Davis Langdon
An AECOM Company

MARKET FORECAST
THAT SINKING FEELING

January 2012

Trends and Forecast

Executive summary

Tender price index

Tender prices have moved little all year, but may have slipped backwards slightly in the last quarter as prospects for 2012 deteriorated. The outlook remains gloomy except for those in the infrastructure sector.

Building cost index

Building costs rose 3.8 percent over the year to the fourth quarter 2011 as materials prices continued to be a concern. Materials prices are expected to be more subdued in 2012, but the input of labour costs is expected to result in overall inflation of approximately 3 percent.

Retail price index

Retail price inflation eased to 4.8 percent in December. Annual percentage inflation for the Retail Prices Index and the Consumer Prices Index are expected to fall sharply as the V.A.T. increase falls out in January, utilities prices ease and the price of imported goods drops.

2011 ended immersed in uncertainty. The Eurozone had lurched from crisis to crisis unresolved throughout the autumn and into winter. The year had begun somewhat optimistically: the austerity measures were anticipated but had hardly begun to bite; and there were signs of life in the private commercial property market, at least in London. Indeed the button was pushed on a number of large office construction schemes in London, including the towers at Leadenhall Building and 20 Fenchurch Street, the “Walkie-Talkie.” But the wind was slowly sucked from the sails as the economy refused to grow and uncertainty returned to haunt the boardrooms.

Although statistics show that construction activity picked up in some areas (see page 8), it was not enough to cause any rebound in construction prices after the 18 percent fall that occurred in early 2008. In fact, prices ‘bumped along the bottom’ for the whole year, edging up mid-year where conditions allowed, and in response to higher materials prices, but dropping back in the fourth quarter as materials price pressures eased and sentiment about 2012 order books hardened. Overall, at the end of the year, prices were on average one percent lower than at the end of 2010.

After three years of fighting for workload and cutting costs, many contractors are now very lean, meaning that their estimating teams can sometimes only cope with a few bids at a time. In consequence, there are perhaps more examples of tendering opportunities being declined now, not so much because of full order books but because of the necessity to be more selective due to lack of estimating resource. Some small contractors are surviving hand-to-mouth; many large contractors are surviving by selective under-bidding.

There remains a huge amount of surplus capacity in the industry, which is why prices have not moved upwards even when workload picked up last year. But with an even poorer outlook for 2012, contractors are reluctantly laying off directly-employed staff. Those contractors fortunate enough to have full order books currently are reluctant to expand given the near-term prospects.

Faced with rising materials prices last year, firms were only able to hold prices by further cutting labour costs. Costs included in preliminaries were trimmed again when possible. Management staff has been spread wider, across more than one project when they can get away with it. Sub-contractors are now being expected to provide some preliminaries costs. Where plant is owned, recovering its cost may be ignored.

Low or even cut-throat pricing means that claims are inevitably more to the fore. Some contractors are adopting claims principles on all their contracts but many are more discerning, trying to maintain good relationships with clients who may have more work to offer in the future.

Clients and their consultants and main contractors are now even more concerned over the stability of the supply chain with increasing numbers of sub-contractors going into administration. The number of companies going to the wall peaked in 2009, but the latest figures show the trend increasing again.

What are this year's prospects for the industry? The economic outlook in the first weeks of 2012 has certainly not improved. In fact, Friday 13 January pushed another stake into the heart of the Eurozone as Standard & Poor's downgraded the credit ratings of nine European countries, including France and Austria. A Greek default looks ever more likely increasing the possibility of a break-up of the Eurozone with untold consequences. Even without these events, Europe seemed to be heading into recession. Germany's economy contracted in the fourth quarter of 2011 and France probably flat-lined. What about the U.K.? The latest forecasts suggest that Britain is already in recession. The Ernst & Young Item Club estimates that growth in 2012 will be 0.2 percent with business investment stagnated.

The Centre for Economics and Business Research is even gloomier, forecasting a shrinkage of 0.4 percent this year, followed by growth of just 0.1 percent in 2013 and a mere one percent in 2014, even if the Eurozone remains intact. Interest rates are now widely expected to remain at 0.5 percent until 2016. This suggests that Britain is well into its 'lost decade' if these figures prove correct and perhaps only something 'out of the box' will now prevent that from happening.

