

***Construction CFO Roundtable 2008
Media briefing***

In late September, chief financial officers and tax directors from more than 75 engineering and construction firms gathered in Lake Las Vegas to discuss the credit crunch and its impact on their industry. The gathering was hosted by Ernst & Young LLP's Construction practice led by Michael Lucki.

This roundtable can best be described as a “tale of two sectors,” with the engineering and construction sector, which focuses on both vertical construction and infrastructure construction, at a 30-year high in revenue, backlog, and profits, as compared to the homebuilding sector, which is at the lowest level of revenue in 20 years, and at best can be described as being on “life support.”

The roundtable included a survey which asked participants questions related to the credit crisis, the outlook for the construction market in the U.S. and the impact of sustainable building practices on the construction sector. The results of the survey are attached.

The roundtable also included panels and presentations on a wide range of topics related to the sector. Here is a summary of some of the key points identified by Mike Lucki and members of the Construction practice:

OUTLOOK

In 2007, construction companies had their best year for the top line and more importantly, the bottom line since the 1980s. 2008 looks even better, due to a backlog of major construction projects in the works that is at the highest level in 30 years, primarily in the infrastructure and oil and gas sectors. This backlog, in fact, will run through the middle of 2009. CFOs project that revenue could be hit in 2010 because at that point the project backlog is expected to have run its course and project financing requests have tailed off since the onset of the credit crunch. Companies are seeing projects being cancelled due to lack of financing, although this has not yet been overly prevalent.

CFOs report that money for project financing is available for companies building their own facilities, but none is available for developers. CFOs say they are seeing their clients closing some deals, but finance rates are higher than they have been in recent years.

One of the sectors expected to recover from the credit crunch in North America and Europe is infrastructure. CFOs and engineering and construction firms agree that infrastructure funds are liable to remain attractive investments since large scale infrastructure is a relatively secure

and long term asset. There is however, an anticipated slowdown in the infrastructure sector over the next two years.

CAPITAL

However, infrastructure funds will have to do deals with lower leverage. In the past they might carry 70–80% leverage; today that figure is 60-70%, and could go lower before the credit crunch ends.

Banks now want to lend money to the construction and engineering sector because the risk profile of the industry has meant it has always been a low leverage business. Deals have historically been financed at 10–25% debt to equity, which is far lower than in other sectors such as real estate.

M&A

This relatively strong position for the engineering and construction sector means that firms in North America have tremendous free cashflow (from ongoing projects), access to capital (if they want it) and are thus positioned to participate in merger and acquisition activity. Some are even looking overseas for targets.

Individual sectors showing good fundamentals from a construction industry perspective are: infrastructure, commercial construction, process engineering, oil & gas, and chemical. However, valuations are being challenged and have been coming down, which will make sellers less willing to sell.

TAX

Taxing authorities are getting more aggressive in pursuing revenue enhancement, both domestically and internationally. One key area where they are doing so is in transfer pricing. Rules are changing, and some foreign jurisdictions may not accept them, which may lead to more controversy in both international and US markets. This is exacerbated by a significant amount of ambiguity in US rules.

As budgets become tighter, states are also becoming more aggressive in apportioning income, and are taking different approaches to have income apportioned into their states. Economic nexus states are attempting to have some income apportioned into their state that has an economic benefit from work being done in another state. Economic nexus states' income depends on where the customer resides, not where work is done. As a result, companies will end up being taxed in both states for the same income.

Especially sobering were speaker Rob Hanson's comments about the need for major tax and budget reforms to address the gap between projected nondiscretionary spending and tax revenues while making the US more competitive from a corporate tax rate perspective.

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