Tender Cost Update UK
Q1 2017

PRICE PRESSURES PERSIST AS CONSTRUCTION INDUSTRY SEES SLUGGISH GROWTH

	2017	2018	2019
LONDON	1.5%	0%	1.5%
NATIONAL	2.5%	0.5%	1.5%

With the economy behaving much as expected, Mace Cost Consultancy has maintained its forecasts for this year and next.

We still expect slightly weaker tender price growth in London than the rest of the country with the commercial sector not performing as strongly as in previous years. Construction growth has started to slow but firms are optimistic and will attempt to pass on the higher input prices they are facing. As the UK negotiates its exit from the European Union, conditions in 2018 and 2019 will prove tough and we do not foresee any substantial increase in tender prices.

"The last quarter has seen little change in sentiment, with continued strong demand despite a background of ongoing uncertainty. Significant increases in material costs affecting key trades and ongoing market capacity issues continue to have a positive impact on tender prices. The snap election may cause a temporary slight slowdown in some sectors but we would expect a swift recovery."

Steven Mason
Managing Director
Mace Cost Consultancy

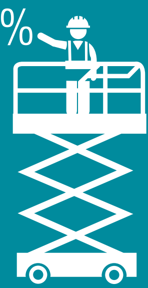
Both GDP and the construction industry suffer a slowdown in the first quarter.

The economy grew by...

+0.3%

whilst construction rose...

+0.2%



Producer prices started to slow in March.

Output prices slipped to...

3.6%

...whilst input prices fell to...

17.9%

Private housing output
2.8%
lower in February

Real wages have now started to fall.

TENDER PRICE INFLATION FORECAST

Little has happened since our previous report to warrant a change to our 2017 and 2018 tender price forecasts. London still appears likely to see slower growth than the rest of the country as the commercial market in the capital struggles to grow. Material price inflation will remain high for much of the rest of the year and short of the industry seeing considerable declines in output, firms will try to pass on these costs. Similar to 2017, 2018 is forecast to be tough. Unlike this year, there should be little pressure from exchange rate movements and as such tender price growth will be marginal.

Moving into 2019, we expect prices to rise at a slightly faster rate than in 2018 as growth starts to rise. Key to our assumption that London and national rates will grow at the same speed, is the proportion of foreign construction workers based in the capital. Whereas in many parts of the country this has been estimated as less than 10%, in London this figure is closer to half. Even if Brexit were to result in few additional controls on immigration, the pound's weakness along with the decision to leave the EU are likely to make the UK a less attractive destination. Skills shortages are a well-known issue in the sector and a shrinking pool of labour would exacerbate this and put employers under pressure to increase wages.

ECONOMIC CONDITIONS

Higher inflation impinging on consumer spending and causing growth to slow has led to the economy's trajectory this quarter being roughly as forecast. These forces are likely to persist throughout the rest of 2017 with CPI currently at 2.3% but predicted to rise to 3%. While the result of the snap General Election is anticipated to provide Prime Minister May a larger Conservative majority, such change will do little to alter the underlying economic forces. The uncertainty around what Brexit means has not changed and whilst construction firms currently appear confident, this could drain quickly especially given the poor figures in official statistics on output and orders.

GROWTH

There was a slow start to 2017 as growth in the first quarter managed just 0.3%, marginally below expectations and someway down on the 0.7% achieved at the end of last year. Dragging growth down was a reduction in the consumer sector as higher inflation starts to bite. Construction saw output rise just 0.2% quarter on quarter, 1.9% higher than where it was in the first quarter of 2016. Lower than anticipated growth may lead forecasters, who have regularly revised up their expectations for growth this year, to bring down predictions from their current average level of 1.7%.

