WHATS IT COST

One of the few positives about the up and down nature of the economy and construction spending is that it has created an environment that offers little support for runaway price inflation. The excess of caution has prevented demand for any commodity from pushing prices to excess. Even with a monetary climate that is ripe for sparking high inflation – with bloated money supply and almost no interest rate – the lack of sustained higher demand will keep inflation for construction material and products at moderate levels.

At the end of 2011, prices for most construction materials will be relatively close to the prices at the end of 2010. For those commodities that did experience increases – steel, cooper and aluminum – the cooling off in the second half of 2011 resulted in year-over-year inflation of between ten and fifteen percent, roughly the increase in 2010. Overall, however, because of those materials and a 30 percent increase in diesel fuel the cost of the materials and products used by construction did go up about eight percent. That's more than double the pace of growth of construction put in place, conditions that contractors will be unable to sustain. And even four percent inflation was enough to put pressure on developers in many markets still deep in a real estate recession.

Looking ahead to 2012, there is little on the immediate horizon that suggests a different scenario in the coming year, except to say that the industry is highly susceptible to changes in the supply and demand dynamics.

Construction's basic materials are all in global demand and so unexpected growth in other markets would push prices higher. Construction is also dependent upon the price of oil, which has proven to be an unpredictable commodity of late. Oil as energy can make the cost to manufacture goods higher, drive the cost of shipping to distribution and jobsites higher and inflate the cost of equipment usage. Building products generally are bulky and difficult to transport and increasing the capacity to supply them is problematic.

While analyzing the factors that would drive inflation yields few likely scenarios at this point, it's important to recognize that the supply chain for construction requires very little disruption – especially after a period of contraction – to send prices much higher.

As 2011 ends, however, there is no reason to suspect that demand for more construction is going to spike and cause disruption. Non-residential construction is being restrained by an overhanging supply of commercial buildings, limited government spending and balky financing conditions. And the industry's largest sector – housing – shows no sign of rebounding in 2012.

These market realities make it difficult for manufacturers and suppliers to get pricing leverage. Perhaps nothing better illustrates this than the drywall manufacturers. For the third consecutive year the gypsum board industry has notified customers of its intention to raise prices. Increases of 20 percent were implemented without success in 2010 and 2011, both times owing to the depressed demand for wallboard due to depressed residential construction, compounded by the steep decline in commercial work. This time

the manufacturers have stepped up the increase to 35 percent, with the expressed intent of maintaining that pricing level throughout 2012. USG and National Gypsum both took pains to explain the rationale and each also announced the discontinuation of quoting prices during bidding and guaranteeing prices after October 15.

While the manufacturers' frustration is understandable – these companies have lost money for more than four years and laid off thousands – without changes in the supply and demand dynamics it is unlikely that these price increases will stick in 2012. Drywall makers have continued to shutter plants and reduce line capacity but there is little on the horizon to suggest that supply will be constrained, at least not to the point of supporting 35 percent increases. And no economic scenario supports a 35 percent increase in demand for drywall in 2012.

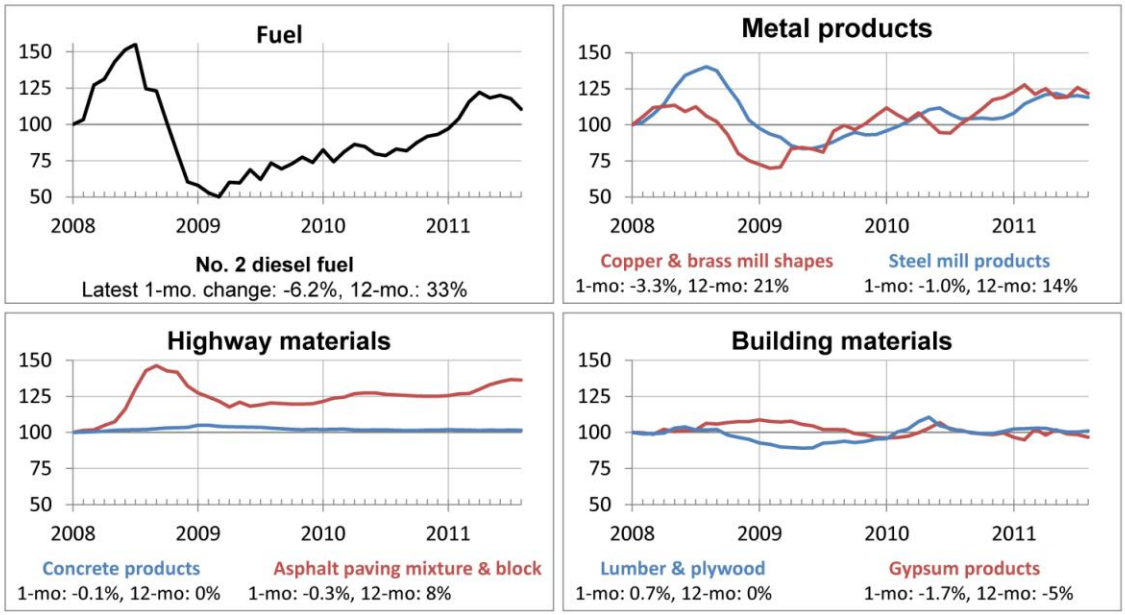
For gypsum board makers, as well as most manufacturers, the prospects for getting higher prices through the market will not improve until a more robust recovery in construction consumption occurs, something that isn't going to occur until the new housing market begins to grow again.

