July 2016

Tender price forecast revised down as construction output set to slow

Tender Cost Update UK

Some investors and occupiers review risks and appraisals but the industry remains busy.

Economy
GDP up 0.6% in Q2 but construction falls by 0.4%

Property
Significant deterioration in sentiment post Brexit vote, particularly London

Housing
Private sector output remains strong but growth levels off

Commercial
London Regions
Future workloads in doubt as output remains 30% below pre-recession level

Business investment
2008 2014
Fell for 2nd consecutive quarter and down 0.8% from Q1 2015

Inflation
+0.5%
CPI creeps up to 0.5% in June, ahead of Brexit vote

Infrastructure
Output lower and prospects dependent on new government policies

Surveyors' workload
Activity still rising but at slowest rate for three years

Labour Market
£
Unemployment down to 4.9%, construction earnings rise by 8.3%

Retail sales
Still growing but awaiting post Brexit verdict by consumers

Following the vote in favour of leaving the EU, Mace Cost Consultancy has carried out a full review of the potential effects on construction workloads and tender prices. Although it is still early days in terms of assessing the impact of the referendum result, we have taken the view that there is likely to be a modest slowdown in the demand for construction in the medium term. This slowdown is expected to see the current upward trend in tender prices level off for the remainder of 2016 and into 2017, with a small fall in the medium term.

We expect prices nationally to have increased by 2% in 2016, but a softening in demand in the regions will result in a 1% reduction during 2017 followed by flat prices in 2018 as a degree of economic stability returns. In London, we expect the ongoing pipeline of work to lead to stable prices in 2017 with the softening of demand coming in 2018 and leading to a fall of about 1%.

“Although we have seen a handful of projects affected by the referendum result due to occupiers reviewing their risks and appraisals, the vast majority of our workload is currently unaffected and contractors and supply chain companies remain busy, particularly in London and the South East. Despite this, we feel that the resulting slowdown in demand will lead to tender prices softening, leading us to revise our forecasts downwards. We believe there's a strong role for industry to promote opportunities across the country and support mobility of goods, services and labour between the regions. With support from the Government and clear local engagement targets for major projects and programmes, this could help bring communities together.”

Chris Goldthorpe, Managing Director
Mace Cost Consultancy

Economic conditions

The true economic effects of the UK leaving the EU will not be known for some time to come, but we expect growth to slow in the short to medium term as businesses and investors look to reduce risk. In the meantime, most statistics relate to the period before the referendum and still give an indication of the underlying state of the economy.

Growth

The GDP figures for Q2 show that the economy grew by 0.6% in the quarter which represents a 2.2% increase on the same quarter the previous year. Services increased by 0.5% and production by 2.1%, but construction was down 0.4% and agriculture fell by 1.0%. These figures apply to the period before the referendum result and the IMF has recently downgraded its forecasts for UK growth to 1.7% in 2016 and 1.3% in 2017, still the second fastest growth in the G7 after the USA.

Labour Market

At 4.9% in the three months to May, the unemployment rate was at its lowest level since 2005 and total employment is at the highest level since records began in 1971, with monthly figures indicating continuing growth but at a slower rate than last year. Productivity in the services sector was 1.1% higher than the previous year, but was 1.5% lower in manufacturing, while total weekly pay increased by 2.3%.

Retail sales

The latest Office for National Statistics (ONS) figures for June show retail spending continuing to rise, up 4.3% on the same month last year. This contrasts with a rise of just 1.2% reported for June in a survey carried out by the British Retail Consortium/KPMG, although retailers attributed much of this slow down to weather conditions.

Inflation

After remaining at 0.3% for most of the first half of the year, Consumer Price Inflation crept up to 0.5% in June. Any effects of a weaker pound since the EU referendum are not yet included, but we do expect higher inflation over the coming months as increased import prices feed through to the consumer.

Interest rates

At the July meeting of the Monetary Policy Committee (MPC), the Bank of England agreed to maintain the existing Bank Rate of 0.5% but the minutes note that the majority of MPC members expect monetary policy to be loosened in August due to the outlook of weaker growth following the Brexit vote.

Global

Growth in the EU slowed slightly in Q1 to 1.8% and we expect the UK referendum result to have a dampening effect, which may result in further softening in the second part of this year. Despite this slowdown, the fundamentals remain positive, and we expect growth to improve in the longer term.

US GDP figures for Q1 have been doubled since the original estimate to show annual growth of 2.1% and recent strong figures for employment and personal disposable income have led to calls for a further increase in interest rates

China's growth rate of around 6.5% for 2016 is slightly slower than last year and the gradual slowdown is expected to continue next year. India's recent annual growth of between 7% and 8% looks set to continue and government policies have improved the country's long term prospects.