Forecasts suggest that new construction output will fall by at least five percent this year. Since the Construction Products Association and Experian formulated their latest forecasts before Christmas, economic conditions have probably taken a further turn for the worse. There remains a strong pipeline of private commercial work in London (but not elsewhere), programmed to start during 2012. But developers are once again becoming nervous and perhaps holding back from actually pressing the start button. Occupier demand is falling. Banks are embarking on a fresh round of redundancies. Rental expectations have fallen.

John Lewis and Sainsbury reported a bumper Christmas sales period, but most other retailers are finding life hard. Tesco suffered a surprising fall in sales, prompting its share price to drop by 16 percent. In consequence, the chief executive pledged to decrease capital expenditure. In more bad news for the industry, he said that "capital expenditure in 2012-13 will be lower than the market was expecting." Instead of continuing their large store building programme, they intend to concentrate on refurbishing their existing stock.

The housing market often leads the way in the fortunes of the construction industry, whether trending up or down. Home prices in 2011 ended slightly down, and while there may not be a consensus for the trend in 2012, many believe 2012 will be worse than 2011. The Bank of England believes mortgages will become even harder to obtain. House building did pick up in the middle of last year and house builders report a slow but stable market. With government help for first-time buyers, there may be a slight further increase in housing starts this year.

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Social housing activity increased in 2010 and has been fairly stable since, but a significant reduction is expected in 2012 as public funding is slashed and new delivery mechanisms are sought. Some contractors in this sector have moved out as available margins have become so low. With something of a hiatus in the first half of this year, there may be a surge in activity towards the end of the year and into 2013, as housing associations compete to spend their grant allocations. With fewer contractors in the market, this may be one area where price rises may be seen later in the year.

So infrastructure may be the only show in town that is really looking up (see Hot Topic) but will only be of benefit to specialist contractors and those that have consciously tried to reposition themselves over the last few years in anticipation.

With construction opportunities declining and spare capacity almost everywhere, the outlook for prices over the year ahead is benign. Contractors may also have to absorb fewer materials price increases this year as a weak global economy exerts less pressure on commodity prices. A stronger pound will also make imported materials cheaper. There may still be an increase in construction activity in London this year as more office schemes and high end residential developments move ahead, but less than seemed likely this time last year. Outside of London and the South East, the public sector cutbacks will impact harder, increasing unemployment and releasing further property onto the market. In London, construction prices will probably continue to flat-line but elsewhere prices may well be forced down a further one to two percent. In 2013, no significant increase in activity is forecast but contractors will try to improve margin wherever they can. If the global economy improves, commodity price rises could re-occur. It may be prudent to allow price rises of around two percent in London and one percent elsewhere.

Forecasts suggest that new construction output will fall by at least five percent this year

Hot topic — Infrastructure

The government has given the go-ahead for HS2, the high speed rail line between London and Birmingham. Will infrastructure spending be the saviour of the construction industry? HS2 is not due to start construction until 2016. However the timing may be apposite. Construction for the London 2012 Olympic and Paralympic Games, is just about complete, save for some post-Games legacy work. Crossrail is now well under way and is currently Europe's biggest construction project at £16bn and is due to finish in 2017. The first phase of HS2 from London to Birmingham is costed at £17bn and is due for completion in 2026.

In fact, infrastructure spending has been growing since 2008 and accounting for a larger proportion of the construction pie. Between 2004 and 2008 infrastructure accounted for between 10 and 12 percent of the construction new build market. By 2010 this had risen to 17percent and last year was probably up to 19 percent. Hence, since the recession, a number of major building contractors have been attempting to reposition themselves to take advantage of this one area of growth. In real price terms the value of infrastructure spending last year – around £16bn -- was 80 percent higher than what was being spent in 2007 when all other spending was at its peak.

Since 2007 the biggest increase in investment has been in railways and this looks to continue into the foreseeable future with Crossrail and now HS2 to follow.

The National Infrastructure Plan 2011 was published in conjunction with the Autumn Statement last November. It set out a pipeline of over 500 projects worth over £250bn for delivery over the next decade and beyond. Two thirds of the expected investment between 2011 and 2015 is expected to be privately funded, and therein may lie the proviso. The main vehicle for funding is the planned use of U.K. pension funds. With little experience of such funding and with little appetite for risk, it remains to be seen how realistic this ambition is.

