

Building bulletin



Building cost update

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

Q4 2012

The construction sector is suffering from a combination of falling public sector output and a stalling private sector. With all construction output estimated to fall by over 6% in 2012, and with little movement in building costs, tender prices have seen a modest decline during the second half of the year.

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.



Savoy Hill House, London

Market overview

Over the last six months UK economic output has grown slightly, but occupier demand remains weak and rental values continue to fall outside London and the South East in all sectors. Prime rental values are generally stable but secondary values continue to fall slightly at much the same rate as six months ago.

Investment activity remains at much the same level as it was six months ago and at much the same level as it has been over the last two to three years, with much stronger activity in central London than elsewhere, boosted by increasingly strong overseas interest. Over the last six months prime property investment yields have generally not altered, but secondary yields have increased noticeably. As a result, prime capital values remain stable whereas there has been a strong decrease in secondary capital values due to falling rental values and rising yields.

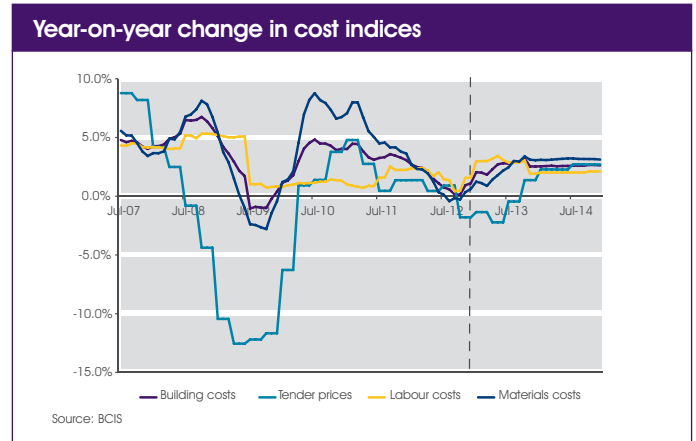
Weak occupier demand, flat prime rental and capital value growth in addition to little change in tender prices mean that development viability has not improved outside London. New commercial development activity is reasonably healthy in London, but not elsewhere. New commercial construction activity has been at a stable level over the last 12 months, but remains weaker than it was at the depth of the recession in 2008/2009 and only about a third of its 2007 peak.

GVA view

- Slightly stronger economic growth is anticipated in 2013 but the outlook is for weak growth for some years. The latest consensus forecasts expect below trend growth in 2014, 2015 and 2016. We expect negative rental and capital value growth will persist in some sectors and locations in 2013, but there should be a slow gradual improvement from the end of 2012.
- New development activity will reflect the weak outlook for rental and capital value growth and this will be reinforced by constrained availability of development finance.
- Stronger economic growth is expected in London and its hinterland than in the rest of the UK but the uncertain world outlook may affect the strength of occupier demand in London. However, strong overseas investment demand should persist, keeping yields low, capital values high and development activity reasonably healthy.
- The shortage of development finance from banks will persist for some years to come but this is less of a concern for the larger developers in areas of the country where the economy is buoyant and pre-lets are possible. Alternative sources of finance are also increasing for developers with a good track record. However, in many areas of the country the shortage of finance remains a problem as does poor development viability.

Tender prices and building costs

- Falling workloads have resulted in a slight decline in tender prices over the second half of 2012 but forecasts indicate that this will recover in 2013.
- Material prices have fallen back in the second half of 2012, showing little change over the year. Growth is expected to resume next year at around 3%.
- Labour cost inflation will remain below general inflation for the next two years as workloads fall, before gradually increasing to 4% pa by 2016.



Tender prices

Tender prices have changed little over the last two years. Falling work output, softening materials prices and increased competition have led to a modest fallback in tender prices in the second half of the year. BCIS expects tender prices to end the year 1.8% lower but increase 1.5% in 2013.

