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.

Q2 2013

This bulletin provides an outlook for the construction sector. It examines the movement of tender prices and input costs such as material prices and labour costs, with forecasts over the next five years.

It also provides an analysis of the sectoral components of construction output, together with forecasts for construction output. But firstly the scene is set by examining the wider market conditions.

Market overview

UK economic growth was positive in Q1 2013, exactly offsetting negative growth in the previous quarter, meaning no overall growth over the last six months. Occupier demand is, not surprisingly, generally weak outside London and the south east. Rental values continue to decline for anything other than prime property, where rents are stable or improving slightly.

Investment transactions increased slightly over the last six months, with strong activity mainly confined to London, due to intense overseas demand. Prime property yields remain stable or have edged lower, but poorer quality property investment yields have continued their upward trajectory over the last six months. Consequently, prime capital values have been stable or have increased slightly, but at the other end of the quality spectrum capital values continue to fall due to lower rental values and higher yields.

Outside London weak economic growth and occupier demand, stable prime rents and capital values and little change in tender prices has meant little change in development viability or activity over the last six months. Over the last year new office construction orders have weakened slightly, new retail construction orders have declined noticeably, but new industrial construction orders have actually increased.

GVA view

- Economic growth and occupier demand should be slightly stronger in 2013 compared to 2012 and stronger still in 2014, but the improvement will be slow and patchy. Below trend growth is expected up to 2016. Rental and capital values should increase (marginally) in many areas in 2013 and in most areas in 2014.
- New development activity should slowly increase in 2013 and thereafter, reflecting the gradual improvement in rental and capital values and the increasing shortages of available prime office and industrial property. Development finance will remain a constraint, but increasingly less so as market conditions improve. The retail sector will recover more slowly due to the continuing decline in wages (in inflation adjusted terms) and the continuing strong growth of online retail spending.
- London and its hinterland should continue to see stronger economic growth and occupier demand than the rest of the UK. The world economic slowdown in 2012 did affect the level of office occupier demand in London, but not investment demand, which increased. Stronger world economic growth in 2013 and particularly in 2014 should strengthen office occupier demand and rental values, and overseas investors will continue to see London as an attractive safe haven, pushing up capital values.

Tender prices and building costs

- According to BCIS tender prices have shown little movement over the past year but growth will gradually accelerate to 4.5% pa by 2017.
- Material prices have also shown little movement over the last year and increases are forecast to show a similar trajectory to tender prices, reaching 3.5% pa by 2017.
- The BCIS labour cost index has increased 2.7% over the year to March 2013. We expect wage rises to remain subdued over the next two years.

Tender prices

The BCIS tender price index has shown some volatility over the past year, due to upward cost pressures and downward market pressures. However, the quarterly increase of 4% in Q4 is thought to be a blip. The underlying trend is more benign and shows little movement over the year, similar to other published tender price indices.

BCIS forecast an increase in tender prices of 2.2% to Q1 2014. Growth should accelerate thereafter, increasing to 4.5% pa by 2017.

Input costs

The BCIS building cost index rose by 1.4% over the year to March 2013, as a result of an increase in labour costs, while material prices have shown no movement over the same time period. Building costs are forecast to increase 1.6% pa to Q1 2014, rising to 3.7% pa by 2017.

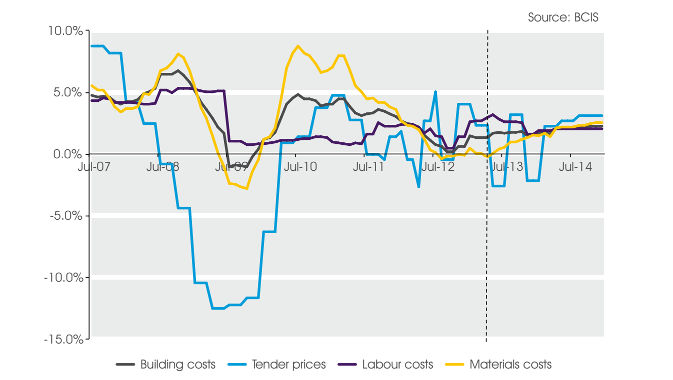
Materials

While the overall material prices index has shown little movement, some materials have seen significant price fluctuations, with the most notable increases over the year to March including sand and gravel (9.1%) and particle board (6.1%). These increases have been counterbalanced by significant falls in other building materials such as concrete reinforcing bars (-7.6%) and crushed rock (-5.6%).

