Tender Cost Update UK
Q1 2017

mace

STRONG GROWTH IN RESIDENTIAL SECTOR BUT INFLATION CONTINUES TO RISE

	2016	2017	2018
LONDON	3.0%	1.5%	0%
NATIONAL	3.3%	2.5%	0.5%

Large increases in the cost of materials will put pressure on construction firms facing a marketplace likely to see limited growth in 2017.

However, minimal growth is better than a reduction in output and it now appears the industry will stutter rather than crash, with the economy exceeding expectations in recent months. As such, Mace Cost Consultancy now sees tender prices growing **2.5%** across the country and **1.5%** in London with a weak commercial sector holding back increases in the capital. Conditions in 2018 will not prove any easier but with the inflationary effects from the pound's depreciation dissipating, we expect tender price growth to be lower.

"The current market is providing mixed messages. Whilst we are seeing foreign investors use the weaker pound as an opportunity to fund projects more cheaply, the pound's weakness together with increasing steel and oil prices has started to filter through to the supply chain who are limited in their ability to absorb the increases. In spite of the ongoing global economic uncertainty, prospects for 2017 look much more positive than forecast 6 months ago, although this is now balanced against anxieties around 2018. Such dynamics will continue to persist and whilst this will create challenges, with these will also come opportunities."

Steven Mason
Managing Director
Mace Cost Consultancy

The **Consumer Price Index** has jumped to its highest level in

2 years...

...with **materials** and **fuel prices** increasing by... **15.8%**

Opec's decision to cut production has pushed **oil** above **$55** a barrel

Commerical output fell...

OCT 2016 ▾1.4%

NOV 2016 ▾2.6%

Public housing grew **5.6%** month on month in November, helping yearly growth reach... **14%**

TENDER PRICE INFLATION FORECAST

As in our previous forecast, we expect national tender prices to outperform London. The main reason for this is the weakness of the commercial market, an area the capital is more reliant on than other regions. Before the EU referendum, a number of City firms highlighted how they may be forced to move parts of their operations if the UK chose to leave the Single Market. This is now almost certain to happen, with HSBC and UBS having already announced plans to shift jobs abroad. Financial firms count for a substantial proportion of the London market and irrespective of any further decisions to change location, spending will slow. Added to this is the recent adjustment in business rates to take account of changes in property prices. Whereas London values have skyrocketed, other parts of the country have not done nearly as well, falling in some areas. The introduction of these rates in April will hurt London's competitiveness and some firms may look for alternatives.

In the three months since our last tender price update, the economy has held up surprisingly well and economic forecasters have substantially revised upwards their expectations for growth. GDP is now forecast to grow 1.4% in 2017 as opposed to 1% three months ago, whilst fixed investment has been bumped up from -2% to -0.2%. It is the economy's resilience, as well as additional price increases in key inputs, which have triggered our decision to raise forecast tender prices for the current year.

Our forecasts are for typical large projects but based on the analysis in this report, we can highlight how certain developments will face differing inflation rates. In particular, we believe that projects involving substantial amounts of brickwork will face higher prices. Brickwork plays a far more important role in the residential sector than commercial and as we have seen, it is here where growth is most likely. Aggravating these issues and also leading to higher prices is a current shortage of skilled brick layers.

2018 is still likely to prove a tough year, especially following recent announcements from the Prime Minister indicating a hard Brexit, with the UK leaving the Single Market appearing all but certain. In addition, the inflationary effects from sterling's depreciation will rescind and we therefore expect tender prices not to change in London and only grow 0.5% nationally.

ECONOMIC CONDITIONS

As we leave a year of political upheaval and move into 2017, when the economic ramifications will start to take place, the economy held up surprisingly well. The UK is likely to be the fastest growing large advanced economy in 2016 and employment remains at near record highs. The one noticeable downside is the pick-up of inflation but even here, the current level is still below the Bank of England's target. However, this positivity is not expected to continue, nor is it being seen in the construction sector. With growth in the industry likely to be subdued and considerable price pressures in the offing, 2017 will prove to be a tricky year.

