change | |
|------------------------------|------------|------------|---------------|----------------|----------|
| | | | | 04 to 05 | 05 to 06 |
| Total Construction | \$ 1,027.7 | \$ 1,119.8 | \$ 1,204.7 | 9.0% | 7.6% |
| Residential | \$ 570.0 | \$ 632.8 | \$ 689.6 | 11.0% | 9.0% |
| Lodging | \$ 12.0 | \$ 12.0 | \$ 12.5 | 0.1% | 3.9% |
| Office | \$ 45.1 | \$ 46.3 | \$ 47.8 | 2.8% | 3.2% |
| Commercial | \$ 66.6 | \$ 71.8 | \$ 75.5 | 7.8% | 5.2% |
| Health Care | \$ 34.1 | \$ 36.7 | \$ 39.8 | 7.4% | 8.6% |
| Educational | \$ 72.3 | \$ 77.0 | \$ 80.5 | 6.5% | 4.6% |
| Religious | \$ 8.1 | \$ 7.6 | \$ 7.8 | -6.4% | 3.0% |
| Public Safety | \$ 9.1 | \$ 9.9 | \$ 9.9 | 9.0% | 0.0% |
| Amusement and Recreation | \$ 19.9 | \$ 19.0 | \$ 19.7 | -4.3% | 3.6% |
| Transportation | \$ 26.9 | \$ 27.1 | \$ 28.6 | 1.1% | 5.3% |
| Communication | \$ 13.5 | \$ 14.3 | \$ 15.2 | 5.6% | 6.4% |
| Power | \$ 34.6 | \$ 33.9 | \$ 34.3 | -1.9% | 1.1% |
| Highway and Street | \$ 60.5 | \$ 67.1 | \$ 75.1 | 10.9% | 11.9% |
| Sewerage and Waste Disposal | \$ 15.7 | \$ 17.8 | \$ 18.5 | 13.9% | 3.7% |
| Water Supply | \$ 10.9 | \$ 12.2 | \$ 12.4 | 11.7% | 1.4% |
| Conservation and Development | \$ 4.9 | \$ 5.4 | \$ 6.1 | 9.7% | 13.6% |
| Manufacturing | \$ 23.7 | \$ 28.8 | \$ 31.3 | 21.8% | 8.6% |

Individual Sector Forecast:

In order of size, the following are forecasts for each construction sector in 2006:

1. Residential (\$632 billion in 2005): After a sluggish fourth quarter in 2005, housing starts were up 14.5% in January 2006, due in large part to a temporary sag in interest rates and the nation's warmest January on record⁷. Sales in February 2006 show signs of lagging and it is expected the Residential sector will finish the year up 7.6%. The Residential sector is cooling off from three years of record growth due to material and labor inflation and rising interest rates.

2. Education (\$76.9 billion in 2005): Over the next four years, the Education sector will grow between 5% - 10% annually as enrollment in primary, secondary and post-secondary is increasing, college construction is booming, and private schools are becoming increasingly trendy⁸. The majority of this demand is coming from southern states, with northern states possibly realizing decreases in spending.

⁷ Nation's Building News - 3/11/06 online article

⁸ The 2005 - 2006 U.S. Markets Construction Overview, FMI Corporation

3. Commercial (\$71.8 billion in 2005): Retail revenue is the largest component of the GDP, with sales over \$4 trillion and an employee base of twenty three million. Consumers are spending more and more leading to an increased retail demand that has led to a strong rebound of this industry after suffering setbacks in the 2001 through 2003. Increased commercial construction will likely continue through 2009.

4. Highway & Street (\$67.1 billion in 2005): Due to recent passage of federal construction funding legislation (SAFETEA-LU), growth in Highway and Street construction will grow modestly over the next four years. Without the passage of this bill, this sector would have been stagnant at best. Growth between 5% and 6% is forecasted through 2009.

5. Office (\$46.3 billion in 2005): Office has had the same trend as Lodging over the past decade – extremely hot in the mid nineties followed by a drastic let down from 2001 through 2003. The Office sector has recovered due to increasing employment, increasing cost per square foot and decreasing vacancy rates.⁹

6. Health Care (\$36.7 billion in 2005): The Health Care segment will continue its steady growth for the next several years to accommodate the aging baby boomers. A 2004 survey conducted by *Hospitals & Health Networks* found that 60% of hospitals and 68% of health systems need to replace aging facilities.¹⁰

7. Power (\$33.9 billion in 2005): After three years of declining or flat expenditures the Power sector is poised for modest growth due in large part the passage of the U.S. Energy Bill in 2005. This bill creates incentive for the development of clean coal technologies, requirements for corn-derived ethanol, and new nuclear power plants.