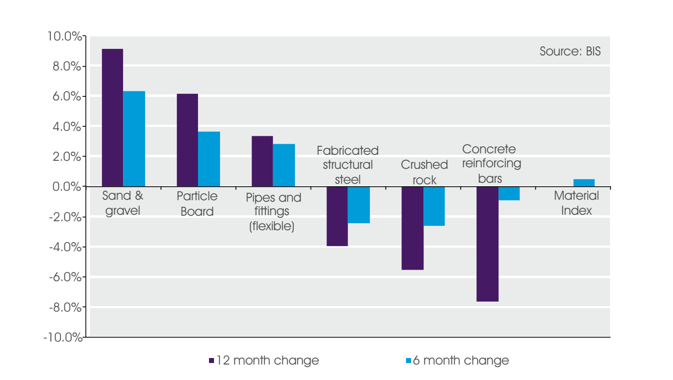
According to BCIS, material prices are forecast to rise by 1.5% over the year to Q1 2014, tempered by falls in the price of iron and copper. Global demand is not expected to have a significant impact on prices, which are forecast to gradually rise to 3.5% pa in 2017.

The price of oil has adjusted downwards over the last two months. It fluctuated between $110 and $115 a barrel in the six months to March this year but dropped below $100 in April. However, the benefits will have been partially offset by the value of sterling weakening against the US dollar. Sterling has also fallen against the euro, increasing the price of imported materials.

Year-on-year change in cost indices



Material price growth to Sep 2012



Labour

The BCIS labour cost index rose by 2.7% in the year to the end of March. Labour costs are forecast to rise by 1.9% over the coming year to the end of March 2014 and gradually increase to 4% pa by 2017.

There was a 2% increase in basic wage rates from January 2013. A number of operatives received this award including builders (BATJIC), civils (CIJC) and steelworkers. Operatives in the heating and ventilating industry received a pay increase of 1.5% from April as did those in the thermal insulation industry, of 2.5%.

According to the Construction Products Association (CPA), few contractors reported difficulty in recruiting general operatives in Q4 2012, which compares with 60 to 80% pre-recession.

GVA view

The construction market remains generally depressed across all sectors with both contractors and their supply chain suffering from a continued slump. Construction activity continues to decline year on year and the sector is weighing heavily on the overall performance of the UK economy.

Infrastructure, commercial and industrial sectors have all fared badly but infrastructure and the private housing sector are forecast to lead the recovery. The large house builders have seen an upturn in their fortunes and have been helped by Government schemes such as New Buy which has bolstered sale levels. In contrast social housing has suffered badly due to the Government focus on the provision of affordable rather than social housing.

Whilst labour costs for contractors have seen slight increases, material prices have generally remained at last year's levels. We believe that tender price growth will be strongest in London due to greater activity compared to the rest of the country.

Contractors continue to experience extremely competitive tendering conditions in a declining market. Margins remain under pressure and these will continue to be set at very low levels, until there are signs of capacity being taken out of the market through an increase in work volumes.

Whilst previously contractors have turned to the supply chain to achieve cost savings, sub contractor pricing levels appear to have hardened. This may be a result of reduced competition due to the numbers of firms lost to insolvency over the past few years. Contractors are becoming more risk adverse and selective in the jobs they are prepared to bid for, seeking profit over turnover.

Construction output forecast

- Construction output fell by 8.1% during 2012. The Construction Products Association forecasts output to contract this year, but by much less (-2.1%) and recover next year with growth of 1.9% followed by 3.8% in 2015.
- We expect infrastructure spending and private housing to provide the main drivers of growth. Commercial activity, accounting for a fifth of all construction output, continues to be hampered by sluggish growth but should start recovering in 2015.
- Public sector contraction will continue with public education and health construction output forecast to fall 15% this year.

Construction output fell 8.1% during 2012 and contracted 2.4% during Q1 2013. There is a more positive outlook for the rest of the year, at least in stemming the decline in output. The CPA forecasts a fall of 2.1% in construction output for 2013.