GROWTH

The UK economy finished 2016 in positive fashion, growing 0.6% in the fourth quarter leading to annualised growth of 2.2% compared to 2015. Once again this was driven by the services sector. Construction, which fell 0.8% in the third quarter, managed a slight rebound but growth of 0.1% for the period and 0.8% for the year point to a struggling sector. The retail sector was the largest contributor to growth in the final quarter but the coming year is likely to see consumers, who appeared once again to be financing their spending through debt, cutback. As a result, growth is forecast to dip in 2017, only managing 1.4%.

LABOUR MARKET

Unemployment has remained remarkably steady since the summer and in the three months to November it had fallen to 4.8%, down from 4.9% in the previous quarter. This is the lowest it has been in over a decade with the only concern in the latest release due to a minor fall in employment. With slowing economic growth in 2017, the consensus view for unemployment is it will rise to 5.2%, a low figure by historical standards. One reason for the ongoing robustness of the labour market is an increasing proportion of self-employed workers, which may limit any increases in unemployment this year. This has also fed through into average earnings, which grew 2.8% year on year in November.

EXCHANGE RATES

Over the last three months there have been noticeable swings in the pound but nothing like the movements that took place in the previous quarter and for the moment it seems to have reached a floor. However, its inability to stay below $1.20 will provide little comfort for firms reliant on imports, including many construction companies, and we are aware of a number of instances when there have been substantial price increases in materials for a project, in part due to sterling's weakness.

INFLATION

Consumer price inflation jumped to 1.6% year on year, its fastest rate in more than two years in December. The largest contributors to this growth rate were transport and food and non-alcoholic beverages. Inflation is predicted to carry on rising in 2017 with the collection of Treasury forecasts pointing to growth of 2.8%, outpacing expected average earnings growth of 2.6%. Were these forecasts to prove accurate, it would mean workers would face a real wage cut in 2017. This would dampen consumption, the main driver of growth in recent months and impact the housing and repair and maintenance sectors of the construction industry.

MONETARY POLICY

Following their decision to cut interest rates and increase quantitative easing in August 2016, the Monetary Policy Committee have met three times and on each occasion voted unanimously to leave things unchanged. Due to the depreciation in the pound, the Bank of England expects inflation to overshoot its target of 2% but believes this will prove temporary and for the time being the costs of trying to limit inflation outweigh the benefits of making any adjustments. With the Bank waiting to see how the UK's decision to leave the EU unfolds, any short-term change in monetary policy would likely be as a result of large surprises in economic data.

GLOBAL

Over the last three months two changes have taken place across the Atlantic which could have a bearing on UK construction. Firstly, and most obviously, is the election of Donald Trump. Following campaign promises to boost infrastructure spending, a number of commodities have seen sharp price rises as investors anticipate increased demand and this will feed through into British firms having to pay more for materials. Secondly, the Federal Reserve increased rates in December and with U.S. inflation rising, is expected to make further moves in 2017. This could lead to a stronger dollar and on the flip-side a weaker pound and thus additional inflationary effects. These two factors may combine to change the attractiveness of investing in the UK. Recently American investors have been heavily involved in a number of large projects so the industry could be sensitive to such a change.

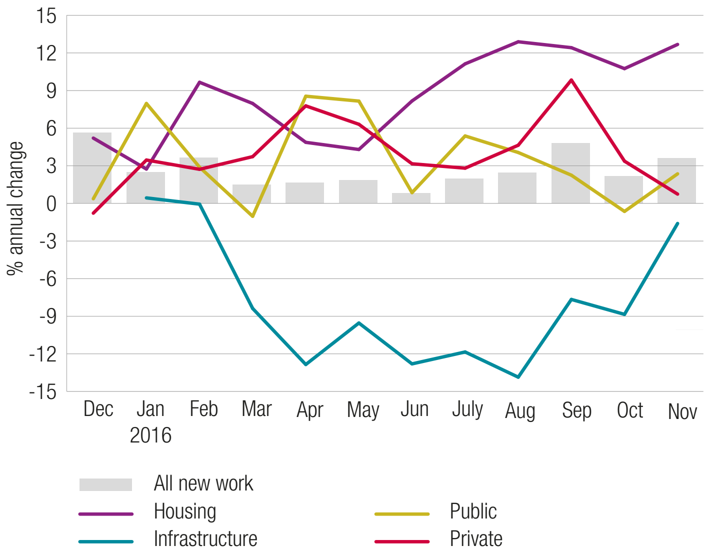
U.S. growth finished the year slight slower than expected at 1.9%, and the world will be watching with interest to see what the impact the new President has. Of the other major economies, only China have released Q4 GDP figures, showing an increase of 6.7% for 2016, which is in line with government targets.

