Industry Outlook: Construction

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Key Points

1. Overall construction spending is still in a slow recovery and expected to grow moderately at +7% for 2014 and +8% in 2015, but the outlook differs among public and private segments.

2. Public construction is expected to recover slightly (+1% in 2014 and +3% in 2015), due in part to Congress' decision to extend the current highway bill through May 31, 2015

3. Private commercial construction is slowing (+10/11%), but office and hotel investment continue to offer opportunities (approximately +13% /14% in 2014 due to pent up demand)

4. The housing market recovery still faces challenges such as declining home purchases by "young households" (homeowners under age 35 declined from 43.6% in Q2 2004 to 35.9% by mid-2014)

Overview – *Continued Tepid Growth*

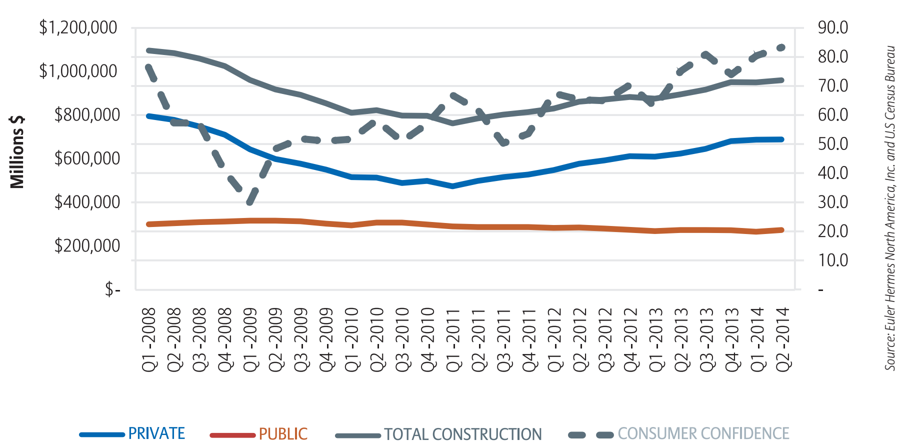
A common barometer to gauge the current state of the economy — construction spending — is linked to a number of key economic indicators such as unemployment, interest rates, and the purchase of durable goods. Since the housing bubble burst in 2007, followed by the credit crisis and subsequent Great Recession of 2007 – 2009, the U.S. economy's recovery has been tepid. One must look no further than homeownership statistics and construction spending figures to reinforce the reality of a slow U.S. economic recovery and a weakened middle class. The good news is total construction spending is expected to grow 7% for 2014 and 8% in 2015.

The U.S. construction sector can be separated into two segments: private and public. Opportunities are apparent in private commercial construction with the strongest growth stemming from office and hotel investment. However, negative growth has been observed the first half of 2014 in public construction (-0.63% for H1 2014), with notable contraction in public safety (-4% forecast for 2014) as federal budgets remain cash-strapped. Although challenged, public spending is expected to turn slightly positive by year-end 2014.

Outlook – *Still a Slow Recovery with Mixed Results*

In Q1 2008, just as the U.S. was in the first several months of what came to be known as The Great Recession, total construction spending (public + private) was approximately $1.1 billion (seasonally adjusted annual rate) and declined 30% to $760 million by Q1 2011. Since this low point, total construction spending has increased 26% to $959 million in Q2 2014, helped by strengthening consumer confidence. However, this is still 13% below the

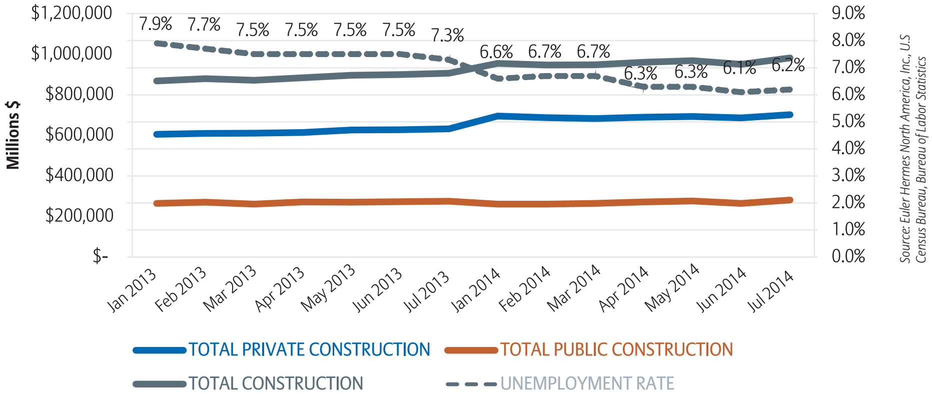
Consumer Confidence and Construction Spending
(Public, Private, seasonally adjusted annual rate)



spending level prior to the recession, and this disparity grows further if compared to the height of the construction boom in the mid-2000's when unemployment was 4.5% – 5.5% (unemployment was 6.2% as of July 2014). Total construction spending is expected to moderately grow at 7% for 2014 and 8% in 2015.