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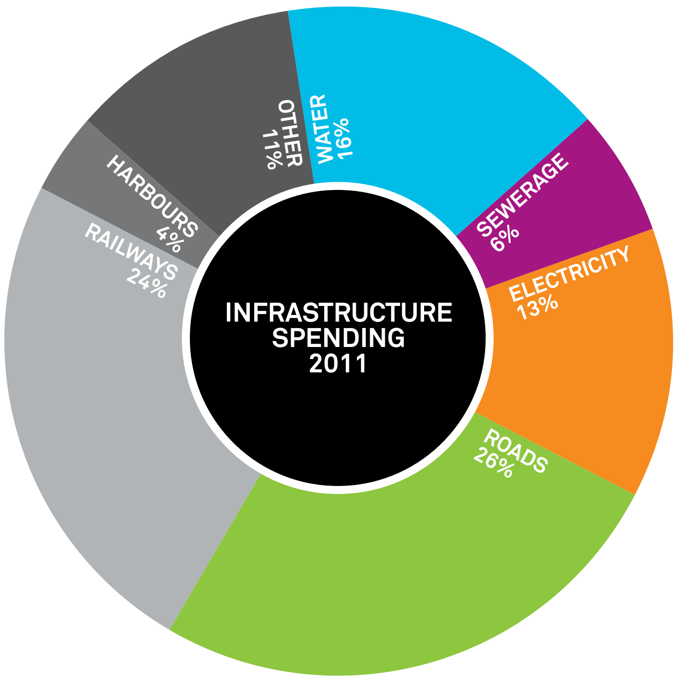

The majority of projects in the pipeline relate to energy and transport, see table below.

The energy projects include electricity distribution, generation and transmission; and gas distribution, storage and transmission schemes including nuclear, wind and tidal projects. Included within this is the National Grid's £20bn investment programme in gas and electricity transmission infrastructure between now and 2021.

The Chancellor, in his Autumn Statement, gave an immediate go-ahead to 35 road and rail schemes. Sseveral of these had already received formal backing but are nevertheless being accelerated. These include the electrification of the TransPennine Express between Manchester and Leeds; the Tyne and Wear Metro; and a new crossing of the Lower Thames. Transport spending will progressively shift from road to rail with the Highways Agency's capital programme almost halving between 2010-11 and 2013-14. On airports, BAA is expected to spend over £16bn at Heathrow over the next 10 years, including at least £1bn this year.

In spite of doubts over the scale and timing of future private sector funding, infrastructure spending looks to continue its growth. Both the Construction Products Association (CPA) and Experian, in their latest winter forecasts, build strong growth figures from the sector into their estimates. CPA expect a 90 percent rise in rail construction spending over the next four years and a threefold rise in energy as nuclear power station construction begins in earnest in 2013. Increases in expenditure in 2012 are expected to be only slight (1% to 1.6%), bringing little benefit to declining overall workload, but accelerating thereafter as more major schemes reach site.

Since 2007 the biggest increase in investment has been in railways and this looks to continue into the foreseeable future with Crossrail and now HS2 to follow

Sector	Number of projects/ programmes	Infrastructure investment (£ million, 2010-11 prices)
Transport	115	89,321
Energy	274	117,730
Communications	11	20,414
Waste	38	3,887
Water	32	20,920
Flood	35	4,937
Intellectual capital	8	203
Total	**513**	**257,412**

Source: HM Treasury estimates from UK infrastructure pipeline data

The Scottish government has announced its intention to use capital investment to build its way out of recession that will include widespread road construction and a commitment to the Forth Replacement Crossing, described as the largest civil engineering project in Scotland in a generation. Longer term, it has also announced its wish to invest in high-speed rail links so long as HS2 is extended further north. Scotland is moving ahead with Tax Incremental Financing that enables local authorities to fund infrastructure projects by borrowing against future business rates, one of the tools advocated in the National Infrastructure Plan to facilitate certain developments.

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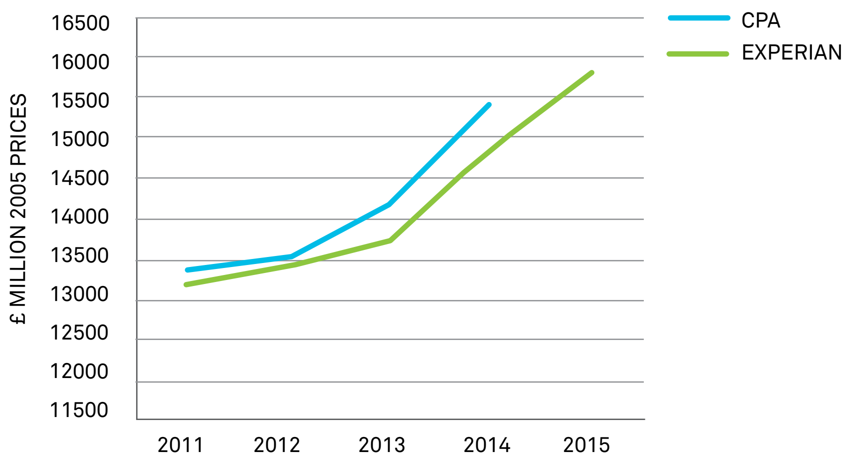
INFRASTRUCTURE OUTPUT FORECASTS