Falls in public sector output continue to weigh on overall output, having fallen by 8% since 2010, while the private sector has also fallen by 4%. The construction sectors that are likely to show growth over the short term include private housing, infrastructure and factories.

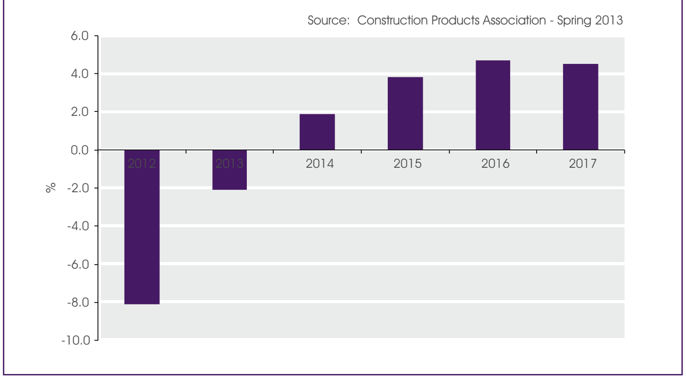
Improvement in private housing construction has taken time to gain traction but government policy is starting to impact positively on the sector with FirstBuy and the more recent Help to Buy. There is concern that these schemes will fuel house prices rather than house building, but the scale of Help to Buy is likely to significantly help the finances of house builders as well as buyers.

Infrastructure construction output saw the strongest growth in the years following the recession but contracted by 12% last year as key projects were delayed. However, it is expected to assume its role as a key driver of growth, primarily with rail investment in Crossrail and Thameslink, peaking over the next few years. Road commitments include the Forth Replacement Crossing and the Mersey Gateway Toll Bridge. Decommissioning is the key driver in the energy sector.

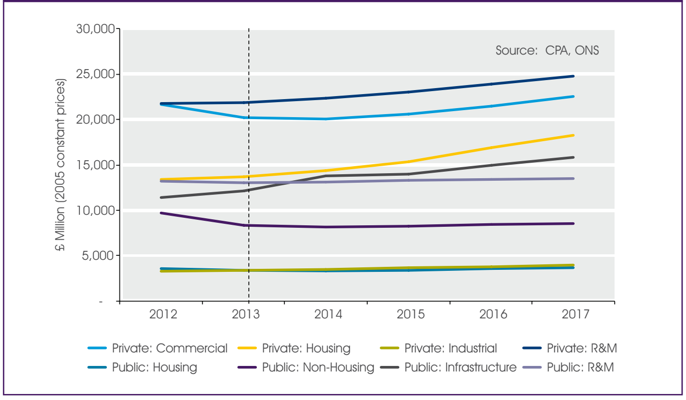
Commercial construction output is expected to fall by 6% this year and 1% in 2014. The London office market continues to outperform the rest of the country and there are a number of large projects in the pipeline. These include Google's £300 million HQ at King's Cross and Goldman Sachs' 1.2 million sq ft headquarters at Holborn Viaduct. There is currently 11 million sq ft of central London offices under construction, the highest level for nearly four years.

Contraction in the retail sector is expected to continue this year as firms have reduced the scale of expansion plans, although the supermarkets are concentrating more on smaller stores, refurbishment and online retailing.

Construction output growth



Construction output forecast – Spring 2013



In the industrial sector, factories will be the main driver of growth as construction orders have shown a recent upturn. In particular, major investment projects are planned by GlaxoSmithKline and Tata Motors.

Public housing output is likely to see a further fall of 8% this year and next before resuming modest growth. The DCLG's decision to allow house builders to challenge Section 106 agreements is likely to benefit private housing but hinder public housing output.

Similarly public non housing sector is forecast to fall a further 16% this year and next. The building programmes in the education sub-sector make up over half of this output and the health sector is driven by the capital investment framework Procure 21+. Other significant projects include the MOD's £1 billion investment in new accommodation and work on the facilities for the Commonwealth Games in Glasgow next year.

The CPA caveats its forecasts with a downside scenario which primarily includes risks associated with the uncertainty regarding energy investment, in nuclear and gas and the extent to which Help to Buy feeds through to house building rather than higher prices. Conversely, positive take-up of the Green Deal provides an upside scenario.

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