CONSTRUCTION OUTPUT AND ORDERS

The three months to November saw new construction work grow 0.5% compared to the previous three months, with yearly growth greater than 4%. The largest contributor to growth in 2016 has been housing and most notably in November there was a large jump in public housing spending. This helped push annual growth in the sector above 14%, slightly faster than private housing which managed 12.5% and has been above 10% in all but two months in 2016. Moving into 2017, based on government commitments on building new housing and with significant funding provided, we would expect this sector to carrying on expanding. Private housing, however faces a number of risks. Firstly, a number of forecasters expect limited house price inflation in 2017, potentially putting housebuilders off investing. The largest risk however, comes from an increase in interest rates which at their current record low have boosted recent spending. We do not expect such a move in 2017 but if inflation were to truly take off and force the Bank of England to take action, it could have substantial repercussions for the sector. With output in the sector already at record highs, a slowdown in growth could easily occur.

The entire construction industry, which includes repair and maintenance as well as new work, did not see anything like housing growth figures in the final quarter. Whilst managing to recover from a 0.8% decline in the third quarter, growth of 0.1% resulted in its largest six month drop since the second half of 2012. No detail has currently been provided on specific sectors of the industry but data from October and November show weakening repair and maintenance. Of more relevance for tender prices is the weakening commercial sector. Accounting for almost 20% of construction output, if month on month reductions of 1.4% in October and 2.6% were to persist, it may lead to more competitive bidding at tender stage.

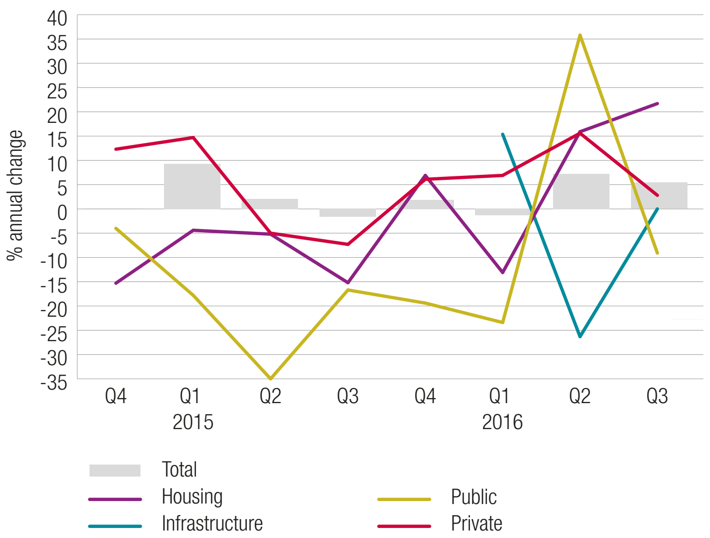
New construction output



Construction orders suffered a setback in the third quarter, falling 2.4% due to lower public non-housing and private commercial demand. One of the main contributors to this reduction was a one-third drop off in the value of new commercial orders in London, with all new work in the capital down 7% on the quarter and 17% yearly. This weakness is likely to continue in 2017, with average business rates for offices and shops in London increasing on average over 10% and much more in some cases.

On a more positive note, private housing, which jumped substantially in the second quarter has stayed steady at these heights, leading to yearly growth in the volume of new orders of 5.5%. Due to the lag in new order data releases, this is the first set of results covering the period following the EU referendum and we should bear in mind how the survey data looked six months ago. For the most part, it was incredibly negative and the new order statistics would justify businesses feeling this way. With more recent surveys indicating better performance, it would seem likely that new orders will recover in the fourth quarter and into the start of 2017.

Construction new orders



MARKET VIEW

The Markit/CIPS UK Construction PMI finished the year on a high, with four consecutive months of expansion; a marked improvement on the slump that occurred during the summer. New orders rose to their highest level since January 2016 and business confidence also picked-up. Underpinning much of this performance is the residential sector. Commercial activity continues to struggle, although its figure now does suggest limited expansion. The report's most notable metric and with respect to tender prices it is a major one, is the significant increase in input costs. These have now reached their highest level since 2011 as the pound's depreciation takes full effect. It also appears construction firms are concerned about further rises, increasing stocks in an attempt to provide security.

