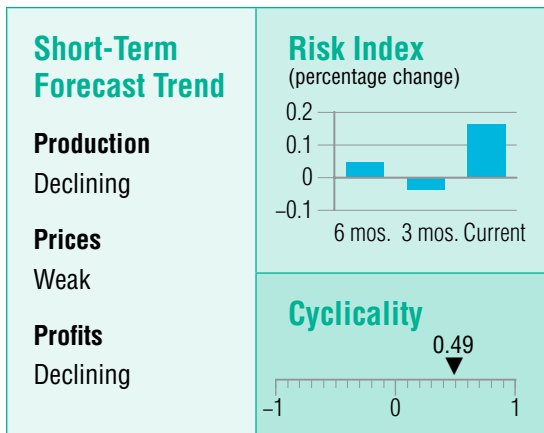




## Canada's Residential Construction Industry



### KEY ISSUES

- ↓ **Mortgage Rules**—Last year's regulatory changes on mortgage conditions are slowing buying intentions, especially among first-time buyers.
- ↓ **Uncompleted Work**—The number of condo units under construction has increased, but completed work is lagging. This suggests that developers may be having difficulties pre-selling their units.
- ↑ **Stable Prices**—Home prices have remained firm so far, despite weaker sales.

### KEY INDICATORS

	2009	2010	2011	2012f	2013f	2014f	2015f	2016f	2017f
<b>Real GDP</b> (2002 \$ millions)	20,881	23,348	23,737	25,306	25,179	25,140	25,965	26,939	27,886
	<i>-9.4</i>	<i>11.8</i>	<i>1.7</i>	<i>6.6</i>	<i>-0.5</i>	<i>-0.2</i>	<i>3.3</i>	<i>3.8</i>	<i>3.5</i>
<b>Employment</b> (000s)	524.8	589.7	591.6	598.7	584.4	582.9	594.0	609.5	624.2
	<i>-6.2</i>	<i>12.4</i>	<i>0.3</i>	<i>1.2</i>	<i>-2.4</i>	<i>-0.3</i>	<i>1.9</i>	<i>2.6</i>	<i>2.4</i>
<b>Price index</b> (2002 = 100)	138.8	141.9	145.0	148.4	149.0	150.3	154.1	157.6	161.2
	<i>-2.3</i>	<i>2.2</i>	<i>2.2</i>	<i>2.3</i>	<i>0.4</i>	<i>0.9</i>	<i>2.5</i>	<i>2.3</i>	<i>2.3</i>
<b>Revenues</b> (\$ millions)	104,442	115,423	118,862	130,847	130,793	131,699	139,427	147,982	156,657
	<i>-2.1</i>	<i>10.5</i>	<i>3.0</i>	<i>10.1</i>	<i>0.0</i>	<i>0.7</i>	<i>5.9</i>	<i>6.1</i>	<i>5.9</i>
<b>Costs</b> (\$ millions)	99,623	110,138	114,242	125,868	127,451	128,277	135,337	143,187	151,470
	<i>-1.3</i>	<i>10.6</i>	<i>3.7</i>	<i>10.2</i>	<i>1.3</i>	<i>0.6</i>	<i>5.5</i>	<i>5.8</i>	<i>5.8</i>
<b>Profits before taxes</b> (\$ millions)	3,547	3,969	3,195	3,873	3,342	3,421	4,090	4,796	5,186
	<i>-22.0</i>	<i>11.9</i>	<i>-19.5</i>	<i>21.2</i>	<i>-13.7</i>	<i>2.4</i>	<i>19.6</i>	<i>17.2</i>	<i>8.1</i>
<b>Profit margin</b> (per cent)	3.4	3.4	2.7	3.0	2.6	2.6	2.9	3.2	3.3

f = forecast

*Italics indicate percentage change.*

## CURRENT ENVIRONMENT

The residential sector is expected to cool this year and next. Housing starts were stronger than expected last year but dropped in the final quarter. Changes were driven by the multiple units segment, while the single-detached segment was relatively stable. Construction spending will remain firm through the first half of the year, as units that were previously started are completed and demand for renovation continues to be the major source of revenues, but a drop is expected later this year. Total spending on residential construction is expected to decline by about 2.1 per cent this year.