Of bigger concern for project owners and developers looking at 2012 should be the pricing squeeze that contractors and specialty subcontractors have experienced during the past two years. Most experts predict that construction inflation will remain in the six to nine percent range for the next couple of years, but that rate of inflation is unlikely to be absorbed by contractors. Recessionary pressures on construction have been in place for three years and 2012 may well be the year that contractors respond by passing costs along. Unusually competitive markets – like those that existed in the 1970's – inspire more efficiency and higher productivity. They can also eventually result in higher rates of contractor failure. The prudent course for owners in 2012 would seem to be to plan for higher cost increases than the past few years have produced and be prepared to act on a surprise if the market gives money back. Planning for another tight market in 2012 looks to be a higher risk.

PERCENTAGE CHANGES IN COSTS	Sept 2011 compared to			
	1 mo.	3 mo.	1 yr.	Dec. '03
Consumer, Producer & Construction Prices				
Consumer price index (CPI-U)	0.2	0.5	3.9	23.1
Producer price index (PPI) for finished goods	0.5	0.5	6.9	33.2
PPI for construction	0.0	-0.2	8.1	49.3
Costs by Construction Types/Subcontractors				
Residential buildings	0.0	-0.1	6.7	40.0
New industrial building construction	0.1	1.2	2.2	N/A *
New warehouse construction	0.0	1.2	2.8	N/A *
New school construction	-0.1	0.9	3.0	N/A *
New office construction	-0.1	1.0	2.6	N/A *
Concrete contractors, nonresidential	0.0	0.7	-0.2	N/A *
Roofing contractors, nonresidential	0.0	0.6	3.1	N/A *
Electrical contractors, nonresidential	-0.1	1.3	3.6	N/A *
Plumbing contractors, nonresidential	-0.1	0.7	2.5	N/A *
Costs for Specific Construction Inputs				
#2 diesel fuel	3.3	-4.9	39.4	223.5
Asphalt paving mixtures and blocks	-0.1	0.8	8.4	114.0
Concrete products	0.2	0.2	0.3	36.0
Brick and structural clay tile	-0.4	-0.5	-3.2	14.8
Plastic construction products	-0.5	-0.1	6.3	45.7
Gypsum products	-1.7	-3.9	-4.6	11.2
Lumber and plywood	-1.3	-0.7	-0.4	-9.6
Architectural coatings	0.1	0.2	5.3	52.1
Steel mill products	-0.6	-1.0	13.5	93.7
Copper and brass mill shapes	-0.7	1.4	14.8	192.5
Aluminum mill shapes	-1.8	-4.2	10.4	32.3
Fabricated structural metal	-0.3	0.2	4.2	42.6
Prefabricated metal buildings	-2.0	-2.2	10.4	91.6
Crude petroleum (domestic production)	14.5	-1.4	33.2	231.2
Asphalt (at refinery)	-4.9	-4.2	23.1	264.9
Cement	1.3	-1.4	-1.5	24.9
Iron and steel scrap	0.8	1.1	20.7	180.3
Copper base scrap	1.8	-1.5	18.6	324.7

Source Bureau of Labor Statistics, Updated October 15, 2010
Compiled by Ken Simonson, AGC Chief Economist
** Data for this series was unavailable prior to 2010*

Producer Price Indexes for Key Inputs
1/08-8/11 (January 2008=100)



Source: Ken Simonson, Bureau of Labor Statistics