Whilst also finding housebuilding outperforms both commercial building and local authority work, the Bank of England Agents' report was less positive, recording construction output falling to its lowest level in more than three years in November. A reduction in material shortages and better recruitment conditions may help counter-act some of the price pressures firms face from material costs and costs of imported goods rising to their highest scores since spring 2012. A bounce back in commercial real estate and the housing market, which both weakened significantly in the aftermath of the EU referendum, mainly took place outside London.

In its fourth quarter trade survey, the Construction Products Association reported the majority of firms had seen sales rise. However, confidence has suffered a sharp downturn with the balance of firms expecting rising sales in the next quarter falling from 45% to 6% for heavy side manufacturers and 67% to 29% for light side manufacturers. The number of firms reporting rising costs rose sharply, both for raw materials and fuel and energy, reaching the highest proportion for five years.

The Deloitte Winter London Office Crane Survey reported a 4% rise in construction activity from its previous survey at the end of Q1 but a 42% drop in the number of new starts suggests this may be short lived. Average project durations have increased by one quarter with developers pointing the finger at increased uncertainty around tenant demand due to Brexit. Given financial firms accounted for 42% of pre-completed leases and current concerns around passporting, these fears would seem reasonable.

Occupier demand rose slightly in the RICS Commercial Property Market Survey but only as a result of the industrial sector. Landlords of retail and office space have started offering more incentives in an attempt to increase muted demand. Demand fell in London for the third successive report with more than half of respondents in the capital expecting relocation to happen as a result of Brexit. The weaker pound has led to increased interest from overseas buyers helping push up investment enquiries.

Given the impression from official statistics of a struggling industry with differing performance depending on the sector, it is perhaps not surprising that output shows no clear direction in these surveys. One area they are pointing in the same direction, is on prices with various measures reaching their highest levels in half a decade. Additionally, and strongly interlinked, is the weakness of London and the commercial sector, an issue also seen in government data.

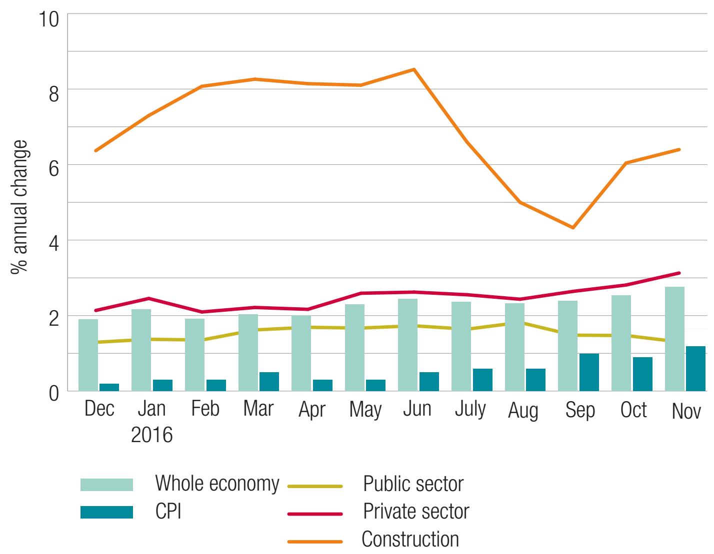
INPUT COSTS

Labour

Having seen a slowdown in growth in the immediate aftermath of the EU referendum, construction earnings rebounded in October and November. This pushed yearly growth to 6.4%, below the recent high of 8.6% seen in June but far faster than both average earnings and CPI. Bonuses played a significant part in driving total earnings growth back above 6% but growth of regular earnings fell in each of the last three months. It now stands at 4%, still much faster than in most other sectors.

The relative strength of the labour market should prevent any significant drop in earnings in the first half of 2017. The 1.6% downsizing of the construction workforce between June and September appears to be temporary with more recent survey data pointing to rising employment. Supporting these reports is ONS data showing the number of construction vacancies to have reached their highest level since November 2007. Short of a significant reduction in construction output wages will continue to grow, leading to tender prices responding accordingly.

