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Rx for an Ailing Economy

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Equipment dealers are as anxious as anyone to understand how the economy affects them and what can be done about it.

The construction industry and equipment dealerships are experiencing specific symptoms brought on by the general economy's infirmities:

The end of September 2008 brought three consecutive quarterly declines in business purchases, which hasn't occurred for five years. The impact on the construction equipment market, according to Citi Investment Research's 3Q08 Global Construction Dealer Survey, is a projected 13.3 percent decrease in unit sales for 2008. "We see North America industry volumes down 4 to 5 percent in 2009, the fourth consecutive decline," wrote Citigroup analyst David Raso.

"The weak U.S. dollar and strong international markets have been a solid profit source and relief valve for used equipment inventories for U.S. dealers, particularly those on the east and west coasts," Raso wrote. "The recent rally in the U.S. dollar and softening international markets could cause U.S. used equipment inventory to rise, lengthening the healing process of a market already down three years." He also stated, "Likely to add to this pressure is word that the major U.S. rental houses are likely to go into a more significant 'fleet reduction mode' in 2009."

For the third quarter of 2008, prices of used equipment in North America were 2 percent lower than during the same quarter of the previous year (a comparison called year-over-year, or y-o-y). It was the seventh consecutive quarter for y-o-y price declines. Y-o-y new equipment prices, on the other hand, rose 2.6 percent in the third quarter of this year. That's twice as much as the second quarter increase, and it marks 23 successive quarters of higher new equipment prices compared to the same period of the previous year.

A severe downturn in residential construction followed by a lack of need for public works projects to serve new residences have reduced construction activity.

"Rental equipment is directly related to actual activity and utilization of fleets," said Eli Lustgarten, senior research analyst with Longbow Research. "Both [sales and rental] markets are going to feel the pressure, and production is going down, and demand will go

Examining the Symptoms

“You basically talk about the construction business in two different buckets. There’s the residential bucket, and then there’s the nonresidential bucket,” said Ron Riecks, general manager of Wells Fargo Construction.

Historically, he said, there’s a pattern of residential construction slowing down for a year or two while construction surges on things like schools, hospitals, shopping centers, and roads. Then, nonresidential construction slows down as residential activity picks back up. But an extended malaise in residential construction is lengthening this normal cycle.

“Nonresidential has been pretty robust through probably the first half of 2008, but those projects are coming to an end, and there isn’t much on the books for 2009,” Riecks said. Some publicly funded projects have their own set of woes, as well.

“Tax revenues are down, which impacts public financing of infrastructure, so those projects have either been cut back considerably or postponed,” said Tony Perrone, a principal in FMI’s Investment Banking practice. “Many projects, especially the more discretionary ones in the private building market, have been either postponed or cancelled because they just haven’t been able to get the money.”

Those observations are bolstered by FMI’s 2009 Construction Outlook report, in which construction economist Heather Jones states, “Project delays are 2.2 times the normal rate and are currently at 17 percent. Project cancellations are 2.5 times the normal rate and are currently at 9.9 percent. Contractor backlogs are also getting shorter.”

But don’t jump off any tall buildings just yet. “The good news is public construction, especially for highways, bridges, and water and wastewater treatment facilities, should continue to be good – not great, but at least they’ll be positive, we expect, over the next couple of years,” Perrone said.

And the widely publicized credit crisis is not a limiting factor in the construction equipment market, according to Riecks.

“There really isn’t any shortage of credit today for dealers that are experienced and have been in business and have a track record and make money,” Riecks said. “There are still people actively lending to dealers and contractors. We have money to lend, and we’re still losing transactions every day, meaning a competitor is doing them instead of us.”

Credit is still a factor in funding construction projects, however. “The ugly year [2010] has a slight chance of not being so ugly if the government’s fiscal policies actually work and credit unfreezes before backlogs run out and delayed projects fill in the gaps while new projects are brought into the pipeline,” Jones wrote.

Prescriptions for Progress

“We’re pushing a three-pronged approach to economic stimulus,” said Christian Klein, AED’s vice president of Government Affairs. The three initiatives are aimed at creating jobs, encouraging purchasing by businesses, and shoring up the residential housing

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“There are three very good arguments for infrastructure investment,” he said. “First of all, it will have an immediate impact on the economy.” He points to 3,000 highway projects totaling \$18 billion that have already been engineered and are ready for construction as soon as money is available, according to the American Association of State Highway and Transportation Officials.

In addition, the National Association of Clean Water Agencies has identified \$3 billion in sewer projects awaiting funding, and they estimate the number nationally amounts to \$10 billion. Implementing these projects quickly would immediately create jobs in the construction industry, where the jobless rate is now 10.8 percent. Furthermore, an inadequate infrastructure poses an ongoing threat to the nation’s economy.

According to a National Chamber Foundation report, “Transportation infrastructure is vital to the success of the five major economic sectors that account for 84 percent of the U.S. economy: services, manufacturing, retail, agriculture and natural resources, and transportation providers.” The Foundation forecasts a \$1 trillion shortfall in meeting the country’s transportation needs between 2005 and 2015. An infrastructure stimulus program would help close that gap.