LABOUR MARKET

In the three months to February unemployment fell to 4.7%, 0.1% down from the previous quarter and reaching a level not seen since the 1970s. Such strong performance, helped by 39,000 more people in employment is not expected to last and by the end of 2017 unemployment is forecast to rise slightly to 5%. In contrast to the strength of unemployment figures is the weakness of earnings. Wage growth slipped again in February and now stands just below inflation meaning real incomes have started to fall. The reduction in real wages should come as no surprise but how consumers respond to such a change will determine the economy's performance over the rest of the year.

EXCHANGE RATES

Between early March and the end of April the pound has staged a minor recovery, gaining around 3.5% against the euro and almost 6% relative to the dollar. This however only makes a slight dent into last year's sell-off and purchasers should not expect a reversal in price increases. Much of the pound's strength came following the announcement of a General Election as investors believed a larger majority would improve the Government's negotiating position. Whilst in our view such a majority would increase the potential for a transitional agreement, it does little to reduce the chances of a hard Brexit.

INFLATION

Over the last quarter consumer prices continued to rise and inflation now stands above the Bank of England's target level. Year on year growth in March remained unchanged from February at 2.3% but further increases are forecast. On average the Treasury's collection of forecasts expect CPI to reach 3% by the end of 2017 before falling back to 2.5% in 2018. In June last year inflation stood at only 0.5% and the rapid change has resulted in prices growing faster than wages. This will hurt consumers which in turn will lead to the economy seeing weaker growth. As more than 10% of total construction output comes from private housing repair and maintenance this sector could be particularly susceptible to households cutting spending.

MONETARY POLICY

The Bank of England does not currently view the fact that inflation has risen above its target level, and is set to continue rising, as overly problematic. At their last meeting on 15 March, the Monetary Policy Committee voted 8–1 to leave interest rates unchanged. This marked a deviation from the unanimous decisions seen at the meetings following the cut to 0.25% in August 2016. The minutes of the meeting highlighted the possibility of further members voting for a rate rise were inflation to pick-up more than expected but such a move currently seems unlikely.

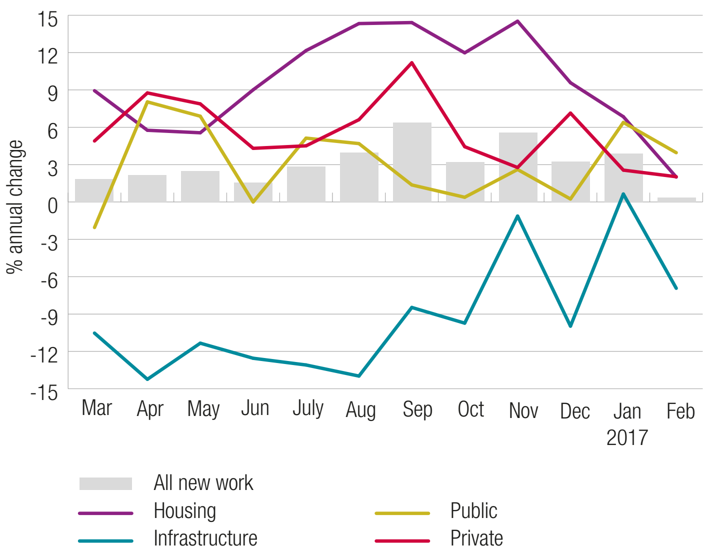
GLOBAL

Economic growth in other countries also disappointed. In France GDP was up 0.3% in the first quarter whereas annualised growth in the United States was 0.7%. Yet, for the time being neither figure should be considered a significant issue and political issues continue to dominate.

In France, Emmanuel Macron defeated Marine Le Pen and since it became clear Ms Le Pen's anti-euro stance was unlikely to win, the euro has noticeably appreciated. Similarly, all eyes have been on the new President in the US but hopes that he will increase infrastructure spending and provide considerable tax cuts are still a long way from reality.

Annualised growth in China was 6.9% for the first quarter, its fastest rate since the third quarter of 2015. However, not everything is rosy as iron ore prices have fallen recently and steel mills talking about shutting down suggest demand is not matching supply.