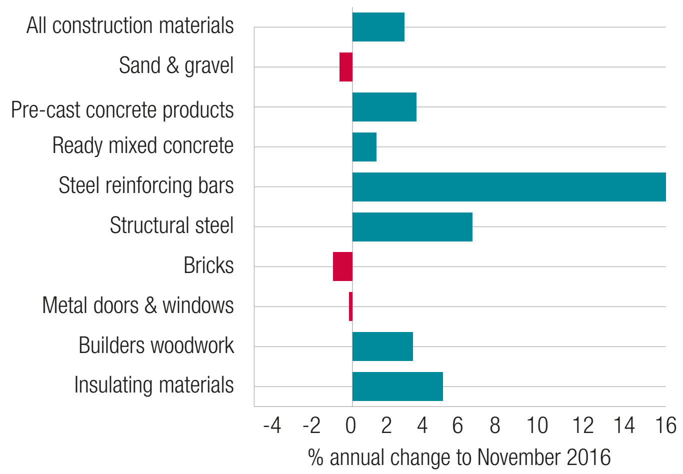
Average weekly earnings



MATERIALS

Even before the fall of the exchange rate in June, there had been a solid upward trend in the price of building materials in 2016. While nine months of successive increases came to an end in November, this drop is likely to prove temporary and we expect further growth. With the impact of the weaker pound starting to feed through to prices, even taking into account the recent fall, the all work building index has grown 1% in the last three months since our last tender cost update. As a result of these rises, the yearly growth rate now stands at 2.6%, its fastest rate since April 2012. In particular, double-digit annual growth in concrete reinforcing steel bars and imported sawn wood have led the way.

Materials prices



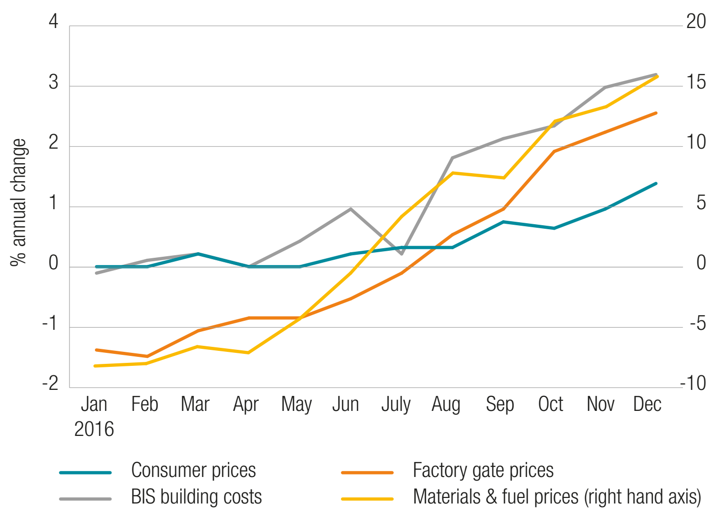
In December the yearly growth of input producer prices rose to 15.8%, partly down to a 57% increase in the amount businesses pay for crude oil, a factor likely to see additional changes in the short-term. Having previously announced plans to cut oil production, at the end of November, Opec countries came to an agreement on how such a reduction would take place. With Russia also agreeing to cuts, the price of oil has stabilised at around US$55 per barrel at the start of this year. Before the agreement, oil stood above US$50/b for only nine days so such a move is significant and one compounded for British firms by the change in sterling.

Forecasters anticipate only a minimal reversal in 2017 providing little respite to firms and leading to upwards pressure on tender prices.

Imported metals have also grown strongly, rising 36% over the last year. Once again, the pound's depreciation has exacerbated market rises, driven by external forces. In the case of many metals, hopes that Donald Trump's election will boost infrastructure spending has led to a jump in prices.

Due to the dependency of the input price indicator on commodity prices and oil in particular, the series is very volatile and double-digit yearly changes are common, seeing figures of below -10% and greater than 30% within the last decade. Worryingly, the last two occasions a figure this high was reached, in 2008 and 2011, the construction industry was on the verge of falling into recession and there is evidence linking spikes in oil prices with a weakening economy.

