Building bulletin

Building cost update

A review of the construction market covering the economic and property market backdrop; movement in material prices, labour costs and tender prices and the medium term outlook for the sector.

Q2 2012

There has been a renewed downturn in construction activity, following the small upturn in 2010 as private sector demand struggles to replace the public sector stimulus

This will keep pressure on input costs, although tender prices are likely to show modest growth as contractors struggle to absorb further costs.

This bulletin starts with a review of the market as this sets the scene for our analysis and forecasts for construction output and for tender prices and building costs.

Market overview

Over the last six months UK economic output has shrunk 0.5%, occupier demand has been weak and rental values have fallen in many locations, particularly secondary locations. Central London has been an exception with retail and office rents increasing, but at a more muted rate than a year ago.

The pattern of investment activity matches occupational activity, with much stronger activity in London than elsewhere. Over the last 12 months investment yields have edged down marginally, but over the last six months this has ended and yields have started moving up. As a result capital values are now falling.

Weak occupier demand and falling rental and capital values have affected development viability and new commercial and industrial development activity. The small upturn in activity that occurred in 2010, when capital values were rising, has reversed and new construction activity is now lower than it was at the depth of the recession in 2008/2009 and only about a third of its 2007 peak.

GVA view

- Economic growth should improve in the latter half of 2012 but overall economic growth in 2012 will be very weak and no better than in 2011. Slightly stronger growth is likely in 2013 and then close to trend growth should occur in 2014, 2015 and 2016. We expect negative rental and capital value growth in 2012 and weak, but positive, growth in 2013, accelerating slowly thereafter.
- New development activity will reflect the pessimistic outlook for the economy and rental and capital values. This will be reinforced by constrained development finance. Development activity is, therefore, unlikely to increase over the next year or two.
- Stronger economic growth is expected in London and its hinterland than in the rest of the UK. This, coupled with healthier occupier demand, strong overseas investment and a shortage of prime stock, should stimulate a continuation of the development upturn in central London.
- The shortage of development finance from banks will continue to affect the amount of development activity for some years to come, but alternative sources are emerging although not on a sufficient scale to make up the shortfall. Development finance and JV development agreements will be limited to the best quality schemes in the best locations, with substantial pre-lets to minimise risks.

Tender prices and building costs

- In spite of falling workloads, tender prices are forecast to show modest growth as contractors struggle to absorb further costs.
- Material price growth has weakened over the past year but growth should stabilise at between 3% and 4% pa.
- Labour cost inflation will remain well below general inflation for the next two years as workloads fall, before gradually increasing to 4% pa by 2016.

Tender Prices

Tender prices have increased 8% since their low point in 2010 but growth was flat in the second half of 2011, according to BCIS. They have recorded 0.5% growth in the first quarter of 2012. In spite of an expected fall in new work output this year, this modest growth is likely to continue in line with input costs as contractors struggle to absorb further costs. BCIS forecasts 0.9% pa growth in 2012, 2.2% in 2013 and gradually accelerating to 4.2% pa by 2015

Materials

Material price inflation was flat in the second half of 2011, compared to strong growth seen during the previous two years, reaching a peak of 8.8% pa growth in July 2010. The first quarter of 2012 has seen a pick up in modest price growth and BCIS forecast growth of 3.3% for 2012. The moderation in material prices is largely due to the fall in steel prices over the past six months.

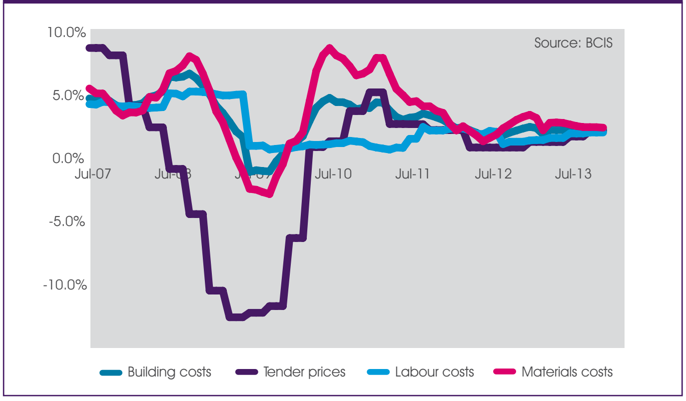
However, materials that are dependant on oil prices, such as coated roadstone and paint, as well as energy intensive manufactured materials, such as bricks and cement, have seen above inflationary growth over the past year. Oil prices are exacerbated by the comparative weakness of sterling against the dollar compared to four years ago.