8. Manufacturing (\$28.8 billion in 2005): After suffering five straight years of declines between 1999 and 2003, Manufacturing has rebounded with back to back years of solid growth. Although the sector as a whole continues to be much smaller than its peak in 1998 (\$29.5 billion in 2005 vs. \$40.7 billion in 1998), the weak dollar is drawing Manufacturing back to the U.S.

9. Transportation (\$27.1 billion in 2005): Due to growing rail demand and increased airport traffic, transportation related construction should realize steady growth over the next five years (5% to 7% annual increases).

10. Sewage & Waste Disposal (\$17.8 billion in 2005): Although this sector was up nearly 14% in 2005 and substantial demand exists for new and expanded wastewater systems in the U.S., EPA funding was cut in 2005 and additional cuts are forecasted over the next several years. The EPA estimates a national investment need of \$390 billion over the next twenty years to replace existing aged facilities. With the federal cuts, states and municipalities will be required to fund large portions of the work.

⁹ The 2005 – 2006 U.S. Markets Construction Overview, FMI Corporation

¹⁰ Ibid, page 55

11. Amusement and Recreation (\$19.0 billion in 2005): Tourism drives growth in this sector and the decline in leisure travel post 9/11 impacted revenue significantly. Tourism has recently started to increase, as travel and hotel occupancy is up, therefore this sector will rebound modestly in 2006. Casino development is currently the backbone of this sector.

12. Communication (\$14.2 billion in 2005): After significant cutbacks in revenue in 2002 (-9%) and 2003 (-31%), the Communication sector has rebounded modestly over the past two years. As much of the wireless infrastructure is currently in place, this sector will realize only marginal growth over the coming years, with international work making up the majority of the new revenue.

13. Water Supply (\$12.2 billion in 2005): Due to expansion of residential and commercial construction throughout the country, and mainly the southern states, the need for water is growing rapidly. Due to aging infrastructure, increasing populations and environmental regulations, this sector should grow between 6% and 7% annually through 2009. The EPA cutbacks will require states and local municipalities to provide funding.

14. Lodging (\$12.0 billion in 2005): Business travel has increased greatly over the past two years sparking a large demand for additional hotel rooms, which will expand revenue over the next several years. The Lodging sector was extremely hot in the mid 1990s but revenues plummeted considerably after 9/11 and the recession of 2001-2003.

15. Public Safety (\$9.9 billion in 2005): The U.S. continues to house the largest inmate population in the world. Although inmate growth slowed this past year, the demand for new facilities and facilities upgrades continues. Federal cutbacks in the Department of Corrections budget resulted in a flat 2005. Modest growth, if any, will result over the next four years (3% to 4%).

16. Religious (\$7.6 billion in 2005): Religious facilities will likely follow the housing boom over the next few years, and additional facilities will be required to accommodate the growing population. Growth between 2% and 4% is expected for the next several years.

17. Conservation & Development (\$5.4 billion in 2005): The EPA continues to promote growth in this sector through Brownsfield developments (the cleanup and redevelopment of environmentally sensitive sites). Annual growth of 7% is forecasted through 2009.

Part V – Construction Material and Labor Inflation

2005 represented the third straight year of extreme construction inflation. Economists predict inflationary pressures will ease in 2006 as the housing market boom appears to have peaked, the rebuilding of the Gulf Coast will take time, and the demand for construction materials in Southeast Asia is slowing.

| Index | Actual 2004 | Actual 2005 | Forecast 2006 | % Change | |
|-------------------------|-------------|-------------|---------------|----------|---------|
| | | | | 04 - 05 | 05 - 06 |
| Building Cost Index | 4123 | 4329 | 4394 | 5.0% | 1.5% |
| Construction Cost Index | 7311 | 7647 | 7861 | 4.6% | 2.8% |
| Skilled Labor Index | 6909 | 7199 | 7509 | 4.2% | 4.3% |
| Material Index | 2420 | 2575 | 2493 | 6.4% | -3.2% |

Last year ENR's Construction Cost Index ("CCI"), which takes into consideration both labor and material, increased by 4.6%. With the exception of 2004, this represented the largest annual increase since 1986. 2004's 9.2% increase was largest annual increase in twenty-five years.