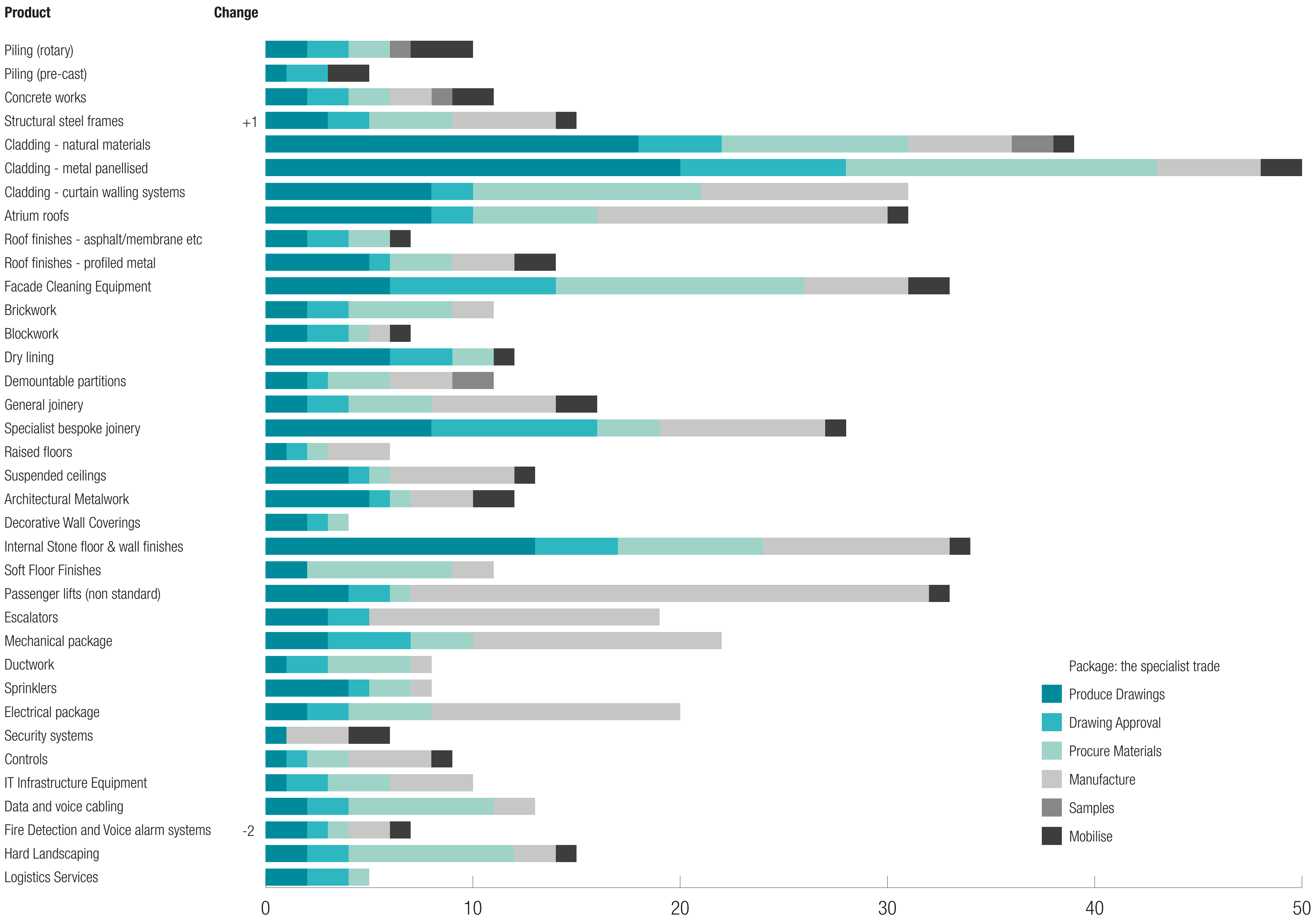
Inflation Indicators



SUPPLY CHAIN FOCUS

"We are experiencing the lowest level of change following a long period of rising lead times, indicating that the market is meeting current levels of workload. Sub-contractors are generally reporting lower levels of enquiries than six months ago, indicating that this levelling off is being generated by a cooling in the market. A common theme coming from many specialist contractors is a difficulty in recruiting sufficient skilled labour which will prevent lead times from falling as workload levels off."

Brian Moone
Director of Supply Chain Management at Mace



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