Some macroeconomic factors today are positive for the industry, such as steady job gains, better consumer credit conditions, and low interest rates. But these factors will not be enough to counter a correction in the housing market. Supply has been especially strong in the last few years, and that has exhausted demand. As well, the new mortgage rules implemented last summer are making it harder, especially for first-time buyers, to get access to credit.

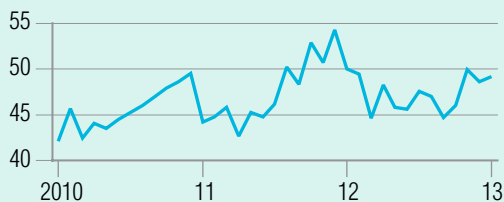
The combination of lower spending and higher costs will see industry profits drop to an eight-year low this year, but they should recover fully before the end of the forecast period. Over the longer term, the multi-units segment will continue to be the main driver of construction growth in Canada, which may help builders limit the impact of rising lumber prices as the U.S. housing market revives. Builders' flexibility when it comes to hours worked and materials used will save the industry from seeing its profit margins drop further.

## MACROECONOMIC DRIVERS

1

### Consumers Growing More Cautious About Making Major Purchases

(share of survey respondents who said now is a bad time to make a major purchase, per cent)



Source: The Conference Board of Canada.

Many macroeconomic factors are positive for the residential construction sector. Most importantly, consumers have improved their credit situation and the job market continues to post healthy gains. As well, interest rates are not expected to increase in the next year. That's because inflationary pressures will remain weak as economic activity remains below potential in most developed countries. On the other hand, builders will face higher input prices as the U.S. housing market revives and demand for major material inputs intensifies.

### Canadian Consumers

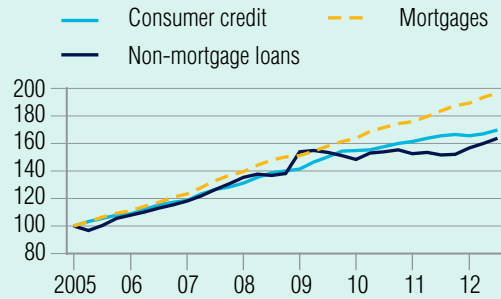
Even though the Canadian economy is heading toward a couple of years of modest growth, consumers remain in a fairly stable position. Around 200,000 new jobs were created last year, and the unemployment rate in December was 7.1 per cent, the lowest in four years. Consumers are feeling more optimistic; our Index of Consumer Confidence gained 5.1 points in January to reach 83 (2002 = 100), bringing the index to its highest point since June 2011. The gain was driven by improving confidence in future job and income prospects, but this was offset slightly by continued reluctance to make a major purchase, such as a home or a car. Indeed, 49.2 per cent of consumers surveyed said that now is not a good time to make a major purchase. (See Chart 1.)

The Bank of Canada has been warning consumers for several years now about their high debt levels, saying many are in no position to cope with the eventual increase in interest rates. The message has seemingly been heard, as consumers have slowed their acquisition of new credit, especially consumer credit and loans other than mortgages. Between 2005 and 2010, consumer

## 2

### Consumers Continue to Take on More Debt, but at a Slower Pace

(index, 2005Q1 = 100)

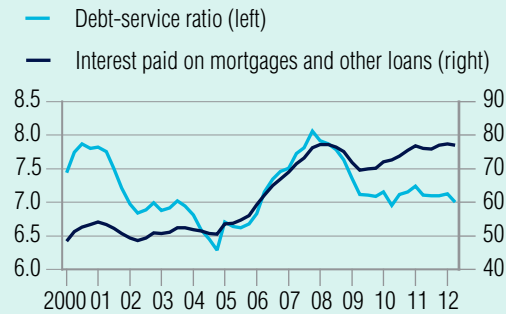


Sources: The Conference Board of Canada; Statistics Canada.