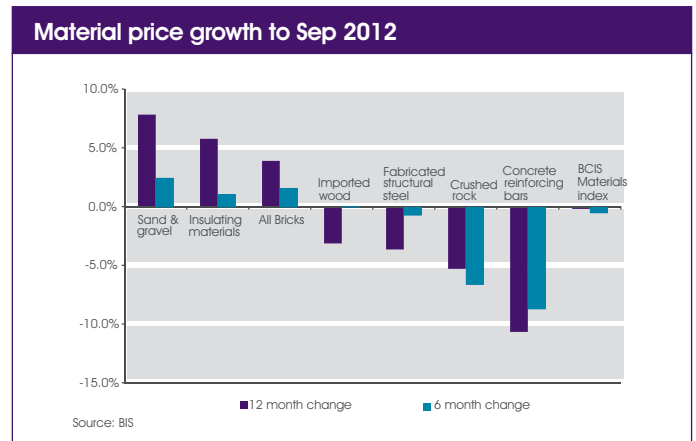
Tender price growth should accelerate in subsequent years and reach around 5% pa by 2016/17. London and the South East are likely to lead the recovery in tender prices, with growth being earlier and stronger than in other regions.

Materials

There has been a significant slowdown in material prices over the past two years. They increased at the beginning of the year but have since fallen back, showing little change over the year. Growth is expected to resume next year at around 3%.

The slowdown in the world economy has seen a reduction in commodity prices as supply has outstripped demand. This has affected the price of steel and materials such as concrete reinforcing bars and crushed rock which have also seen a significant fall in price. As the pound has strengthened slightly against the euro over the past year there have been price falls for imported products such as sawn wood. With the euro crisis still not resolved this position is likely to be maintained or strengthened further.

Materials that have shown significant increases over the past year include sand and gravel and insulation, in response to the green agenda. Oil prices have been quite volatile this year ranging from \$125 a barrel in March to \$90 in June and currently lie at \$110.



Labour

The BCIS labour cost index rose by 1.4% over the year to the end of August 2012 and is expected to increase by 2% pa over 2013 and 2014 before gradually accelerating to 4% pa by 2017. Those in the construction industry benefiting from a wage increase this year include plumbers (3% in January), demolition workers (2.5% in July) and building operatives who will receive a 2% increase from January.

Operatives in the heating and ventilating industry have received their first wage award since 2010 but along with builders under the BATJIC agreement negotiations are still ongoing. Electricians have not received a pay increase since January 2010 but have agreed an increase of 1.5% from January 2013 and 2% from January 2014.



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GVA view

- The construction market remains generally weak across all sectors with contractors and their supply chain suffering from a continued slump. Whilst labour costs for contractors have generally remained static or have seen increases in line with inflation, the volatility in raw materials has resulted in tender prices being put under pressure.
- Whilst tender prices may now be close to bottoming out, indications are that they will remain stagnant or limited to below inflationary adjustment in the near term. Large contractors continue to target work on smaller projects to help maintain workloads in a market where client budgets are continuing to be reduced.
- 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 slightly.
- Growth next year is likely to be muted and only be realised if favourable economic circumstances permit. Such marginal growth may lead the way towards a gradual recovery of the construction industry heavily led by the private sector. The challenges facing the global economy in recent years have however made accurate forecasting near impossible.

“ Whilst the level of commercial property development remains low, sentiment on the ground does appear to be improving slightly. ”

Construction outlook

- Construction Products Association (CPA) estimates a fall of -6.3% in construction output this year, -1.4% 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.