There is little doubt that the decision to leave the EU will result in a short term reduction in investment which will impact UK growth. The underlying economy, however, remains reasonably robust and the financial system is in good health after the regulatory changes made following the banking crisis of 2007/8.

We expect a period of consolidation to take place, with lower growth and a weakening in economic statistics relating to the labour market, business investment and retail sales. In the longer term, much will depend on actions taken by the new government to reassure investors, together with progress on trade talks with both the EU and other major countries.

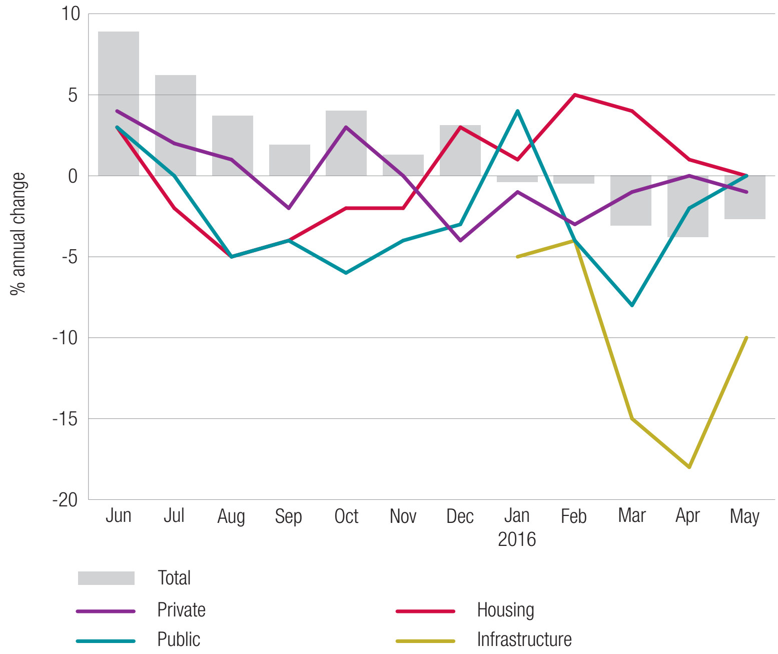
Construction output and orders

The weakening in new construction output growth has continued into Q2 and now indicates a shrinking of the market. This has been due to lower housing growth together with a significant fall in infrastructure workload which would appear to indicate that some major projects are winding down, while the commencement of new projects is being held up, although the figures for this sector may still be unreliable following the reclassification carried out last year by the ONS. There has been little change in private and public sector workloads, reflecting the hiatus that existed pre-referendum.

While new orders for public sector work continue to fall, the private sector has returned to growth in the last two quarters but housing remains weak. With the changing circumstances due to the EU vote, the historical nature of the new orders statistics becomes somewhat less relevant than would normally be the case.

Although the availability of new space is still limited, the Brexit vote may cause a slowdown in construction output in the short term as clients defer decisions due to uncertainty regarding the economic outlook. In the longer term, the sell-off in property funds that has already taken place will lead to a reduction in capital values and reduce the amount of finance available for new construction. Reduced foreign investment was already apparent before the EU referendum and is now likely to fall further while the future of the UK-EU relationship remains uncertain. We therefore expect overall construction output to show a small fall by the end of 2016, followed by falls of between 2% and 3% per annum over the next two years.

Figure 1: New construction output



Note: Infrastructure 2015 figures deleted due to reclassification by ONS

Figure 2: Construction new orders

Market view

Experian's July forecast for construction growth in 2016 has been downgraded from 2.0% three months ago, to just 0.3%. This forecast was set before the EU referendum and Experian has commented that the result of the vote is likely to have a negative impact. The forecast for growth in 2017 is 1.7% which is expected to be maintained in 2018. This downgrade is the latest in a string of downward revisions by Experian over the last three quarters.

The latest **Savills** Commercial Development Activity Report for June shows the UK commercial property sector slipping back into contraction territory with the headline index at -3.3%. Developers were pessimistic about the three month outlook with the future expectation balance dipping to -4.5% with all areas of activity expected to fall. The contraction in London was the second in consecutive months, while other areas of the country posted marginal increases in activity.

The **Purchasing Managers Index** for June signalled a return to falling output levels across the UK construction sector, led by a steep decline in residential building and a reduction in commercial work for the first time since May 2013. With 80% of responses received before the EU referendum, respondents linked the downturn to uncertainty ahead of the vote and the general economic outlook. There were reductions in new invitations to tender, deteriorating order books and a lack of new work to replace completed projects.