## 3

### Cost of Carrying Debt Falls

(debt-service ratio, per cent; interest paid, \$ billions)

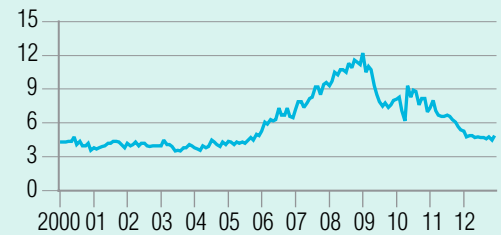


Sources: The Conference Board of Canada; Statistics Canada.

## 4

### Inventory of New Houses for Sale Has Fallen Sharply in U.S.

(months of supply at current sales rate, seasonally adjusted)



Sources: U.S. Census Bureau; The Conference Board of Canada.

credit, which is mostly credit cards, increased by an average of 8.5 per cent a year and other loans were up an average of 8.7 per cent. From 2010 to the third quarter of 2012, consumer credit increased by 3.2 per cent a year and other loans rose 2.4 per cent a year on average. Mortgage debt, on the other hand, has increased by an average of 6.7 per cent per year since 2010, likely supported by consumers who want to upgrade or acquire a home before interest rates rise. (See Chart 2.) As a result of the slower pace at which consumers have been acquiring credit and the still very low interest rates, the consumer debt-service ratio, which indicates how much it costs consumers to carry their debt, has improved once again. (See Chart 3.)

### Interest Rates

In its most recent *Monetary Policy Report*, the Bank of Canada announced that it would maintain its overnight target rate at 1 per cent, which was expected. However, the Bank has changed its tone regarding upcoming increases, noting that its growth and inflation forecasts have weakened. In the last couple of years, Governor Mark Carney has always clearly stated his intention to raise the policy rate in the near future; but in the January 23 report, his tone regarding an upcoming rate hike changed. He hinted that the probability of a rate increase this year is receding, and that means that mortgage rates are likely to remain exceptionally low for at least another year.

### U.S. Housing Revives

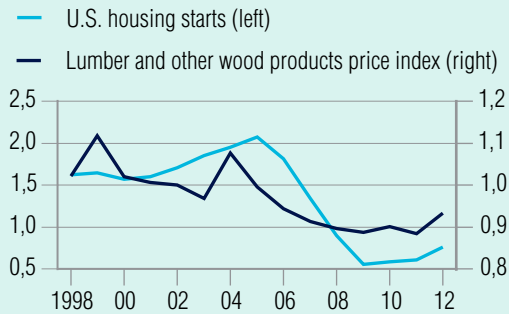
The U.S. housing market is finally on the mend, thanks to a combination of low mortgage rates and an easing in the supply of foreclosed properties on the market. Existing home sales have increased sharply over the past few months and prices are also climbing. At the end of 2012, the months of supply of new homes on the market fell to 4.5, which is essentially back to where it was before the housing bubble burst. (See Chart 4.) As the stock of existing houses for sale shrinks, demand for new construction is reviving. In December 2012, housing starts reached an annual rate of 954,000 units, the highest in more than four years. For the year as a whole, a total of 780,000 units were started—still less than what demographic growth requires, but a big improvement from the annual average of 584,000 units we saw over the three previous years. Housing starts are expected to reach a million units this year and to progressively re-align with demographic needs of about 1.5 million units a year by 2015.

The softness of the U.S. housing market has resulted in lower material prices for Canadian builders over the past few years. This is particularly true for lumber and other wood products used predominantly in residential construction. Lumber and other wood products represent close to 20 per cent of the

5

**Lumber Prices Are Expected to Increase as the U.S. Housing Market Revives**

(starts, millions; price index, 2002 = 1)



Sources: U.S. Department of Commerce; Statistics Canada; The Conference Board of Canada.