New construction output



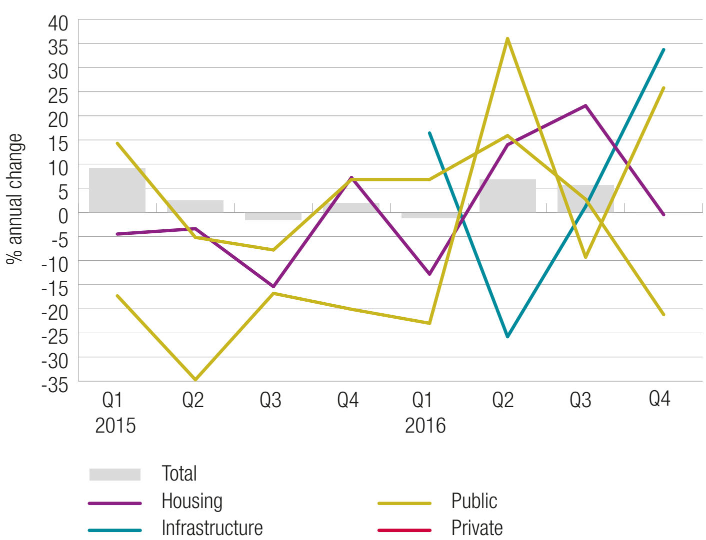
CONSTRUCTION OUTPUT AND ORDERS

Similar to the whole economy, growth in the construction industry slowed in the first quarter. Including repair and maintenance, which accounts for around one third of the sector, growth dipped to 0.2%, having managed 1% in Q4 2016. A 0.3% increase in March was all that prevented lower output in the sector with monthly falls in both January and February.

The annual change in new construction work fell to almost zero in February as the housing market which had previously been the largest driver of growth fell to 2% on an annual basis. This is considerably below the 14.5% it was at the time of our last report and comes in part as a result of falling output in January and February. In making up 35% of total new work, any slowdown in housing is likely to have a detrimental effect on the sector. House price growth is forecast to be muted this year as changes to the ability of landlords to offset interest payments and lower real incomes weigh on the market making a repeat of the substantial growth rates in 2016 unlikely. The commercial sector, which is the second largest part of the industry has also got off to a slow start this year, falling 1.3% month on month in February. It could potentially see further falls this year having finished last year with two quarters of poor new orders.

The final quarter of 2016 was a poor one for new construction orders as they fell 2.8% from their third quarter level. This followed a 2.6% reduction in the third quarter and if firms start to worry about the size of their order books, it is likely to result in more competitive bidding and lower tender prices. New order figures tend to be very volatile but the annual pace of growth has now fallen for three consecutive quarters to just below 0%. The commercial sector once again suffered a big drop, falling 10.6% in the fourth quarter, almost exactly the same as seen in the third quarter. London managed to avoid a repeat of the third quarter when commercial new orders were over a third lower but a further 4.6% reduction means it is at its lowest level in three years. In the Chancellor's Budget in March only minimal relief was offered for the change in business rates that will hit London firms particularly badly. Combined with the difficulties in maintaining passporting leading to financial firms planning on shifting some operations away from the UK, a substantial rebound would appear tricky.

Construction new orders



MARKET VIEW

In 2016 the housing sector was the largest driver of growth in the construction industry. This makes the recent fall in residential output worrying and along with signs of building weakness, figures from Halifax and Nationwide's house price indices suggest sluggish sales. Adding to this impression is the RICS UK Residential Market Survey. In their March report they found new buyer enquires to be flat for the third month running whilst sales instructions fell. The number of transactions has also been steady for a number of months but respondents were more confident about the next year, expecting sales and prices to improve.

