

Checking the pulse

Where Northeast Ohio professionals think the construction industry is headed

BY ROGER T. GINGERICH,
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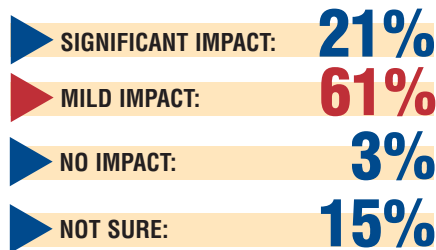
The state of the local and national economy is on everybody's mind, but how it affects one industry or another is hard to understand. To get a full checkup on some of the industries that are thought to have taken a beating recently, *Smart Business* and Skoda Minotti conducted a survey of more than 30 local construction professionals in Northeast Ohio to gauge their view of the industry. After reviewing the construction survey results, we've compiled the following highlights.

The current state

The state of the economy in Northeast Ohio has led to an increase in the competitiveness of the construction marketplace. The market has seen a decrease in the number of homebuyers, which has led to less demand for new residential construction.

According to one respondent, this may be partially caused by the media's por-

Percent of respondents that see the current credit crisis impacting the bonding industry:



trayal of the current housing crisis: "The uncertainty of the economy and the media's portrayal of the housing industry, people are seeing these things and are not willing or looking to purchase new homes or spend money in general."

This has made profitability difficult for many of the companies in our survey to attain, as indicated in their comments below.

When asked, "What is the greatest challenge that your company currently faces

and why?" one respondent explained, "As the residential market dries up, competition is increasing on public construction projects. Due to the dynamic nature of the construction market in NE Ohio, it becomes more difficult for contractors to both obtain work and remain profitable."

According to Ian Frank, a construction lawyer with Frantz Ward LLP, there is an upside for companies that keep a close eye on their bottom line.

"This increased competition provides opportunities for success for the disciplined construction company that has put in place strong estimating, cost, contract risk allocation and project management controls," he says. "On the other hand, it can prove disastrous to those that do not take these precautions."

The work force problem

Several respondents commented that their No. 1 concern moving forward is finding talented workers in an industry that is



suffering from a shortage of employees with the necessary skills to perform the required work. Nationally, the construction industry has seen a realignment of talent take place. According to a study performed by The Associated General Contractors of America (AGC), nonresidential construction nationwide saw an employment increase of approximately 23 percent between February 2006 and December 2007, while residential construction saw a decrease of 33 percent. A majority of this gain and loss can be attributed to residential workers performing tasks such as installing wallboard, wiring, plumbing and other components in nonresidential projects.

According to the AGC, many of the residential workers making this switch may not have the skills needed for the high-growth construction categories of 2008, such as hospitals. These projects require extremely talented workers skilled in high-steel erection, heavy lifting and close coordination with a variety of crafts in confined or hazardous spaces.

Despite the gloomy outlook for many segments of the construction industry, there will be growth opportunities in various markets. Frank says that, "A substantial number of the industry respondents indicated that their greatest opportunities for growth in the next five years existed in the public construction market and institutional market (e.g., health care, hospitality, etc.). This is no doubt due in large part to the continued growth and expansion of The Cleveland Clinic and University Hospital Health Systems, more than four dozen projects still planned by the Cleveland Metropolitan School District, the ongoing Euclid Corridor Project, the anticipated redevelopment of the East Bank of The Flats by Developers Diversified/Scott Wolstein as well as a number of notable downtown projects, such as the future renovation of the Ameritrust Building."

Going green

THE FUTURE OF THE INDUSTRY IS SUSTAINABLE.

A majority of survey respondents think that green construction will have a "significant" impact in the near future. What does this mean to the industry?

Construction lawyer Ian Frank says, "These results indicate a clear need for continued education and professional development in the technical aspects of sustainable and green construction as well as the legal/financial consequences of this burgeoning market sector."

To download a free Green Construction Resource Guide, visit the Web site of Associated Builders and Contractors at www.abc.org. Additionally, you can visit www.usgbc.org/leed for more information on the Leadership in Energy and Environmental Design (LEED) Green Building Rating System. This third-party certification program is the nationally accepted benchmark for the design, construction and operation of high-performance green buildings.

Legal issues

The survey revealed several interesting facts about the legal environment surrounding the construction industry.

"A majority of the survey respondents indicated that they believe claims for design errors and omissions will be the largest source of claims and change orders in the future," Frank says. "These responses highlight the need for adequate project management controls and risk management techniques. These controls include a clear understanding and appreciation of the contractual risks assigned by the contract documents and a focus on timely protecting/preserving claim rights when they occur. Many recent legal decisions interpreting typical risk-shifting provisions are filled with cautionary tales of contractors that did not create or implement these risk management controls."

With the continued rising cost of materials a top concern for construction companies, fixed-price contracts are becoming a more and more dangerous proposition. Frank believes that, "Given that nearly 70 percent of the respondents perform most of their work on a fixed-

price or lump-sum basis, these concerns result in an increased risk of performance. Contractors eager to take work at little or no margins in order to keep busy often ignore contractual risk issues that will directly impact the project bottom line.

"Add to this dynamic the prospect of widespread price fluctuations for various raw materials and one can see the possibility for an increase in contractor defaults. Also, the recurrent concerns regarding material price increases demonstrate the need for a broader acceptance of shared contractual risk through the implementation of material escalation clauses." <<

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Special thanks to the professionals at Frantz Ward LLP, Parkview Federal and Associated Builders and Contractors Inc. for their assistance developing these surveys. Construction survey results based on 33 companies.