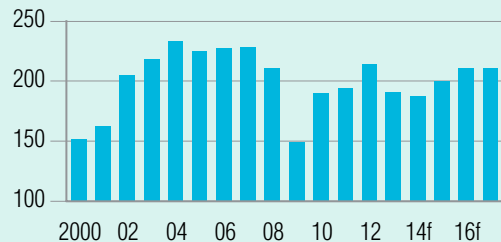
industry’s inputs, and about 90 per cent of all hardwood and softwood lumber is used either directly or indirectly by the construction industry. Wood prices in Canada peaked in 2004–05 but had dropped 20 per cent by the time U.S. residential construction activity hit bottom in the first quarter of 2009. As housing starts south of the border began to pick up, wood product prices also started to rise again. (See Chart 5.) Prices for other major inputs used in the residential construction industry, such as concrete and metal and plastic products, have not, however, fallen to the same extent. That’s because these products are also used heavily in non-residential construction, which experienced a much smaller decline during the recession as it was supported by various governmental stimulus programs. Going forward, Canadian builders will have to factor rising wood prices into their operation costs.

**INDUSTRY TRENDS**

6

**Housing Starts Forecast to Moderate This Year and Next**

(000s)



f = forecast

Sources: The Conference Board of Canada; CMHC Housing Time Series Database.

*Residential construction held up better than expected last year, but the final quarter was significantly weaker than the rest of the year. The multi-family segment has been driving the industry in recent years, but a correction there is expected this year and next. Stricter mortgage rules will contribute to a cooling of buyers’ intentions, especially among first-time buyers.*

**Housing Starts**

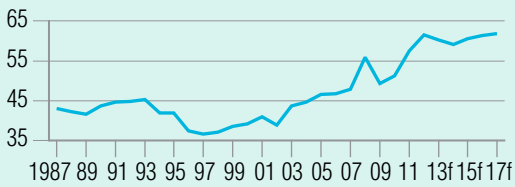
Last year, a total of 215,000 units were started in Canada—slightly more than expected. The increase, however, was due mostly to the launch of a few large multi-family housing projects in the second quarter, and the fourth quarter was significantly weaker than the rest of the year. Single-detached starts remained virtually flat over the course of the year, on par with where they have stood since the recession in 2009. Going forward, starts are expected to fall to 191,000 units this year and 188,000 next year. (See Chart 6.) This will be the result of a decline in multi-family starts, with little change in single-family starts expected. The numbers are consistent with the December residential building permits data, which were published after the completion of this forecast. The data show the value of residential permits fell 13.1 per cent in December, with a 24.6 per cent drop in the multi-family segment and a 5.3 per cent drop in the single-family segment.

In the medium term, the multi-family segment is expected to be the driver of growth in the housing market. Multi-family units (which include condos, but also row houses and semi-detached units) are expected to continue to account for a bigger share of overall construction than they have historically. Since 2008, multi-family starts have surpassed single-family starts every year, and last year they accounted for 60 per cent of starts. By comparison, that share was around 40 per cent in the early 2000s. This new split in the market is

7

**Demand for Multi-Family Housing Continues to Rise**

(multi-family units as a share of total starts, per cent)

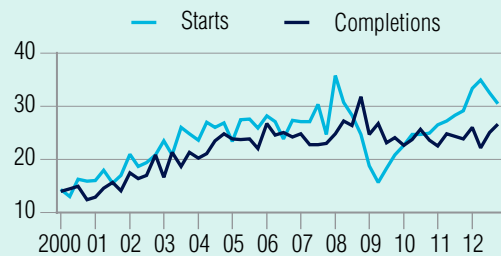


f = forecast  
Sources: The Conference Board of Canada; CMHC Housing Time Series Database.

8

**Builders Are Taking More Time to Complete Construction**

(multi-family units, 000s)

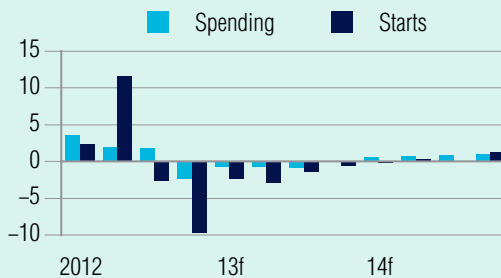


Sources: The Conference Board of Canada; CMHC Housing Time Series Database.