Over the past three months the Markit/CIPS UK Construction PMI has barely moved from a level just above 52. With 50 being the point where activity is expanding, this indicates the sector is growing but only slowly. In another sign that the residential sector isn't performing as well as previously, housebuilding whilst still growing has now slowed in four consecutive months. More positively is the rising level of civil engineering which is now the strongest sector. Similar to input producer prices, this survey has found input costs to have fallen slightly from their peak but are still close to multi-year highs.

The Construction Products Association saw a sharp jump in confidence in its first quarter survey. Whereas previously the balance of heavy side manufacturers expecting a rise in sales in the next quarter was just 6%, this time it had increased to 68%. Light side firms also reported an improvement, albeit not quite as drastic, as a balance of 47% of firms expected rising sales compared to 29% previously. Reasonable sales growth in the first quarter will have helped firm confidence but inflation is still a big concern and 85% of manufacturers believe costs will increase in the next 12 months.

A second survey reporting optimism about the next quarter was the Federation of Master Builder's State of Trade Survey who found almost half of businesses were expecting higher workloads. Whilst the current residential workload balance fell from 30 at the end of 2016 to 11 in the first quarter, expectations around the next quarter have risen from 4 to 34. This suggests that respondents have seen the market slow but expect it to pick back up again soon.

The first quarter RICS UK Commercial Property Market Survey provides some explanation as to why new orders may have been so poor in the commercial sector. They find limited growth in occupier demand, especially for offices and retail with rent expectations also low in both sectors. By contrast the industrial sector sees solid figures for occupier demand, rent and capital value expectations. Investment enquires remain strong, driven by foreign buyers who continue to enjoy the weak pound but around 40% of respondents expect to see firms relocate over the next two years.

Overall, these surveys show that growth whilst by no means strong, continues. In addition, even with all the uncertainty, firms appear confident and believe conditions will improve over the summer. With input prices high and few anticipating cuts, this optimism is likely to lead to firms trying to pass on a substantial part of rising costs.

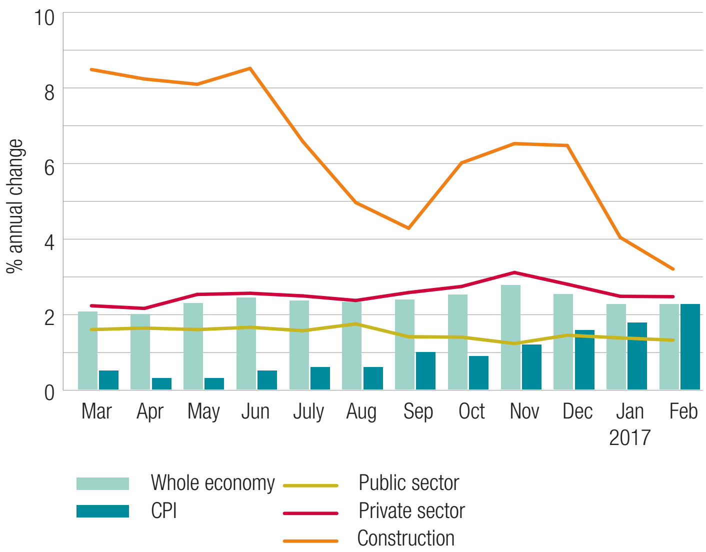
INPUT COSTS

Labour

Earnings in the construction industry have slowed substantially over the past few months. In the aftermath of the referendum total yearly wage growth fell from 8.5% in June 2016 to 4.3% in September before rebounding and finishing the year 6.5% higher than at the end of 2015. The first two months of 2017 have seen a second drop in pace and having far outpaced the national average for most of the past two years, growth has slipped back to close to this level.

Given a number of surveys have reported increasing headcount and employment levels in the industry hit a high for the decade in December, the pace of the earnings slowdown comes somewhat as a surprise. It suggests firms are having to closely watch their wage bills, unable to justify higher labour costs whilst also managing the jump in material costs. If firms can continue to manage these costs it will help limit the rise in tender prices. Whether they will be capable of doing this is a different question. This is particularly true in London where around 50% of workers were not born in the UK and any reduction in immigration due to Brexit is likely to exacerbate current skills shortages.