Material price growth is likely to average around 3% pa for the first three years of the forecast to the end of 2014, rising to 4% pa between 2015 and 2016.

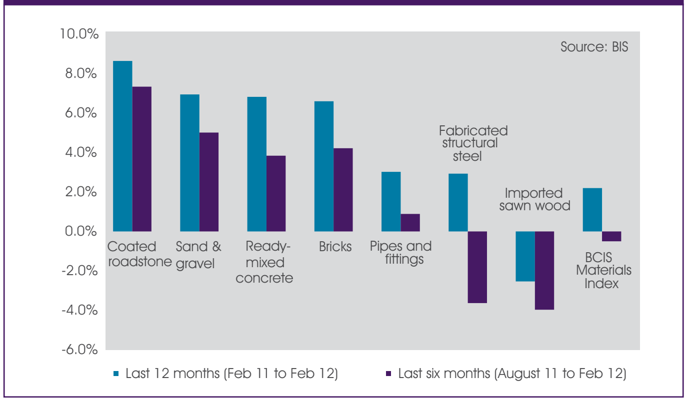
Labour

Wage inflation remains below general inflation. The BCIS labour index grew by 2.2% in 2011, compared to 1.3% in 2010 and current RPI of 3.6%. Wage growth is likely to remain subdued for at least two more years against a backdrop of falling demand. BCIS forecast growth of 1.4% in 2012 and 2.2% in 2013, before gradually increasing to 4% pa by 2016, as demand picks up and wage settlements rise.

Year-on-year change in cost indices



Material price growth to Feb 2012



Recent construction industry wage awards have varied between no increase for electricians and steelworkers, 1.5% for builders, 2% for plumbers and 3% for demolition workers. Employees in the busier infrastructure sector are benefiting from increased workloads. Unsurprisingly the Construction Products Association (CPA) reports that just 2% of firms had difficulty recruiting labour in Q4 2011. This compares to between 60% and 80% before the recession.

GVA view

The construction market remains generally weak across all sectors with building contractors and their supply chain suffering from a continued slump. Small and medium size contractors are under particular pressure as finance from the banks continues to be restrained.

Whilst labour costs for contractors have generally remained static or have seen increases in line with inflation, material prices continue to accelerate. This is due to the volatility in raw materials which has resulted in tender prices being put under real pressure by the increase in input costs. Contractors as a result are generally reluctant to fix these costs and are bidding at cost or below in order to win work in a competitive market place.

Uncertainty regarding the fragile state of the economy continues to hamper the start of new schemes across all sectors. Whilst the level of commercial property development remains low, sentiment on the ground does appear to be improving marginally. There are some encouraging signs within the sector with several high profile projects now under construction. However these are generally limited to London and the South East.

Construction activity in the short term is not likely to recover significantly due to a combination of poor viability, the weak outlook for occupier demand and the time needed for the industry to rebuild capacity. Any recovery is only likely to commence from 2013 onwards if favourable economic circumstances permit. This growth however is likely to be sluggish as cuts in public sector spending deepen and tax rises take hold.

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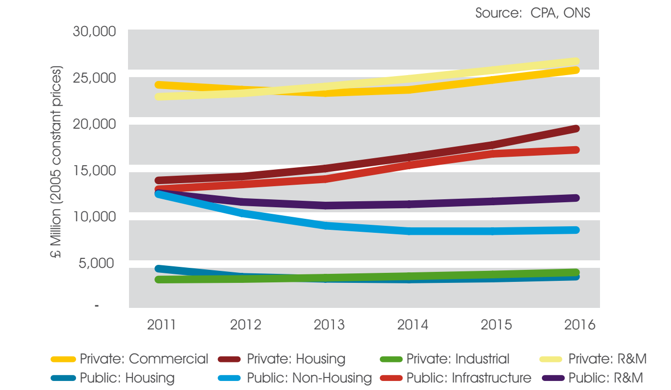
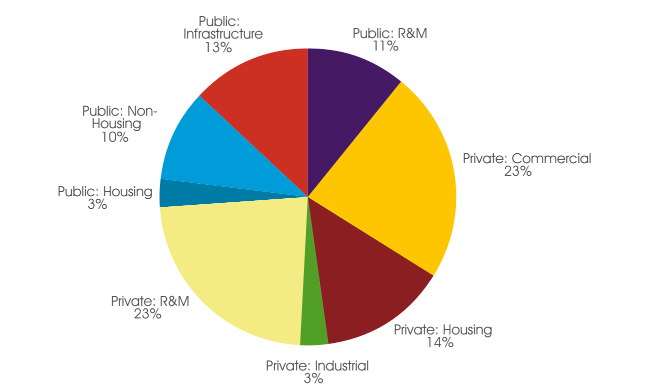
Construction outlook