9

**Starts Will Pick Up Over Time and Sustain Total Spending**

(percentage change)



f = forecast  
Sources: The Conference Board of Canada; CMHC Housing Time Series Database; Statistics Canada.

representative of what we can expect in the next few years, with multi-family units accounting for 60 per cent of new construction. (See Chart 7.) Many factors support this outlook, including the fact that condos appeal to older homeowners seeking to downsize into homes that require less maintenance, and to younger buyers looking for more affordable first homes. Moreover, even though suburbs continue to grow, longer commute times and higher gas prices are making homes close to city centres more appealing.

**Oversupply**

The multi-family segment has been especially buoyant in Canada’s large cities, led by Toronto and Vancouver. Condo prices there have soared in the last decade, encouraging builders and investors to add as many units as possible. For many years, units were being snapped up by buyers even though prices were rising fast. But over the last year, the market has struggled. According to the Canadian Real Estate Association (CREA), new listings of houses for sale were down in half of all local markets in December, with the largest decline in the Greater Toronto Area. There were also significant declines in Greater Vancouver and the Fraser Valley, as well as on Vancouver Island. CREA Chief Economist Gregory Klump explains, “The decline in new supply may reflect purchase offers below asking price that are made to sellers who are under no pressure to sell. Instead, they choose to take their homes off the market once their listing expires.”<sup>1</sup> Although CREA’s statistics are for existing houses, the softness in the existing market is certainly mirrored in the new housing market as well.

Also, while there were many units started over the past two years, units aren’t getting completed as fast as they were in the past. Completions usually match starts, with a lag of two or three quarters. But since 2010, completions have, in fact, remained relatively flat even though starts soared. Between the second quarters of 2010 and 2012, starts of multi-family units rose 40 per cent. Completions, on the other hand, increased by only 3.5 per cent between the last quarter of 2010 and the final quarter of 2012. (See Chart 8.) This suggests that builders aren’t feeling hurried to complete their work or that they may be purposely delaying delivery, something that can happen when pre-sales aren’t as good as expected.

Total spending on residential construction is therefore expected to drop—but not as much as housing starts, as some of the projects already started will be spread out over a longer period of time, which will sustain activity over the next year. While housing starts are expected to decline by 11 per cent, total spending is expected to fall 2.1 per cent. (See Chart 9.) Also, more than half of spending in residential construction is in renovation, a segment that is much more stable and may benefit from the softness of the resale market—people may chose to renovate if they cannot sell their house or if they want to make improvements before selling.

1 The Canadian Real Estate Association, *National Statistics*, <http://creastats.crea.ca/natl/index.htm> (accessed February 11, 2015).

## Mortgage Rules

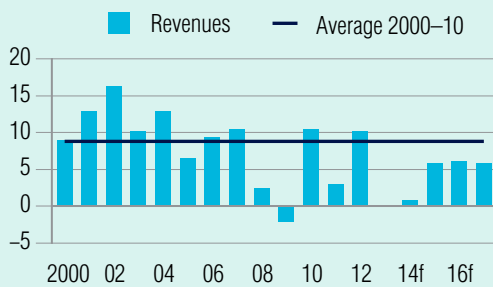
Last July, the federal government imposed stricter mortgage conditions in a bid to cool the housing market and thereby avoid a housing bubble. Mortgage amortization periods are now limited to a maximum of 25 years, rather than 30 years. Also, the amount of money accessible when refinancing is limited to 80 per cent of the property's value, down from 85 per cent. The shortening of the maximum amortization period has taken a toll mostly on first-time buyers, while the tightening of the refinancing conditions affects mostly people who need to consolidate debt. According to a ReMax survey published earlier this year, first-time homebuyers—who were the main drivers of sales in 2009 and 2011—are expected to account for only about 30 per cent of sales over the next couple of years.

## FINANCIAL PERFORMANCE

10

### Revenues Expected to Improve but Remain Below Pre-Recession Levels

(revenues, percentage change)



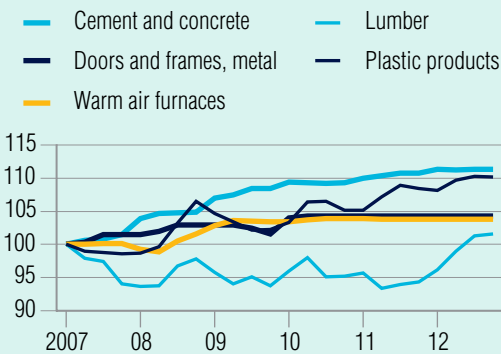
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Sources: The Conference Board of Canada; Statistics Canada.

