Success factors in the construction industry in 2004

> Industry radar – Findings of the trend survey

Munich, June 2004
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A.

The big picture
A.1

The big picture –
Objectives, methods and industry trends
The decline in the German construction industry is now entering its ninth year. EU enlargement is creating an increase in supply, while the sustained recession and empty public coffers are causing a drop in demand. Companies in the construction industry are thus facing new and varied challenges: What success factors do they need to take to heart in the future, how can they differentiate themselves from their competitors and what issues do they need to address? To find the answers to these questions, the Construction Practice Group at Roland Berger Strategy Consultants conducted a Europe-wide study of the success factors in the construction industry in 2003. Due to the positive response, the study was updated and expanded for the German construction market in 2004. The key questions are: Which factors will determine success and failure in the future? In what areas is action urgently needed?
Outlook for the German construction industry: Comparison and importance of success factors for the future (2)

- From February to March 2004, questionnaires were sent to managers of the 30 largest construction companies in Germany (sales of EUR 200 m to EUR 12 bn) – the above-average return rate of around 50% shows that there is significant interest in this issue.

- Once again, the participants assessed past and future conditions, as well as success factors and the extent to which they have been achieved. In addition, the current study examines in greater detail those success factors that were deemed particularly important in the 2003 study.

- The survey findings make it possible to compare the development of conditions and success factors in Germany and to point out where action is needed in the industry.
Participants include 10 of Germany's top 15 companies – and thus some of the country's key decision makers

- Of the 29 companies we approached in the construction industry, a total of 14 participated in the study – the approximately 50% return rate bolsters the meaningfulness of the responses. Of the 15 largest construction companies, 10 took an active role in the trend study.

- The findings of the industry radar are also particularly meaningful because they are based on interviews with top executives – 77% of the respondents are members of the management board or executive management, and 23% are department heads.

### 2003 STUDY

- Member of mgt. board/mg. dir.: 25%
- Department head: 21%
- Other: 54%

### 2004 STUDY

- Member of mgt. board/mg. dir.: 77%
- Department head: 23%
The crisis is entering its ninth year – Order books in the German construction industry are declining 6.7% p.a. on average ...

Incoming orders in the construction industry (operations with > 20 empl.) [EUR bn]

Source: Hauptverband der deutschen Bauindustrie
... resulting in a steady decline in sales – However, the downward trend does appear to be slowing

Construction sales trend (operations with > 20 empl.) [EUR bn]

Residential construction
- 1998: 20.0
- 1999: 19.2
- 2000: 16.5
- 2001: 12.9
- 2002: 11.0
- 2003: 10.2

Business construction
- 1998: 30.1
- 1999: 30.6
- 2000: 29.4
- 2001: 28.8
- 2002: 26.3
- 2003: 24.2

Public construction
- 1998: 25.3
- 1999: 25.8
- 2000: 25.1
- 2001: 23.9
- 2002: 22.7
- 2003: 22.1

Percentage change 1998-2003
- Residential construction: -49%
- Business construction: -20%
- Public construction: -13%

Source: Hauptverband der deutschen Bauindustrie
Once again, it is assumed that there will be a slight increase in the near future – particularly in modernization activity

Construction volume forecast for 2004-2006 [EUR bn]

<table>
<thead>
<tr>
<th>Segment</th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
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</thead>
<tbody>
<tr>
<td>Residential construction</td>
<td>108</td>
<td>110</td>
<td>113</td>
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<tr>
<td>Building construction (excl. residential)</td>
<td>50</td>
<td>50</td>
<td>51</td>
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<tr>
<td>Civil engineering</td>
<td>31</td>
<td>31</td>
<td>32</td>
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</table>

+1.8% p.a.

<table>
<thead>
<tr>
<th>Activity</th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
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<tbody>
<tr>
<td>New construction</td>
<td>88</td>
<td>89</td>
<td>91</td>
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<tr>
<td>Renovation, modernization</td>
<td>101</td>
<td>102</td>
<td>105</td>
</tr>
</tbody>
</table>

+1.7% p.a.  

+1.9% p.a.