The **RICS** Construction Market Survey for Q2 continues the trend from Q1 with a further slowdown in the pace of activity. A positive balance of 17% of surveyors reported a rise in activity over the previous three months, down from 28% the previous quarter. Growth moderated across all sectors with the private commercial, industrial and housing sectors seeing the sharpest slowdown. Evidence from respondents suggests that uncertainty regarding the EU referendum resulted in clients delaying some investment decisions.

The Construction Trade Survey for Q1 published by the **Construction Products Association** reflects the pre-referendum market of increased construction activity for the twelfth consecutive quarter together with shortages of skilled workers and upward pressure on wage bills. The outlook for Q2, however, was less positive, with contractors reporting lower orders in all sectors as projects were paused or postponed ahead of the referendum.

Prior to the Brexit vote, the **Bank of England Agents** summary of business conditions for Q2 reported that construction growth had been stable, with moderate rates of expansion across commercial, infrastructure and private housing. Occupier demand for real estate had remained robust although investor demand for London property had slowed. Demand for the refurbishment of commercial space had increased further and output of new homes had risen.

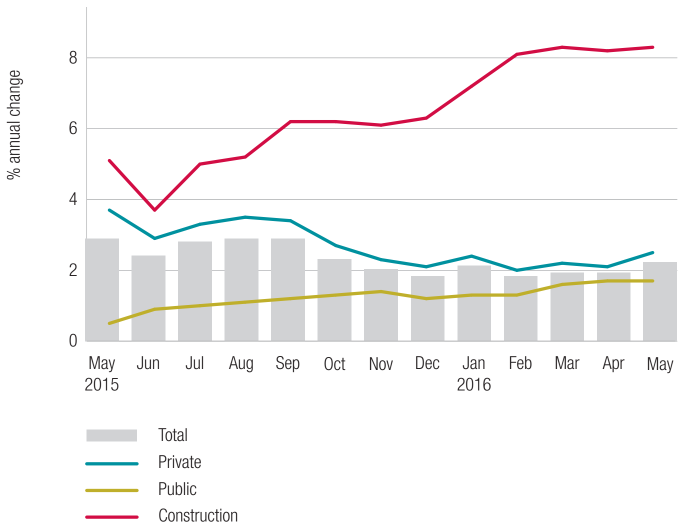
The Commercial Property Market Survey published by the **RICS** for Q2, which includes responses following the Brexit vote, shows a significant deterioration in market sentiment. The survey indicates UK wide occupier demand flat for the first time since 2012 with declines in office and retail but with the industrial sector being more resilient. The shift in sentiment was most noticeable in London with a net balance of -35% of surveyors expecting a decline in property prices over the next year.

In their summer London Office Crane Survey, **Deloitte** reports that the total volume of office construction in the capital has increased by 28% over the past six months to 14.2 million sq ft, the highest level since Q1 2008. In this period 51 new schemes have started with refurbishments accounting for nearly half of the space. The amount of space due to complete will increase during 2016/17 reaching a peak in 2018, and a further rise in demolitions indicates that more construction is imminent.

Input costs

Labour: The skills shortages in the construction industry continue to force up labour costs, and weekly earnings in the industry are now rising at more than four times the overall average rate. We expect this situation to continue in the short to medium term as current project pipelines maintain pressure on the labour market. In the longer term, a reduction in workloads should lead to a softening in wage increases and we expect these to return to long term levels over the next two to three years. The ability to use migrant workers to fill skills gaps is important to the construction industry and the outcome of Brexit negotiations on this aspect could have an impact on future labour costs.

Figure 3: Average weekly earnings



Materials:

Sand and gravel	→	Bricks	↑
Ready mixed concrete	→	Metal doors & windows	→
Steel reinforcing bars	↑	Builder's woodwork	↑
Structural steel	↑	Insulating materials	→

In overall terms, materials prices remain subdued. Although the cost of many materials is still lower than 12 months ago, modest levels of inflation have returned to many elements and the overall cost of materials is now increasing.

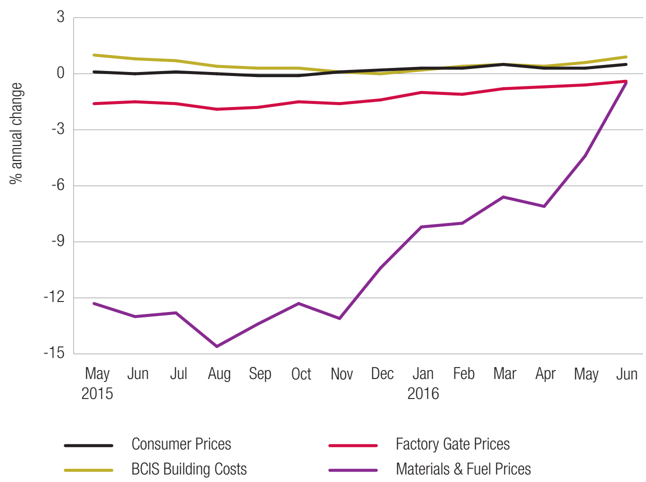
The notable change in recent months has been in steel products where the downward trend of last year and the first quarter of 2016 has been reversed and recent months have seen suppliers increasing prices.