11

### Prices for Some Inputs Stayed High Throughout the Recession

(price index, 2007Q1 = 100)



Sources: The Conference Board of Canada; Statistics Canada.

*Revenue growth in the residential construction industry was better than expected in 2012, as sales volumes and prices remained firm. This was true until the final quarter when sales and prices both declined. This year, revenues will be weak and profits will drop to an eight-year low. Some savings on costs (notably on labour costs) will, however, keep profit margins from dropping even further.*

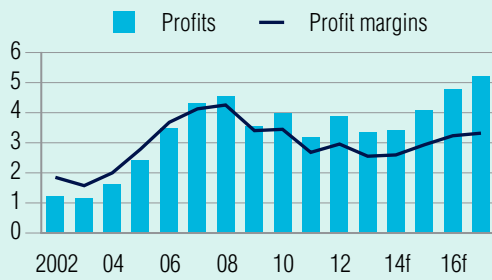
## Revenues

Thanks to sustained investment in construction of new condo units, revenues increased by 10 per cent last year. The 2.3 per cent increase in the average price of a new house also contributed to the rise in revenues. This year and next, revenues are expected to plateau as prices flatten and new starts decline. Projects already under way will sustain spending somewhat, but very little growth is expected before 2015. Starting in 2015, the industry will see revenues grow at an average annual pace of around 6 per cent—a big improvement, but still well below the 8.8 per cent recorded between 2000 and 2010. (See Chart 10.)

## Costs

Last year, the industry saw its costs post their biggest increase in nine years. The 13 per cent hike was driven largely by material costs, as a record number of units were under construction (which means lots of materials were required). Also, because a significant share of the units under construction were in large condo projects, the industry had to purchase materials that are also used in the non-residential construction industry where prices have remained high in recent years. (See Chart 11.) Labour and capital costs also increased in 2012, with labour costs up 5 per cent and capital costs rising 11 per cent respectively. However, labour and capital together account for only about a third of total costs.

### Profits and Margins Will Tighten Up This Year (profits, \$ billions; margins, per cent)



f = forecast

Sources: The Conference Board of Canada; Statistics Canada.

This year, the increase in costs will slow to only 1.7 per cent. This will be the result of a reduced pace of building, job cuts, and a decline in the average wage rate. Together, this will reduce labour costs by 1.2 per cent. Over the medium term, costs are expected to grow in line with production. Material costs will remain the main driver, as inflationary pressures on materials will come from the recovery of the U.S. housing market and the more dynamic non-residential construction. Capital costs will also rise as interest rates increase.

Inflationary pressure from labour costs will remain limited. The residential construction industry employs about three times more workers than the non-residential construction industry, but wages are about 25 per cent higher in the non-residential sector. This is because non-residential construction often requires specific certifications and specializations. But as the residential sector goes through a tight period in which jobs are cut, many existing younger workers are expected to attain new certifications that allow them to find jobs in the non-residential sector, and many older workers may choose to retire earlier. The result is that over the long term, the industry can expect to face stronger competition to attract the workers it needs. Still, as market conditions are expected to be relatively soft in the medium term, the impact of labour should remain moderate over the course of this forecast horizon.

### Profits

The residential construction industry is highly competitive and builders' profit margins are thin. In 2007 and 2008—the best years for margins in the recent past—builders enjoyed average pre-tax margins of about 4.2 per cent. Last year, margins were about 3 per cent, and this year and next, margins will be even thinner, as flat prices and weak sales hurt revenues. However, builders' ability to rapidly cut back on hours worked and materials ordered will save the industry from seeing its profit margins drop to unsustainable levels. As a result, the industry is expected to see pre-tax profits drop from \$3.9 billion last year to \$3.4 billion this year and next. Profits will improve in the following years, even surpassing their previous peak, but margins will remain within the 3 to 3.5 per cent range. (See Chart 12.)