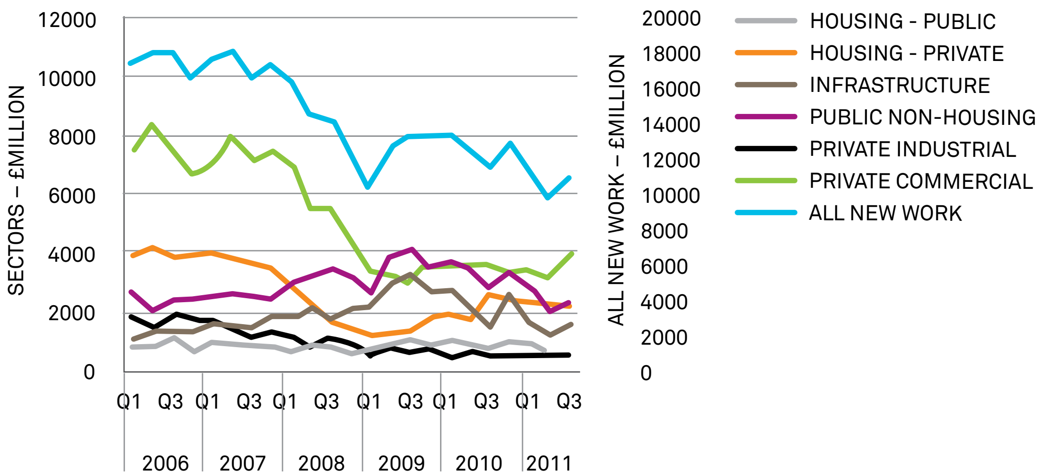
Construction output and new orders

Construction output as measured by the Office for National Statistics held up unexpectedly well in 2011. In fact, total output up to November (the latest month for which data is available) was actually 2.5 percent higher in real terms than during the equivalent period of 2010. This was after the figures indicate that construction output in 2010 rebounded strongly after the collapse that occurred in 2008 and 2009 as the government brought forward spending plans on infrastructure and public non-housing work. Output in the latter sector declined by five percent in 2011 but infrastructure grew by almost 11 percent and private housing by eight percent.

But these strong figures are not expected to be maintained. The chart shows the dramatic fall in the volume of new orders for construction obtained by main contractors in Great Britain since peaking in early 2007. There was some recovery in 2009 as stimulus money came forward, but 2011 saw another sharp fall in orders before a mini rally in the third quarter brought some relief to the ominous trend. The change in direction has brought about a long-awaited increase in private commercial orders. In large part the rise was due to the award of two very large contracts in London – the £400m 40-storey 100 Bishopsgate and the £250m Leadenhall Building (check) – but a number of other regions saw the first signs of a slight pick-up in commercial activity.

Construction output as measured by the Office for National Statistics held up unexpectedly well in 2011

VOLUME OF ORDERS FOR NEW CONSTRUCTION IN GREAT BRITAIN - CONSTANT PRICES SEASONALLY ADJUSTED



The decline in new orders in 2011 will lead inevitably to a reduction of work on-site next year. The CPA and Experian, in their December forecasts, are almost as one in predicting a drop in new work output this year of 6.5 percent and 6.9 percent respectively. Experian are marginally more optimistic in predicting a 1.3 percent increase in 2013 while the CPA does not see an increase before 2014.

Both organisations now pencil in an even more substantial drop in public non-residential work this year (-24% and -30% respectively) than they did three months ago and take a more pessimistic view of the prospects for private industrial work given the deterioration in the Eurozone and the U.K. economy.