Other products that rely on imports are likely to see upward pressure due to the reduced value of Sterling since the EU referendum, packages including M&E installations, curtain walling and stone products are particularly susceptible.

The price of steel billet jumped from $50 to $300 in June, and futures prices indicate that this level is likely to be sustained, making further price rises in steel products almost inevitable. The markets for other metals such as aluminium, copper and zinc have also seen a turn round in commodity markets, with significant recoveries in prices which will feed through into manufactured products over the coming months.

Although prices for Brent crude oil rose above $50 in June for the first time since October 2015, they have since weakened again due to high global stock levels and record production by OPEC in June. Economic uncertainty following the Brexit vote is also likely to have a dampening effect in the short term.

Figure 4: Inflation indicators



The expected softening of growth following the EU referendum will lead to weaker demand which will slow the upward trend in inflation that was apparent before the vote. Set against this is the fall in Sterling's value together with a recovery in the global commodities markets which will introduce upward pressure that will see consumer price inflation starting to increase through the second half of this year.

We expect reducing workloads to temper the current rising labour costs in the construction industry which should return to long term levels over the next two to three years.

Tender price inflation forecast

The vote to leave the EU means that all previous economic forecasts are in doubt and tender price inflation is one of them. Our forecasts in Q1 and Q2 were based on the UK remaining an EU member, and indicated a gradual easing of the construction market, in line with the lowered economic prospects that were becoming apparent. This reflected the feedback from within our own business and the market in general, which suggested that clients were becoming less bullish and tendering opportunities less abundant.

The sudden volatility in financial markets caused by the exit vote was to be expected and could be attributed to an over-reaction and also an attempt by speculators to cash in on the situation. There is, however, an underlying fall in confidence amongst investors which will only be reversed over the long term if the UK economy proves to be resilient.

In the private sector, the weakening of sentiment in the property market that was apparent in the first half of the year is expected to continue. Demand from occupiers is currently strong, but there will be some who will postpone decisions or reduce aspirations, at least in the short term, until they can be more certain of their long term prospects outside the EU. There are also those, particularly in London, who have already stated their intentions to reduce their presence in the UK in favour of other EU locations. However, the hard evidence for this remains to be seen and Morgan Stanley, HSBC, JP Morgan, Siemens and others have changed their tune since the EU referendum and have committed to long term investment in the UK which is still the “safe haven” of Europe. Given the large areas of new space that are currently under construction, both in London and in regional cities, some embryo projects may be put back on the shelf and there will probably be some postponed that are further progressed.

For an industry that was already experiencing a levelling off in demand, the Brexit vote will not help construction, at least in the short to medium term. Many contractors have been expanding and recruiting over the last three years and if order books start becoming harder to fill, competition will increase for the available workload and downward pressure will be put on profit margins and tender prices.

The extent to which tender prices will be affected is very difficult to predict as there is no precedent for the current situation. We know from past recessions that if the economy slows significantly, or even shrinks as predicted by some commentators, tender prices will fall. We take the view that the UK economy is reasonably robust since the recovery from the last recession, and that there is likely to be a slowing of growth over the medium term but not one that will turn into a major recession. This slowdown will reduce construction workloads, leading to increased competition which will reduce, or even reverse tender price inflation over the forecast period.

The inflation that has already taken place in the first half of this year is expected to soften during the second half, although the overall effect is likely to result in a modest increase over the year as a whole. In 2017, we expect prices to be steady in London due to the ongoing workload already in the pipeline, however, we expect prices nationally to weaken as competition for a shrinking workload increases. This effect is expected to be repeated in London during 2018 as projects are completed and available space increases.

Table 1: Tender price inflation forecast

This table gives our current tender price inflation forecasts which should be treated as averages and there will always be variations due to procurement methods, project type and local factors. Contrary to previous forecasts, we have not carried out a comparison with other forecasts as there were none written post referendum that were available at the date of publication.

	London			National		
	2016	2017	2018	2016	2017	2018
Mace current forecast	+2.0%	0.0%	-1.0%	+2.0%	-1.0%	0.0%
Mace pre-vote forecast	+4.0%	+3.5%	+3.0%	+4.0%	+3.5%	+3.0%

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