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## AT A GLANCE

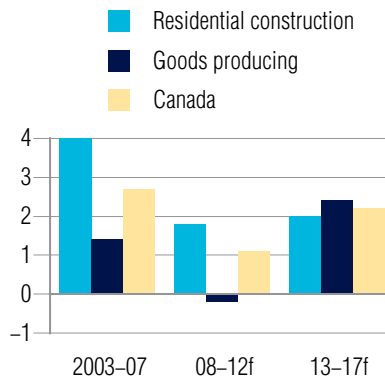
### Main Inputs, 2009

Commodity	Per cent
Architectural, engineering, and related services	6.6
Plastic building and construction materials	4.5
Other wood millwork products	4.4
Wood kitchen cabinets and countertops	4.4
Carpets and rugs	3.5
Heating and cooling equipment	3.3
Prefabricated wood buildings and components	3.1
Softwood lumber	2.9
Wood windows and doors	2.6
Other ornamental and architectural metal products	2.4
Metal windows and doors	2.3
Ready-mixed concrete	2.3
Concrete products	1.4
Holding company services and other financial investment and related activities	1.3
Legal services	1.3
Engineered wood members and trusses	1.3
Asphalt and asphalt products	1.3

Sources: The Conference Board of Canada; Statistics Canada.

### Average Annual Output Growth

(percentage change)

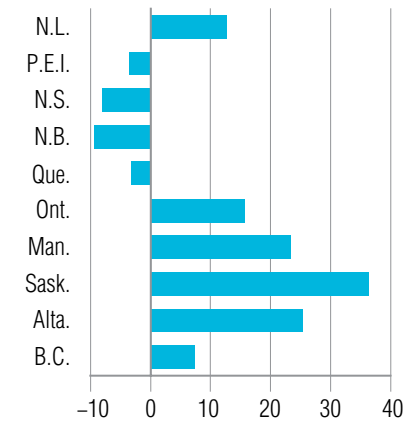


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Sources: The Conference Board of Canada; Statistics Canada.

### Housing Starts by Province

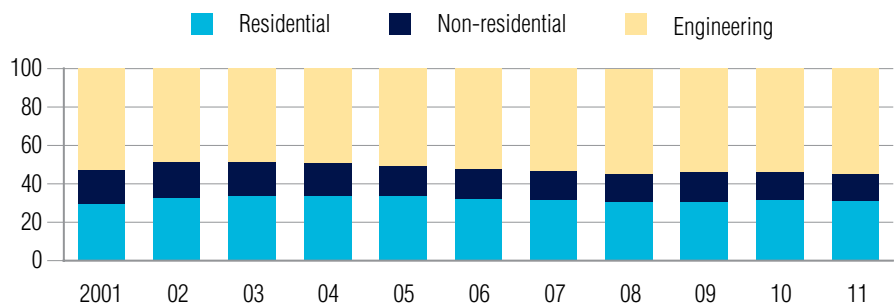
(percentage change, 2011-12)



Sources: The Conference Board of Canada; Statistics Canada.

### Residential Share of Construction Output

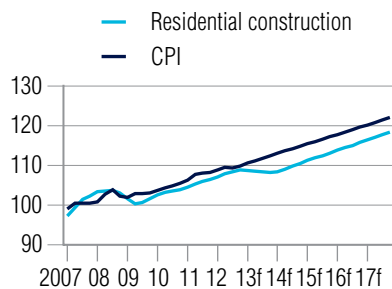
(percentage share of total construction GDP)



Sources: The Conference Board of Canada; Statistics Canada.

### Pricing Power

(price index, 2007 = 100)

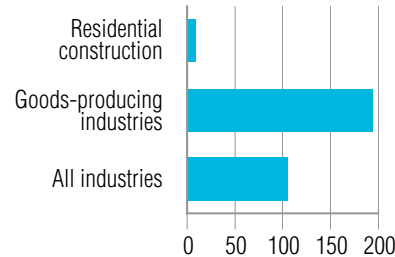


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Sources: The Conference Board of Canada; Statistics Canada.