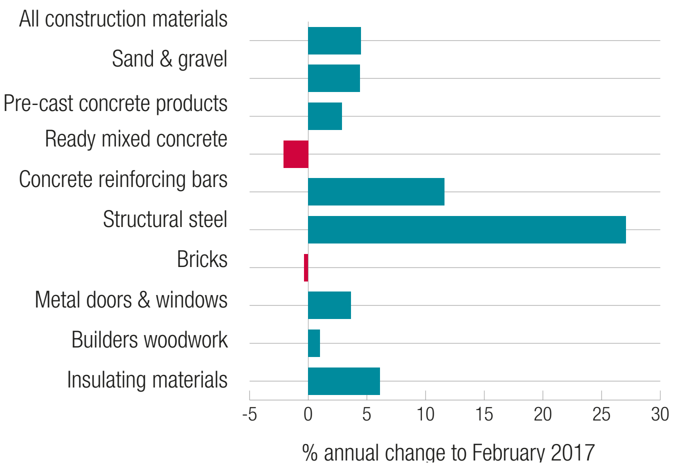
Average weekly earnings



MATERIALS

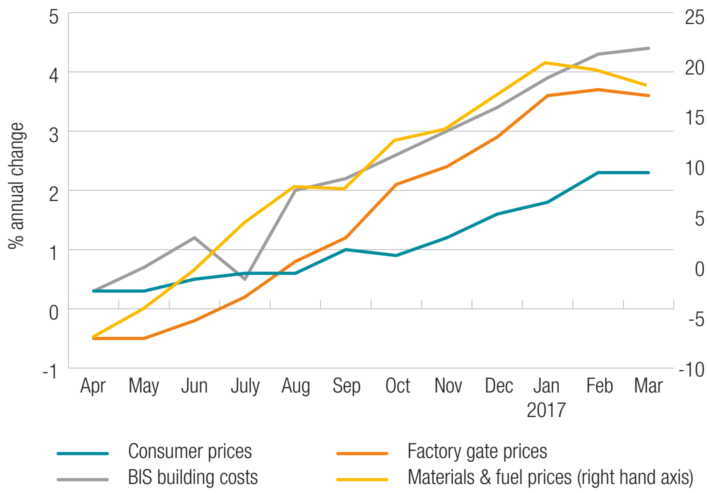
Since our last report the cost of construction materials has risen rapidly. The yearly inflation figure for the all work building index was 2.9% in November but by February this had jumped to 6.1%. Some of this shift was due to base effects following a fall at the end of 2015 but prices have also been rising over the past three months. Most striking over this period was concrete reinforcing bars, up 8.9% in the quarter and 27.1% for the year. Structural steel has also seen considerable growth but neither product should expect prices to continue at this pace for long. Steel prices are forecast to slow as issues in the Chinese market including excessive output and a build-up of inventories have already caused a substantial drop in local prices and the price of iron ore to drop by 16% and these are likely to feed into the wider industry.

Materials prices



The recent strengthening of the pound is unlikely to trigger a sudden reversal in price increases but it should provide some support for importers. Having only recently increased their prices and in many cases informing clients of double-digit rises, suppliers are likely to want to hold onto any increased profits the pound's appreciation will create. They will also be reluctant to cut prices given there is no guarantee the pound won't fall again. Finally, and most importantly, whilst the pound has performed well since the middle of March, it is still considerably weaker than where it was a year ago.