Source: Euroconstruct (11/2003)
A.2

The big picture – Summary of findings
The German construction industry is becoming increasingly proactive – Survival strategies alone are no longer enough (1)

• Despite a slight improvement, the conditions for companies in Germany will remain rather poor in the future (-0.6 on a scale of -2 to +2) – particularly the private sector is expected to continue to have a positive impact (+0.2)

➔ The trends for these conditions allow us to derive a market cycle. Most of the companies believe that the trough has nearly been reached – the conditions are seen as being less negative in the future

• The companies are hoping that particularly private sector investment will have a positive impact

➔ However, the anticipated light at the end of the tunnel, at least in the form of market stagnation, will not bring long-term relief

➔ Increasing competition resulting from EU enlargement (e.g. wage cost advantages) and the continued lack of project pre-qualification (the obligation to provide proof of ability to perform) will boost supply, while empty public coffers and the increase in offshoring by German companies and the attendant investments will reduce demand
The German construction industry is becoming increasingly proactive – Survival strategies alone are no longer enough (2)

- Unlike in the past, German construction companies intend to be less conservative. Key success factors cited are strategic approaches (e.g. innovation ranked 9th in 2003, but took 4th place in 2004). In addition, factors that previously played only a small role, such as employee development, are becoming increasingly important (not mentioned in 2003, 1st place in 2004)

  ➔ German construction firms should rigorously pursue this avenue. Companies that have survived the drastic decline in construction activity have clearly passed the "required" elements – the "freestyle" portion is logical next step to achieve sustainable success

- Not only did the firms recognize the importance of strategic success factors, they openly admit that the need for action is particularly high

  ➔ According to the study, the firms are focusing their activities on implementing the success factors – and it appears to be more than just "lip service" (only a few of the success factors have been less than 50% achieved)

  ➔ The firms are out of the "intensive care unit" and have moved on to the rehabilitation stage, to actively prepare to deal with the future market and competitors
The German construction industry is becoming increasingly proactive – Survival strategies alone are no longer enough (3)

- The success factors that were deemed particularly important in 2003 reflect this assessment. Deficits in strategic success factors were recognized
  - Of the companies surveyed, 80% see a need for more developed risk management (2003: 1st place, 2004: 2nd place), from the basic requirements to comprehensive risk management as a key management tool
  - Employee development (not mentioned in 2003, 1st place in 2004) was cited as the most important success factor in the study 2004. 92% of the companies surveyed already conduct staff evaluations. The deficits are clear: particularly motivation and advanced training are the major problem areas for the future

  The companies feel that the elemental success factors for operations have been sufficiently achieved. The emphasis on long-term success factors, and especially the focus on the essential capital of every construction company – qualified, motivated staff – show that firms are beginning to think long term again. Survival strategies alone are no longer enough
B.

Light at the end of the tunnel –
Companies see conditions as less negative
Light at the end of the tunnel – Companies see the conditions as being less negative

Development of conditions

• While companies do not see the conditions affecting the construction industry as being positive in the coming years, they do see them as being less negative:
  – They hope for positive impact particularly from the private sector
  – They fear that the public sector will continue to be the greatest drag on growth
  – They suspect that economic policy, legislation and price competition change little within the industry

• The companies assess the impact of the individual conditions quite similarly – just two companies had a significantly different view

• Remark: The study reflects the current situation 1:1
  – Empty public coffers (decreasing tax revenues, belt tightening, toll disaster)
  – Stagnating economy, price competition, lack of pre-qualification
Companies view the conditions for the future less negatively and are counting on the private sector

Importance of individual conditions

<table>
<thead>
<tr>
<th>CONDITIONS</th>
<th>PAST IMPACT</th>
<th>FUTURE IMPACT</th>
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<tr>
<td>Public-sector investment</td>
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<td>Private-sector investment</td>
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<td>Economic policy</td>
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<td>Legislation</td>
<td>(standardized)</td>
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<td>Price competition within the industry</td>
<td>(standardized)</td>
<td>(standardized)</td>
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</table>

Source: Roland Berger Strategy Consultants
Most companies believe that the trough has nearly been reached

The conditions define the position in the market cycle

Source: Roland Berger Strategy Consultants
C.

**Focusing on problem areas** – Companies have identified the most important success factors and the need for action
Focusing on problem areas – Companies have identified the most important success factors and the need for action

**IMPORTANCE OF THE SUCCESS FACTORS**

- The success factors have changed little compared to 2003

- The **most important factors** cited are
  - Employee development
  - Effective risk management
  - Innovation
  - Partnerships with customers
  - Lean organizational structure

- Key success factors were rated quite similarly – opinions diverge more for less important success factors

- Only a few criteria for success are met less than 50% – companies appear to fulfill them to a great extent

**ACTION NEEDED FOR THE SUCCESS FACTORS**

- The action needed for the individual success factors can be derived by combining their importance and the extent to which they have been achieved

- The **greatest need for action** and thus pressure to act is seen for
  - Establishing operator models as a segment
  - Long-term partnerships with customers
  - Innovation
  - Expanding into new countries (Eastern Europe)
  - Ability to modernize existing property portfolios
Employee development, risk management and innovation are seen as the key success factors – Slight change over 2003