### Capital Intensity, 2011

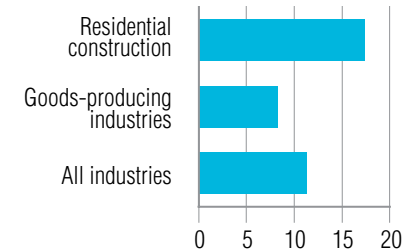
(2007 \$ 000s, capital stock per employee)



Sources: The Conference Board of Canada; Statistics Canada.

### Labour Intensity, 2011

(workers per \$1 million of real output)



Sources: The Conference Board of Canada; Statistics Canada.



**Main Inputs**

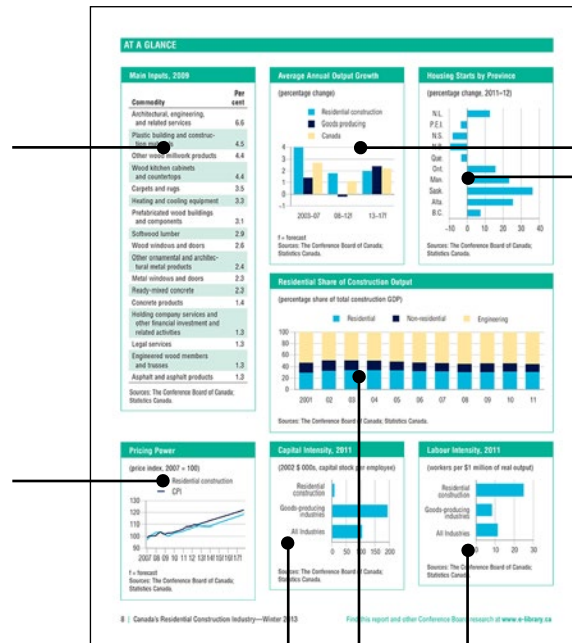
This table lists the industry's major material inputs. The purpose is to indicate the industry's sensitivity to changing prices for its various inputs. This information is based on the input-output tables produced annually by Statistics Canada. It is reported in this table as a share of the total value of material inputs into the industry.

**Pricing Power**

This chart compares the residential construction industry's output price index with the consumer price index (CPI). It indicates whether prices in the industry are rising faster or more slowly than average overall prices over time. Industries with above-average price appreciation are able to consistently raise prices faster than the rate of broad inflation and generally have pricing power. Industries with weak price appreciation generally have poor pricing power. Both price indexes are benchmarked so that 2007 is equal to 100.

**Capital Intensity**

Capital intensity is a measure of how much capital stock—which takes the form of machinery, equipment, and non-residential structures—there is per employee in the industry. High capital intensity can be a barrier to entry in an industry, limiting competition. Industries with higher capital intensity also generally have higher levels of output per employee. For comparison purposes, the chart displays the capital intensity of the residential construction industry, of all goods-producing industries, and of all industries in Canada.



**Average Annual Output Growth**

This chart compares the average annual GDP growth of the industry with that of all goods-producing industries and of all industries in Canada. The comparison is provided over three different time periods: two historical and one forecast. This provides an indication of how the industry has performed and will perform relative to the rest of the economy at different periods in time.

**Housing Starts by Province**

This chart displays growth in housing starts broken down by province. The purpose is to show where the residential construction market is buoyant. The chart is based on housing starts data produced by Statistics Canada.

**Residential Share of Construction Output**

This chart displays the breakdown of total construction output by industry: residential construction, non-residential construction, and engineering construction. The purpose is to track the composition of the overall sector. The chart is based on GDP data produced by Statistics Canada and on estimates from The Conference Board of Canada.

**Labour Intensity**

Labour intensity is a measure of how much labour it takes to produce a unit of output. Labour costs constitute a higher portion of overall costs for industries with higher labour intensity. Industries with higher labour intensity that produce tradable goods or services are also generally more susceptible to competition from low-wage countries. For comparison purposes, the chart displays the labour intensity of the residential construction industry, of all goods-producing industries, and of all industries in Canada.

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## Canada's Residential Construction Industry

by *Maxim Armstrong*

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