ENR forecasts the CCI index will increase by 2.8% in 2006, largely due to wage escalation, while their Material Price Index, which increased by 6.4% in 2005, will drop to 3.2%. Wages grew by 4.2% in 2005 and are expected to increase 4.4% in 2006, based on multiyear collective bargaining agreements reported by the Construction Labor Research Council. Contrary to 2003-2005, wages will be the leading driver of inflation in 2006.

| Item | Actual | | | 2006 |
|---------------------------|--------|-------|-------|----------|
| | 2003 | 2004 | 2005 | Forecast |
| Asphaltic Paving | 4.7% | 7.3% | 5.5% | 1.5% |
| Cement | 3.2% | 12.7% | 5.5% | 0.8% |
| Concrete Reinforcing Bars | 55.5% | 1.2% | -7.4% | -8.6% |
| Construction Equipment | 3.1% | 4.9% | 2.7% | 1.3% |
| Pipe & Fittings | 20.2% | 9.1% | -0.6% | -1.6% |
| Structural Steel | 12.3% | 7.1% | 1.6% | -0.3% |
| Sheet Metal | 10.3% | 3.8% | 1.7% | -1.1% |
| Gypsum Products | 15.1% | 13.7% | 1.8% | -2.5% |
| Lumber | 22.8% | -2.4% | 0.6% | 0.2% |
| Plywood | 18.9% | -4.3% | 7.4% | -2.8% |
| Sand & Aggregate | 3.5% | 6.8% | 4.4% | 2.5% |

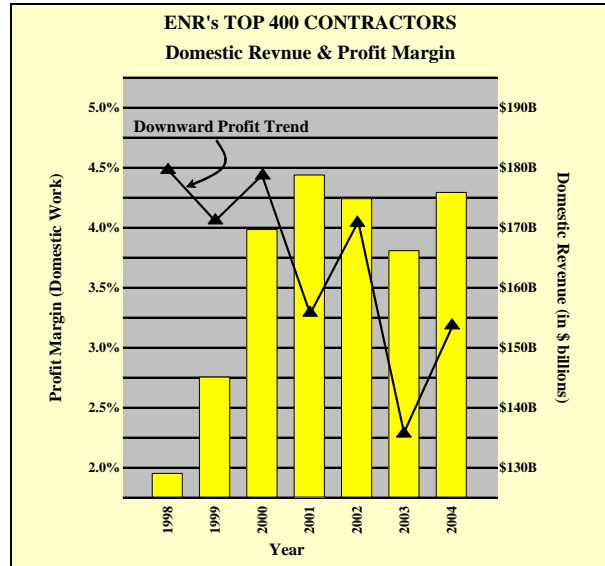
Diesel fuel was up a staggering 59% in 2005 and it is expected to remain high in 2006. Due to the disruption in natural gas supplies caused by Hurricane Katrina, spikes in PVC prices resulted. Before Katrina, PVC prices were up between 6 and 10%. After Katrina, PVC water and sewer pipe jumped up between 20% and 35%. Copper prices have

been going up similar to PVC prices, with copper jumping 20% in the fourth quarter of 2005.

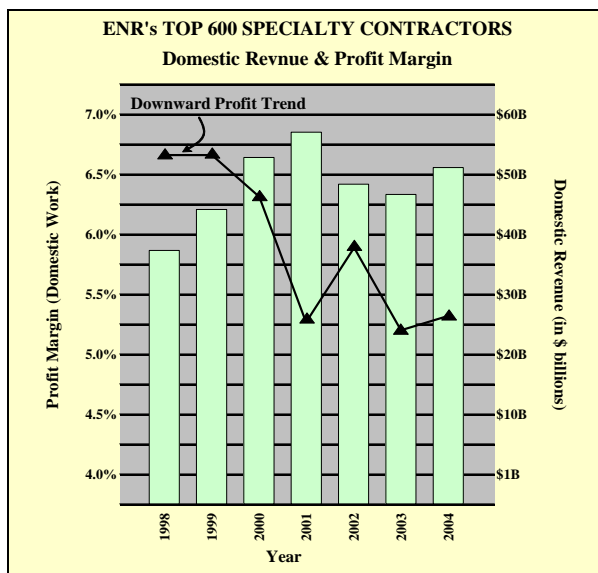
Part VI – Shrinking Profit Margins

Review of Top 400 Contractors:

The top 400 contractors in the U.S. manage approximately twenty percent of domestic construction. Using financial data offered by these contractors through *ENR* as an index for all construction contractors, it is evident the construction industry has difficulty achieving reasonable profitability. Average margins in 2003 were reported to be 2.3%, which is approximately half of that listed during the previous four years¹¹. The 2004 margins improved slightly to 3.2%, still considerably low for the associated risk. 2005 figures will be reported in July. According to R.S. Means, general contractors, on average, bid work with an anticipated net profit margin of 3% to 5%. Considering the risk profile involved with construction, there is little to no room for error. The top 400 contractors are growing internationally at a faster pace than domestically, and margins overseas are nearly double that of domestic work.



Review of Top 600 Specialty Contractors:



Specialty contractors also struggle with profitability. Over the last five years, margins have slipped from 6.7% to just over 5%, a near 25% reduction. Specialty contractors need to achieve higher margins due to cash flow constraints resulting from self performed work and longer collection cycles. Due to the fragmented nature of the construction marketplace, very few specialty contractors are highly capitalized. Sparse competition exists on large volume subcontractor work as only a select few companies can provide adequate bonding. Consequently, higher margins should, and I emphasize should, be achieved due to the lack of competition. The tightening of surety

¹¹ ENR "The Top 400 Contractor" issues from 1999 to 2004

underwriting is a distinct advantage to these select companies.

Review of Public Construction Contractors:

Yahoo Finance is a great source for construction industry financial data. Information is segregated into four categories: 1. General Contractors (Turner Construction, Halliburton, etc.); 2. Heavy Contractors (Perini Corp., Flour Corp., Granite Construction, etc.), 3. Residential Contractors (DR Horton, Toll Brothers, Centex Corp., etc.); and 4. Engineering Companies (URS Corp., Tetra Tech Inc., Washington Group International, etc.).

Net profit margin for General Contractors is listed at 1.70% in 2005, up from -0.30% in 2004. Heavy Contractors didn't fare much better with margins of 1.20% in 2004 and edging up slightly to 1.50% in 2005. Residential Construction, by far the most profitable sector, had margins of 8.00% in 2004 and 8.80% in 2005. Larger engineering firms are now moving into construction markets in order to increase revenue. This has led to diminishing profit margins for nearly all firms taking on this risk – in 2004 engineering companies averaged a net profit margin of 3.65%, which slid back to 1.90% in 2005.

| Industry | 2005 Net Profit Margin | 2004 Net Profit Margin |
|-------------------------------|------------------------|------------------------|
| General Contractors | 1.70% | -0.30% |
| Heavy Contractors | 1.50% | 1.20% |
| Residential Contractors | 8.80% | 8.00% |
| Engineering Companies | 1.90% | 3.65% |
| Property & Casualty Insurance | 6.40% | |

Project Delivery Evolution:

In the early 1980s, project delivery shifted from standard lump sum arrangements to construction management contract forms, particularly on larger construction contracts. The construction management forms allowed general contractors to manage work with considerably less risk and lower fees. This trend caused a major reduction in the quantity of self-performed work offered by general contractors. In essence, general contracting switched 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 through guaranteed maximum price contract forms that often include delay damage provisions. Although general contractors have taken on more risk, fee structures have remained consistent, if not reduced. Warranty provisions have also been overhauled in many instances where general and specialty contractors take on more long-term risk exposure. Owners have also transferred design risks to contractors through design / build contract forms. Collectively, these measures have negatively impacted the viability of the business model employed by contractors.

IV – Tightening Surety Market:

As construction industry profits have decreased over the past seven years, surety losses have trended upward at a record pace. Consequently, the industry has been losing money for four straight years. Due to increased losses, underwriting has tightened to a point where contractors are fighting for additional bonding capacity. Bondability is now a true barrier to entry on construction projects and the tightening underwriting process should help contractor profit margins trend upward.

Strict underwriting coupled with moderate increases in bond fees should result in the surety industry turning mildly profitable by 2006 (Surety Association of America reports preliminary financial data in August). In order to reach profitability, overall loss ratios must remain below 30%. 2005 figures are likely to hover around the 30% threshold and 2006 figures should be below 30% for the first time since 2000.