The second program Klein and AED are promoting is a one-year extension of the depreciation bonus and increased Section 179 expensing levels authorized by the 2008 Economic Stimulus Act (ESA). A combination of these benefits with infrastructure construction funding would be a powerful economic boost.

“The Economic Stimulus Act gives companies an incentive to buy,” Klein said, “and the infrastructure stimulus would give them a reason to buy.” In fact, a summer 2008 AED survey found that one-third of the respondents had taken advantage of the ESA benefits, and more than three-fourths of the respondents said they would be more likely to buy additional equipment in 2009 if the incentives were extended.

The third facet of AED’s economic stimulus recommendations involves strengthening the housing market. In July 2008, Congress passed legislation authorizing a \$7,500 refundable tax credit for first-time home buyers. “Now we need to do something more dramatic because the housing market isn’t turning around, and we see the consequences of the downturn in the housing market creeping into all these other parts of the economy,” Klein said.

AED proposes extending that program and expanding it to anyone who buys a primary residence. Klein describes the \$7,500 tax credit, which would have to be repaid over 15 years, as “basically an interest-free loan from the government.” He stresses that the program offers not only a direct economic impact by shoring up the housing market, but it also stimulates consumer confidence.

“If people see the value of their homes go down, that affects their psychological outlook on

Doctors' Orders

According to Jones's analysis, nonresidential construction will end its five-year growth trend this year. "The bad [news]: 2009 will bring an end to the cycle with a significant downturn in growth," she wrote. "Continued losses in 2010 and 2011 will be off of the large downturn of 2009. The bottom in terms of dollar volume will likely be between 2010 and 2012."

Raso's survey report also predicts ongoing economic declines. He wrote, "The weakening tone in dealer conversations as the survey work unfolded and even weakening data responses toward the end of the data collection suggest North America finding a bottom anytime soon is still a hope, not a reality."

So, what should dealers do to ride out the slow times?

"Cost control is a big item," Perrone said. "Downsizing is the unfortunate part of the cyclical industry that we're in, but you don't want to lose core staff."

"Focus on aftermarket business, because what's going to happen in many cases is instead of buying equipment, people are going to use what they have longer, and that requires service," Lustgarten said.

"My advice is, make sure that you've right-sized your inventory," Riecks said. "Make sure you've right-sized your rental fleet. Make sure that you've financed yourself appropriately for the current environment, which to me means more long-term financing than short-term financing."

He also suggests looking for ways to help customers with their problems. For instance, a contractor may have an aging fleet that is larger than he needs at this time. "You might be able to create a sales opportunity for yourself by taking a bunch of his older equipment in on trade and selling him a smaller number of newer pieces," Riecks said. "The new equipment will have less maintenance costs, it will be more productive, and his general cost of ownership will be lower."

Jeff Lefebvre, a management trainer and consultant who founded PriSim Business War Games, stresses the importance of leadership.

"Owners need to really push on leadership characteristics, in terms of making people feel more comfortable, motivating people about what the future is, painting a good picture for what things will look like after we come out of the end of this thing," he said. "As a leader, you need to get people off of the worrying, because there's no value in it." During slow business times, employees have more time on their hands. "Give them some projects that are more strategic as opposed to operational," Lefebvre suggested. "Have them talking to customers, have them improving processes that perhaps were not working efficiently, have them participating more in planning for what the business is going to do when things do turn around."

“It’s tough to find buyers. Everybody is holding back on making those kinds of investments because of the uncertainty in the overall economy,” he said. “If you do find a buyer, you’re not going to get the price that you should be getting in this kind of environment.”

Prognosis

“We believe what’s going on in the financial markets has the characteristics of a spasm,” Lustgarten said. “Remember, spasms, if you don’t treat them, can be very, very dangerous. But hopefully, the massive capital infusion and massive bailout that’s under way will begin to have effect and alleviate the crunch that’s strangling the domestic economy and the credit markets today.”

Klein is optimistic about seeing AED’s three stimulus proposals enacted. “There’s growing recognition about infrastructure stimulus; that seems to have a lot of traction at this point,” he said. “We’re getting very positive feedback with everyone we’ve spoken to on the Hill about the Economic Stimulus Act extension. Congress likes it because it has immediate-term impact but doesn’t have as big a long-term impact on the federal budget.”

As for the third proposal, he said, “[Congress] recognized the wisdom of doing something on the home purchase tax credit last year. We’re going to make the point that things are worse than we thought and not really showing signs of improvement, so let’s do something very dramatic to get the housing market back on track.”

Taking a long-term view, Lefebvre said, “We know that people are still going to need to drive and be transported around the country in the next five or 10 years. We know that people are still going to need offices and houses. We now have this hiccup, but the primary drivers of demand are still going to be there, and will be there well into the future.”

Statistics cited by Jones support that premise: The United States’ population is expected to grow by 100 million people between 2006 and 2039.

Lefebvre said, “I think the companies that are going to be best off in 2010 or 2011 are those that spend 2009 better preparing for the turnaround that inevitably is going to come.”

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