When the two major components of construction spending are examined individually, public construction has shown less volatility since 2008 than private construction spending, and this is primarily due to U.S. Government stimulus packages distributed throughout the country for various infrastructure projects. However, this spending infusion would eventually run its course, and, coupled with constrained municipal and state budgets reducing public construction projects, we have seen a decline through mid-2014. Congress, however, recently extended the current highway bill to May 31, 2015, spurring street and highway spending, providing a slight boost to public construction, which is now expected to grow 1% in 2014 and 3% in 2015.

Construction Spending YTD July 2014 vs. YTD July 2013
(seasonally adjusted annual rate)



Opportunities – *Private Construction Seeing Low Double-Digit Growth*

Private construction contributes over 70% of total construction spending and this is where we continue to see 10%-11% growth. Residential spending continues to grow as homebuilders are increasing housing supply, which in turn has kept home prices from rising rapidly. Interest rates have also declined throughout 2014, further stimulating home purchases. As the unemployment rate declines, we tend to see a correlation with a rise in private construction spending. However unemployment figures have remained stagnant through Q2 and Q3 2014 which has limited the potential growth of private commercial construction to low double-digits (+10% in 2014, +11% in 2015). Nevertheless, as companies gain confidence in expanding operations and leasing additional office space, tremendous opportunities lie within private commercial construction, namely office and hotel investment of approximately 13% – 14% due to pent up demand.

The outlook for 2015 homebuilding is strong, with an expected 14% increase in revenues supported by rising consumer sentiment and above average growth for luxury homes slightly skewing the overall figures.

The most significant contribution to growth in this sector was made by residential multi-family units (5 units or more). In recent years, multi-family units accounted for 25% of all housing

units constructed but in 2014 their proportion rose to 35%. The authorized permit growth of multi-family units through H1 2014 is an impressive 17.5%, versus a more moderate increase of 6.1% for single-family homes for the same period. Two primary factors driving this trend are growth in the young adult population (those with baby-boomer parents) and the same population's declining rate of homeownership. Residential construction growth for 2014 and 2015 is forecasted to be 12%, but, with the potential for slight moderation in 2015, new homeownership continues to remain sluggish.

Challenges – *First-time Homeowners Declining*

Healthy growth in the overall rate of homeownership is not only critical to the recovery of the construction sector, but to the overall U.S. economic recovery as well. With homeownership comes myriad other purchases, such as consumer durable goods like furniture and appliances and light trucks. Unfortunately, first-time homeowners are facing numerous challenges hindering their ability to purchase their first home such as still-tight credit, stagnant wages, growing student debt, and larger down payment requirements. In fact, the median down payment for the cheapest 25% of homes has increased rapidly to 7.5%, or $9,480, in 2013 from an average of 4.2%, or $6,037, between 2001 and 2007. This higher barrier to entry contributed to a $46 billion decline of mortgage originations in Q2 2014 to $286 billion, its lowest level since 2000. Further evidence of a homeownership rate decline is the drop in first-time purchases of previously owned homes to 28% in June 2014 from the historical level of 40%. Homeownership in "younger" households (under age 35) has dropped from 43.6% in Q2 2004 to 35.9% by mid-2014. An additional contributor to this decline is the growing trend of all-cash transactions by investors to purchase homes, further driving up the down payments needed to remain competitive when purchasing a home.

What this Means for Your Business – *Caution in Public Sector, Growth in Private*

Rising consumer confidence, low interest rates, and declining unemployment are driving demand and growth in residential and commercial construction. This will likely yield increased demand for products in other sectors such as building materials and consumer durable goods. However caution must be used extending credit to companies with a large concentration of government customers as public spending declines have become evident in 2014. A credit insurance policy can help safely expand sales while managing the risk associated with the various components of each sector.