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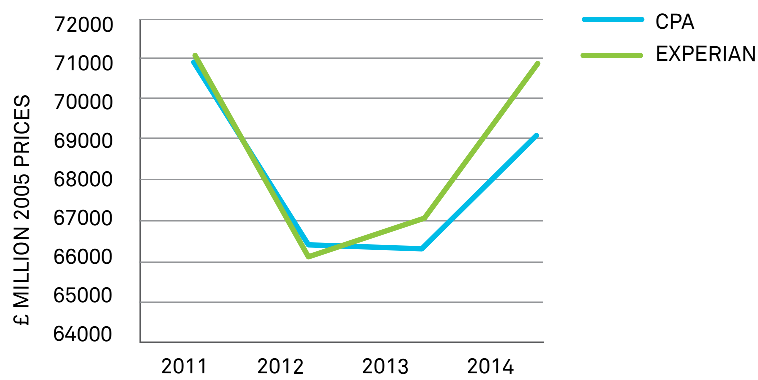
CONSTRUCTION OUTPUT FORECASTS



Building Cost Index

The Building Cost Index rose by 0.4 percent in the fourth quarter 2011 and is 3.8 percent higher over the year. See table below.

Labour

Building and civil engineering operatives secured a 1.5 percent wage increase from 5 September 2011 and will be looking for a further rise from their normal anniversary date at the end of June 2012. September's rise may have been the first for three years but, with further reductions in workload anticipated this year, any increase agreed is likely to be no greater than last year's.

January normally heralds in wage rises for plumbers, electricians and steel erectors. Plumbers benefitted from an agreement made in October 2010 and received a three percent wage increase from 2 January 2012. But electricians and steel erectors look likely to have to endure a wage freeze this year.

Employers of all operatives will nevertheless have to endure a significant extra cost this year. From November 2012, all holiday pay will be subject to National Insurance contributions as the government withdraws the concession that has exempted holiday pay paid through holiday pay schemes that has operated since the 1960s.

Materials

Construction materials prices are up nearly seven percent over the year. For non-housing new work, the annual figure has remained above 7 percent all year. The deflationary figures of 2009 are a distant memory for contractors having to contend with fierce competition and rising input costs. However, most of the increases occurred in the first half of the year and materials prices have been fairly flat since last summer. At the beginning of 2011, manufacturers were hit with sharply rising steel prices that fed their way into construction products such as ducting, partition components and cladding, as well as structural steelwork and reinforcing bars.

Fabricated steel prices rose 14 percent in the first five months of 2011 as the Australian floods caused a shortage of raw materials, pushing up prices, which steel producers were partly successful in passing on. But prices have since drifted down as world steel prices have fallen due to subdued demand. Reinforcement prices rose 19 percent last year and only started to fall back in the last quarter.

Rising steel prices were a feature of the construction industry in 2004, 2006, 2007, 2008, 2010 and 2011 in large part due to China's rapid industrialisation and its effect on the supply and price of raw steel making materials. No spike in prices is expected in 2012. China has taken steps to cool its economy. Prices for iron ore, scrap and coal all seem relatively stable. Demand remains subdued. There is some talk of rising scrap prices, which impacts reinforcement rather than structural steel prices in the U.K., but there was little sign of it at the end of the year when scrap prices ended up 10-15 percent lower than when the year started. Some moderate price inflation may occur in the first half of the year as some restocking occurs, but end year prices are expected to be little higher than now.

Construction materials prices are up nearly seven percent over the year

	Actual 4Q10-4Q11	Forecast 4Q11-4Q12
Labour	+1.9%	+3.3%
Materials	+6.8%	+3.0%

Considering the problems in the Eurozone that have been in the news for so long, the pound remained stubbornly weak against the Euro for much of 2011. But as the crisis deepened, the anticipated movement occurred and the value of the pound against the Euro grew strongly in the last two months of 2011 to finish the year 10 percent above its low point last July. Given that approaching £12bn of construction materials and components were imported last year (about 25% of all materials used) and the majority comes from the Eurozone, a stronger pound, if maintained, will make materials cheaper over the year ahead. Most commentators expect the pound to strengthen further against the Euro so long as the crisis remains unresolved and following the credit downgrading of so many European countries.

The danger for materials prices and the wider economy is oil prices. Talk of sanctions against Iran and possible repercussions involving the closure of the Strait of Hormuz through which one sixth of the world's oil supply passes, have already made oil markets nervous and saw prices jump $6 a barrel overnight at the beginning of January. Closure of the Strait could easily push prices up by $50 or more a barrel very quickly. However, prices did not continue to climb as the threat perhaps did not seem imminent. More relevant now seems to be pressure in the other direction, as Standard & Poor's downgrading of France, Austria and other European nations caused markets to price in an even greater chance of recession in Europe and lower demand for oil.

The danger for materials prices and the wider economy is oil prices

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