Importance of success factors in the next 5 years – 2003 vs. 2004

<table>
<thead>
<tr>
<th>Unimportant</th>
<th>1</th>
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<td>Employee development</td>
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<td>Effective risk management</td>
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<td>Innovation</td>
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<td>More long-term partnerships with customers</td>
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<td>Performance-based payment for management</td>
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<td>Cost-cutting</td>
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<td>Credit management</td>
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<td>Establishing operator models as a segment</td>
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<td>Expanding into new countries – Eastern Europe</td>
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<td>Pulling out of unprofitable regions</td>
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<td>Producing less in-house/outourcing more</td>
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<td>More long-term partnerships with subcontractors</td>
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<td>Organic growth</td>
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<td>More long-term partnerships with materials suppliers</td>
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<td>Diversification (e.g. adding new business areas)</td>
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<td>More long-term partnerships with competitors</td>
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<td>Marketing/PR work</td>
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<td>Growth through acquisition</td>
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Source: Roland Berger Strategy Consultants
In 2004, the greatest need for action is seen for operator models, partnerships with customers and innovations

Action needed based on importance and extent to which the success factors have been achieved

Establishing operator models as a segment
More long-term partnerships with customers
Innovation
Expanding into new countries – Eastern Europe
Ability to modernize existing property portfolios
Employee development
More long-term partnerships with subcontractors
More long-term partnerships with competitors
Specialization (e.g. business streamlining)
Growth through acquisition
Performance-based payment for management
More long-term partnerships with materials suppliers
Expanding into new countries
Marketing/PR work
Lean organizational structure
Effective risk management
Pulling out of unprofitable regions
Producing less in-house/outsourcing more
More flexible working hours
Organic growth
Diversification (e.g. adding new business areas)
Cost-cutting
Credit management

Source: Roland Berger Strategy Consultants
The companies differ greatly in how satisfied they are with themselves – Some have very high standards, others very low

Action needed based on calculations of the participating companies

Source: Roland Berger Strategy Consultants
D.

Major problem areas in detail – How companies have dealt with the most important success factors in the past
D.1

Risk management – Pleasure or pain?
Risk management – Pleasure or pain?

Risk management

• More than 90% of the companies have introduced qualitative and quantitative operational risk management

• However, they need to work on strategic risk management – just 40% of the companies are introducing a system for qualitative aspects, and 30% for quantitative aspects – or do not yet have one

• Specific refinement of risk management is needed for
  – Strategic aspects
  – Quantifying risks
  – Establishing risk management in the organization
  – Introducing risk management as a systematic tool
Most companies have a risk management system for operational risks – But they lag in strategic risk management

Current state of risk management [% of responses]

- Strategic Risks
  - Qualitative Tracking (risk report for offers and projects)
  - Quantitative Tracking (assessment and comparison of risks)

- Operational Risks
  - System in place
  - System being introduced
  - No system in place
  - No system needed

Source: Roland Berger Strategy Consultants
D.2

Employee development –
An increasingly important factor in a challenging environment
Employee development is becoming increasingly important, particularly in difficult economic climates

Employee development

• All companies surveyed consider regular and systematic staff evaluations to be essential

• Evaluation procedures are already in place for around 90% of operational staff and about 80% of administrative staff

• Nearly all of the companies surveyed offer their employees the option of variable compensation
  – Operational staff (71%) are more than twice as likely to have a variable salary component as administrative staff (29%)
  – The key criteria for defining the variable portion are earnings (50%) and performance (29%), as well as qualitative agreements (17%)

• Additional action needed in terms of employee development is complex – deficits affect primarily motivation and advanced training
Primarily operational staff have can opt to receive variable compensation – Usually based on earnings and performance

Employee development (motivation) [% of responses]

Options for variable compensation

| Criteria for Defining the Variable Portion

---

**Options for Variable Compensation**

Is offered | 92

Is not offered | 8

**Employees Groups Affected**

- Administrative staff
  - 29
- Operational staff
  - 71

**CRITERIA FOR DEFINING THE VARIABLE PORTION**

- Qualitative agreements
  - 17
- Performance
  - 29
- Other
  - 4

Source: Roland Berger Strategy Consultants
The action needed in terms of employee development is complex – Primary deficits are in motivation and advanced training

Greatest need for action in terms of employee development [Company responses]

• **Focus on success** (belief in success despite market trend)
• MbOs on all levels
• Motivation
• Employee development and training
• Integration and innovation
• Faster adaptation to new conditions
• Qualification and training
• Methodological and management training
• Improving company communication
• "To little innovative knowledge, willingness to change"
• "It takes much too long for employees to develop a realistic picture of their own performance and really become capable of learning"
• Employee development "... needs to be tailored to every employee"

**CONCLUSION:**

• Motivation and focus on success are the key drivers of future success
• Comprehensive but customized advanced training must be made possible and carried out

*Source: Roland Berger Strategy Consultants*