WHERE NORTHEAST OHIO CONSTRUCTION RESPONDENTS SEE THEMSELVES IN THE NEXT THREE YEARS:

▶ **39.4%**

feel their business will have **MORE OPPORTUNITIES** in Northeast Ohio.

▶ **36.4%**

feel their business will have **LESS OPPORTUNITIES** in Northeast Ohio.

▶ **24.2%**

feel their business will have the **SAME AMOUNT OPPORTUNITIES** in Northeast Ohio.

Housing slump

The real estate industry is still reeling.

BY ROBERT A. RANALLO,
CPA/ABV, JD, CVA

If any industry has felt the troubled waves of the current U.S. economic state as much as the construction industry, it's real estate. Nary a day goes by without talk of foreclosures, mortgage crises and the like. But what about the people on the front lines here in Northeast Ohio? Are things really bleak or just setting up for better days ahead? *Smart Business* and Skoda Minotti conducted a survey of 51 real estate professionals on the current state of the industry. After reviewing the real estate survey results, we've compiled the following highlights.

The local beat

The overwhelming theme of the survey responses focused on the current state of the Northeast Ohio economy. With the low demand for housing, the real estate market has been severely impacted.

The economic troubles caused by the residential real estate market in this region have been well documented. Our respondents do not believe that the situation is going to improve in the near future. Forty-nine percent of our respondents believe that the residential market will offer the least opportunity for growth over the next five years.

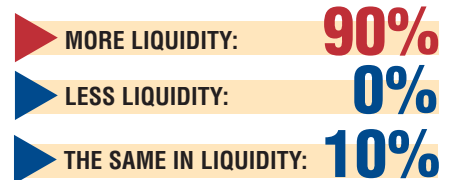
Others mentioned the retail industry specifically as one of the more troublesome segments of the economy: "Slowing retail sales will slow retailer growth, especially in Northeast Ohio," and there has also been a loss of "the retail tenant pool."

Many of the survey respondents conveyed the negative impact that the economy has had on their businesses. One

How respondents feel that the current credit crisis will effect the development industry:



Percent of real estate respondents that feel that banks are asking the borrower for:



respondent stated, "Consumer confidence is the greatest challenge. Companies are hearing all the bad and not taking advantage of opportunities in front of them."

The slow economy has resulted in increased competition for companies in the real estate industry. Much like the results of our construction survey, this increased competition has led to lower property values and ultimately lower profits.

At least one respondent, an adviser to the industry, does believe that there is a light at the end of the tunnel despite the slow economy: "I see businesses growing and have assisted many by educating them on the economic incentives available as well as the benefits of the Economic Stimulus Act of 2008."

The credit crunch

In today's lending climate there has been a heightening of lending restrictions. The majority of our survey respondents (65 percent) were seeing equity demands of 21 to 30 percent, a number higher than what most would have expected in the past.

Additionally, 90 percent of our respondents felt that banks are asking for more liquidity of the borrower than in the past, and 78 percent felt that banks were asking more in terms of a secondary source of repayment from the borrower than in the past. These increased equity and liquidity demands are resulting in a significant slowdown in both deal flow and closings.

Our real estate industry survey respondents also felt that their buyers have been affected by the "credit crunch." One respondent stated, "It is a fight for



every sale. And, then you still have to worry about the buyers obtaining financing even if they have good credit and income.”

Many feel that we may have reached the low point of the real estate market. Only 20 percent of our respondents feel that they will have fewer opportunities in Northeast Ohio in the next three years, while 55 percent feel that they will have more opportunities in the local market.

One respondent's advice is that owners need to think outside of the box in order to be successful in this market: “The real estate industry is changing and landowners need to make the change with the economy. Biofuels and biomedical are just a couple areas that are seeing an emergence in this market, and governmental programs are assisting in this new use of the real estate market.”

Not all of the respondents felt as though the market will recover so quickly. One respondent stated, “Since the population of our region has begun shrinking, it has become increasingly difficult to meet the absorption necessary to profitably develop property for most uses. A reduced number of end users are available to place orders for new homes and tenant spaces as the volume of used, for sale or lease property swells. Add in tighter underwriting and negative public opinion and the impact on new construction and development has shut down many long-standing builder/developers here. Subsequently, durable goods sales are off significantly. As the industries supplying these sectors slow down, employment drops off and we find ourselves in a regional recession. Unfortunately, the demand drivers needed to pull us out of this are going to be difficult to generate, so I expect to see this slump continue for quite some time.” <<

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Smart savings

THE BENEFITS OF COST SEGREGATION STUDIES

Cost segregation studies provide real estate developers an opportunity to uncover significant tax savings in any buildings that they may own or have recently constructed or purchased.

As 59 percent of our respondents were unaware of these benefits, this seems to be an area where many real estate developers may be missing an opportunity. By employing a cost segregation study, we have seen many of our clients have a greater ability to finance a proposed deal because cost segregation will improve the cash flow projections that they can present to the lending institution.

In brief, cost segregation studies utilize an engineering-based approach to classify components of real property to a lesser depreciation life in order to recognize current, future and permanent tax savings.

The classification of assets placed into service in past years can be corrected without the need to amend the prior year's tax returns. Also, the total depreciation adjustment identified for all prior years can be fully recognized in the year of change.

WHERE NORTHEAST OHIO REAL ESTATE RESPONDENTS SEE THEMSELVES IN THE NEXT THREE YEARS:

▶ **55%**

feel their business will have
MORE OPPORTUNITIES
in Northeast Ohio.

▶ **20%**

feel their business will have
LESS OPPORTUNITIES
in Northeast Ohio.

▶ **25%**

feel their business will have the
SAME AMOUNT OPPORTUNITIES
in Northeast Ohio.