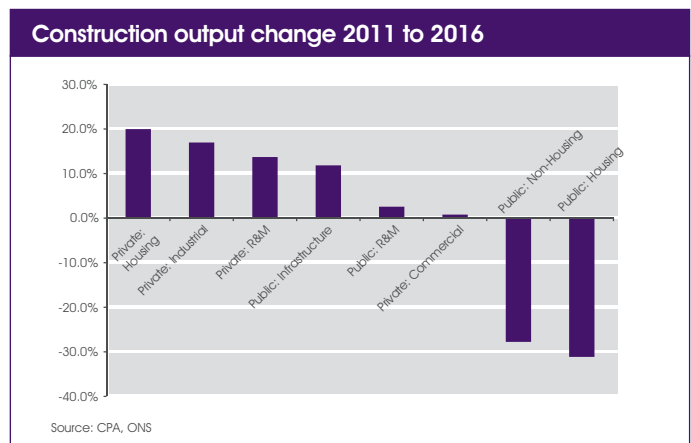
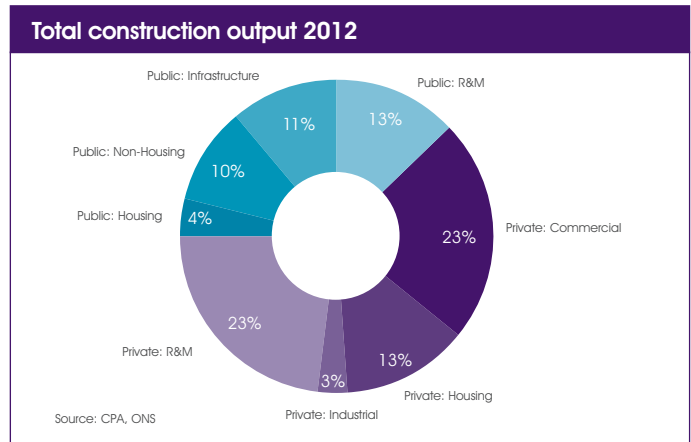
The construction industry is currently suffering from falling public sector output and an increasingly subdued private sector. The CPA estimates a sharp fall in construction output during 2012 of -6.3% followed by a further fall of -1.4% in 2013 before recovery begins in 2014 (3.4%). Any further significant economic shocks are likely to delay the recovery.

The **commercial** sector, which makes up nearly a quarter of all construction output, has seen a significant slowdown during 2012. The London office market is still relatively buoyant with major projects such as the 'Walkie-talkie' and 'Cheesegrater' however the Pinnacle has been put on hold for the second time. Retail sector growth has been driven by expansion programmes of the major supermarkets, although these plans have been scaled back in recent months. The entertainment sector, which accounts for a fifth of commercial output, will see a scaling back in demand following the Olympics, with budget hotel expansion reaching a plateau and no new major stadia in the pipeline. Commercial output is estimated to fall 6% in 2012 and a further 3% in 2013 before showing the first signs of growth in 2014.

The number of homes built remains less than half the number of new households created each year. Recovery in the **private housing** market will be dependant on a shift in the mortgage lending market, which is currently 10% lower than a year ago and 63% lower than the peak in 2006. However this is unlikely to change much over the next two years. The government has introduced a number of measures aimed at boosting the house building sector, the most significant of which is likely to be the additional finance provided for the 'First Buy' scheme to help first time buyers with a deposit. CPA estimates a 3% fall in output this year, recovering in 2013 by 2% and increasing year on year to 10% by 2016.

The cuts outlined in the capital spending review are having a significant impact on **public non-housing** output, which will fall 34% during 2012 and 2013. From this level, there will be modest growth from 2015 onwards. The main schemes affected by the cuts in this sector include work on the Building Schools for the Future programme, ProCure 21+ (the framework for NHS new construction and refurbishment work) and work on new prisons, defence estate, office facilities and law courts.

The **infrastructure** sector has shown continued growth over the past four years but 2012 is estimated to see a 13% fall in output.



Nuclear and offshore wind investment has been pushed back 12 to 18 months but decommissioning work worth £3 billion per year will be the main driver of strong growth in the sector from 2014. Rail investment is showing strong growth with work on Crossrail, Thameslink and Network Rail's capital investment plans pressing ahead. However prospects for expenditure on roads are downbeat with authorities forced to cut capital spending.

Although less high profile to the construction industry, **repairs and maintenance** make up a third of the output. Fluctuations in this type of output are also much less than for new work, showing little overall change until the end of 2013 and then resuming modest growth. Falls in public repairs and maintenance will be counterbalanced by modest private sector growth.

Private housing repairs and maintenance will be affected by consumer confidence and the number of housing transactions but take-up of the Green Deal and the Energy Company Obligation (ECO) will influence output growth in the coming years. Falls in public housing repairs and maintenance output will not be affected as badly as public new house building and will be boosted by the allocation from the Decent Homes Programme. Public non-housing repairs and maintenance (schools, health and roads) will contract by over 4% over the next year and private non-housing (commercial, industrial and infrastructure) - the largest repairs and maintenance sector, worth £12 billion in 2011 - will grow 2-3% pa over the next three years.

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