- CPA forecasts indicate a fall of 2.9% in construction output this year, flat growth next year and a rise of 3.4% in 2014.
- The return to growth in 2014 will be led by private housing, infrastructure (particularly rail and energy construction) and a slow recovery in the commercial sector.
- Significant falls are anticipated in public non-housing (predominantly education and health) and public housing.

Construction Industry Output Forecast



Total Construction Industry Output 2011



Continued construction contraction

Construction output is forecast to fall by 2.9% in 2012, following an increase of 2.4% in 2011. The fall this year is predominantly due to the cuts in the public sector – housing, non-housing and repairs and maintenance. Meanwhile, commercial construction has yet to gain enough momentum to fill the gap left by the cuts, although growth in private housing and particularly infrastructure are providing some buoyancy.

With growth in these sectors along with a gradual recovery in the commercial sector, the CPA forecasts output to remain flat next year, with 3.4% pa growth in 2014 before accelerating to almost 5% pa in 2015 and 2016. Experian forecast a deeper contraction this year of -4.4% but a faster recovery in subsequent years. These forecasts assume no further significant shocks in the Euro zone.

Private housing starts contracted by 3% in 2011 but are expected to recover in 2012 by 5%, before strengthening to double digit growth of between 10 and 13% pa between 2013 and 2016. While starts are still very low historically, improving conditions will be boosted by schemes such as 'New Buy' that assists first time buyers to get 95% mortgages and 'Get Britain Building', set up in March to support construction firms in need of development finance.

Starts for **public housing** on the other hand will be affected by the changes to the funding mechanism and planning policy. Capital funding has reduced significantly and housing associations will be more reliant on capital markets, as there is a shift to make the provision of affordable housing more commercial and enable housing associations to charge 80% of market rents. This will inevitably slow down activity as parties adjust to the new conditions. Consequently, starts are forecast to fall 22% this year and 5% next year, before a modest recovery thereafter.

Public non-housing cuts started in 2011 with a fall of 7% in output primarily due to falls in 'public health' and 'public other' (defence and prisons etc). The size of the sector and severity of the cuts ensure that this sector has a significant impact on overall construction output. Most current health construction projects are under a scheme called 'Procure 21+'. These mainly consist of small to medium size projects whereas there is a lack of larger projects in the pipeline. As contracts complete on 'Building for Schools for the Future' (BSF) and the work on the Olympics completes, output is expected to fall a further 17% during 2012 and a further 20% during 2013 and 2014 before stabilising.

Commercial construction activity made a modest recovery in 2011 with 4% growth as a result of activity in the London **office** market. However, this has since slowed with the stalling of high profile construction projects in the City because of the difficulty in attracting pre-lets. **Retail** was the strongest commercial sub-sector in 2011 with growth of 5% and the outlook remains mildly positive. This was mainly due to the growth of supermarket projects and expansion of niche outlets such as coffee shop chains. **Industrial** construction will see a gradual recovery in construction output from this year. Factory demand will come from an increase in exports to developing nations such as the BRIC countries and warehousing demand from the expansion of the supermarkets and warehouse intensive internet retailing.

Output in **infrastructure** has seen constant growth since 2007. This will continue with 4% growth in 2012 and an average increase of 6% pa between 2013 and the end of 2016. The main contributors to this growth are rail and nuclear electricity. The **rail sector** will be boosted because of works to Crossrail but there will be severe funding cuts to Network Rail's CP5 budget. In the **electricity** subsector output will rise between 20% and 30% pa this year and until the end of 2014. This will be driven by work on nuclear power plants such as Wylfa and Sizewell and offshore wind generation capacity will continue to increase.

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