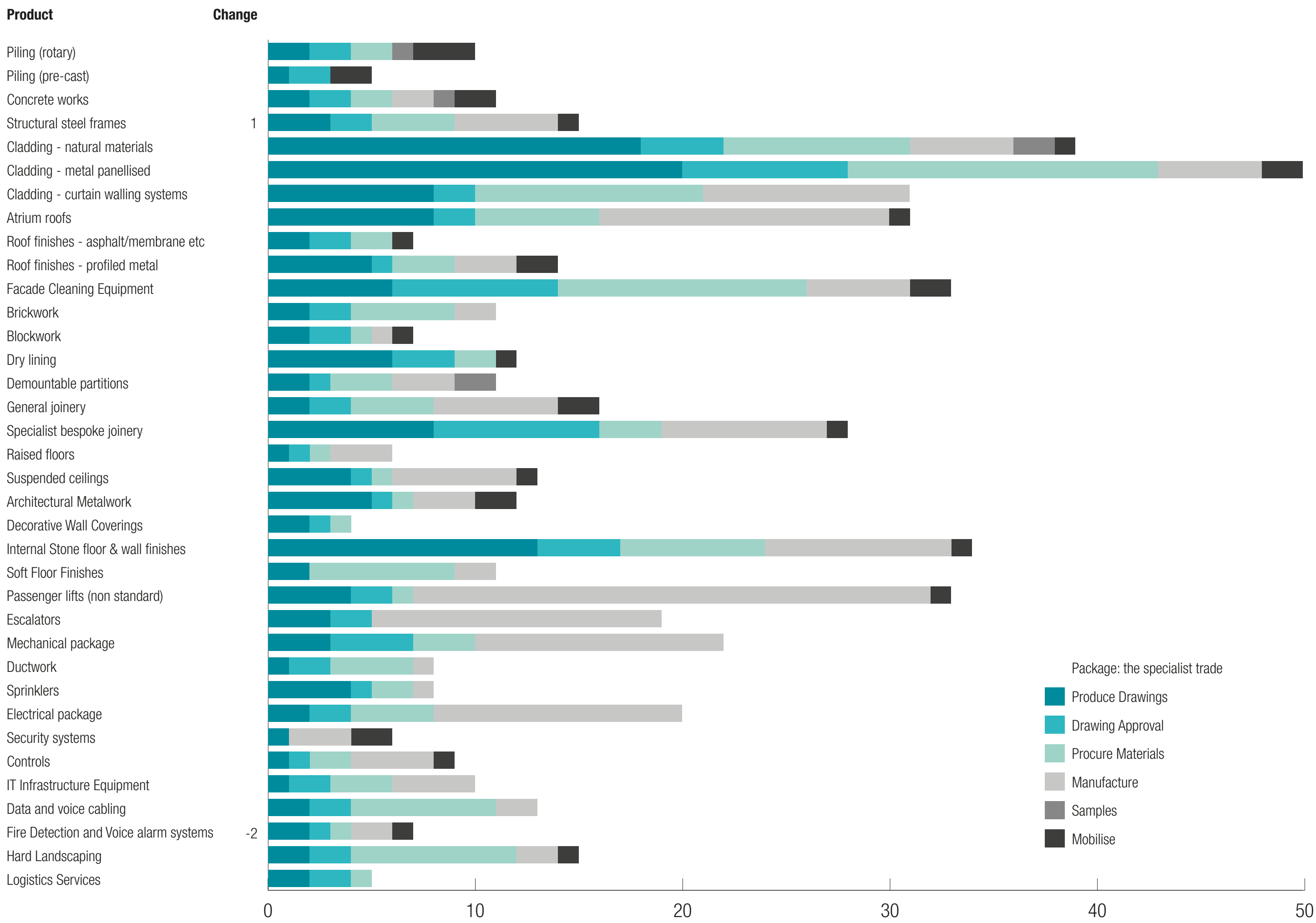
Inflation Indicators



SUPPLY CHAIN FOCUS

"There are signs that lead times are beginning to increase again following the low level of movement last quarter. Four packages including steelwork, architectural metalwork, lifts and mechanical services have increased lead times due to increased workload whilst fire detection and piling have capacity and therefore reduced lead times."

Brian Moone
Director of Supply Chain Management at Mace



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