

MARKET FORECAST ANOTHER TOUGH YEAR

Now that 2009 has come into focus, we can clearly see what a disastrous year it was. Unfortunately, the process of recovering from it will not be quick, says **Peter Fordham** of **Davis Langdon**

01 / EXECUTIVE SUMMARY

Tender price index ▼

The decline in tender prices continued in the fourth quarter but decelerated, falling 1% on the third quarter. This leaves prices 17% below their peak 18 months ago.

Building cost index ▲

The building cost index rose 1% in the fourth quarter as materials prices resumed an upward trend. The index still shows a fall of 0.3% over the year.

Retail prices index ▲

The retail prices index has been on an ascending trend since April last year and increased 3.8% between January and December 2009. This will rise further in January 2010 with the reimposition of 17.5% VAT.

02 / TRENDS AND FORECAST

Tender prices continued their 18-month downward trajectory in the fourth quarter, but the rate of decline slowed. Analysis of tenders shows a further fall of 1% from the third quarter. This leaves prices 10% lower than a year ago and 17% down from their peak in the second quarter of 2008.

Most of the fall can be attributed to the erosion of margins throughout the supply chain, the lower cost of preliminaries and falling labour rates. But lower materials costs have also played their part, notably the 40% collapse in steel prices. Materials prices have now stabilised and in some cases are edging up again. The M&E services sector has been affected by rising copper prices, and the weak pound has counteracted contractors cutting prices.

The fall in prices has not been uniform. The collapse in demand for central London offices has allowed those clients still active in the market to secure even greater price reductions. Prices in the volume housing market, both private and affordable, have reduced but perhaps not so much as in other areas. M&E prices have fallen no more than 5% over the past year in some regions but much more elsewhere; in London prices fell 7.5-10% in the second half of 2009. Prices have held up for specialist work such as repairs to listed buildings, complex jobs that involve working around existing operations, highways and remediation works.

Contractors' overheads and profit allowances are commonly 2-3%, inadequate to reimburse a head office's overheads. Contractors are relying on improving profit using their subcontract works. The cost of preliminaries continues to be trimmed, often down to 8-9% of the construction value, which itself has been reduced. To achieve this, main contractors are often passing the responsibilities for preliminaries down the supply chain. Site teams have been cut by main contractors and

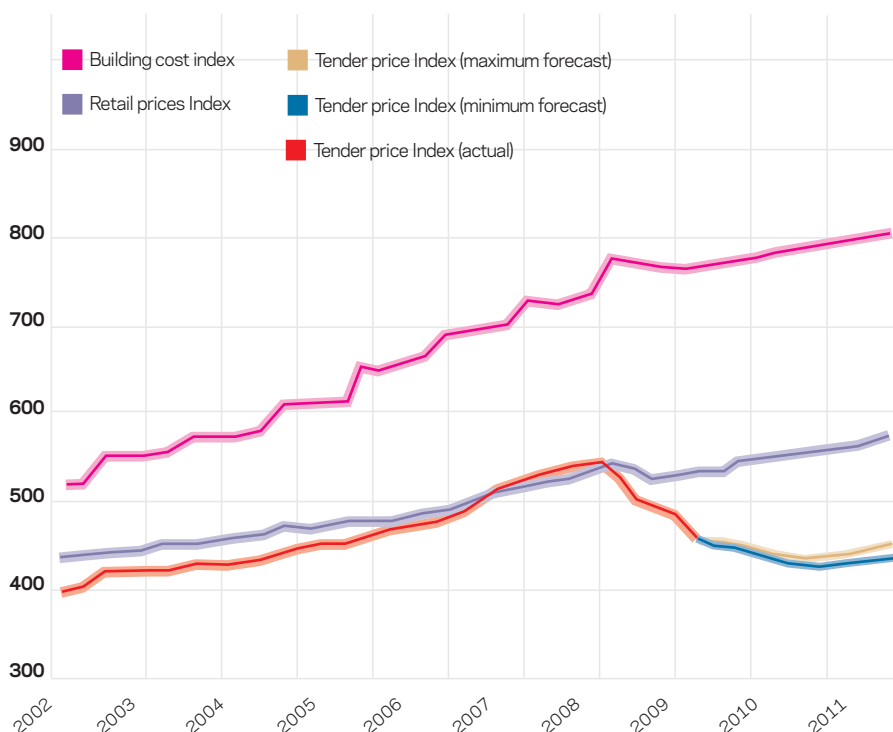
subcontractors. Where contractors own plant, often little or no cost is attributed to preliminaries. When workload picks up, preliminaries costs may well increase sharply to reflect ever increasing standards in health and safety, sustainability and waste management.

The fall in workload is resulting in contractors

actively seeking work wherever they can. Many are seeking it outside of their normal comfort zones; larger contractors are looking lower down the value chain to tread on the toes of smaller contractors or are bidding for work for which they lack expertise.

Single-stage competitive tendering has established itself as the procurement route of

A / PRICE INDICES





choice as building clients exploit the buyer's market. Significant general summary lump sum reductions are being seen again as directors make last-minute adjustments in the hope of winning work. Clients must be aware that a low tender price can carry post-contract risks and they should make a higher contingency allowance. Tight pricing from tenders received over the past year or so has led to an increase in claims on some projects.

A feature of a cut-throat market is that initial tenders frequently contain numerous exclusions and qualifications: it is imperative for a client's advisers to interrogate tenders to ensure that no bidder has been able to gain an advantage by failing to comply with tendering instructions.

Not every contractor is desperate for work: some have relatively healthy order books. Some larger and medium-sized contractors have been able to

make decent margins from framework contracts – but, inevitably, any new frameworks coming up are competitively fought over.

The rate of price reduction may have eased in the past quarter, but the direction is not about to be reversed. New orders continue to decline and construction activity will fall further this year. A drop of between 1% and 4% may be gentle compared with last year's 13%, but is still another loss of £1–2bn to the industry. As contractors' order books become slimmer, competition will increase further among those that survive.

However with so much "fat" already taken out of prices, it is unlikely that they will fall anywhere near as much in the next 12 months as has occurred over the past 18. At the same time, materials prices are likely to rise as the world economy comes out of recession. This year will unfortunately

see an increase in the rate of contractor failure, which will eventually reduce competition. But initially, reducing workload will drive construction prices down further and the forecast is for a fall of 4–6% over the coming year.

The year after will be marked by public spending cuts, whichever party wins the election. In the private sector, capital investment intentions remain weak and activity in the commercial and residential sectors is slow. There is some evidence that credit conditions are easing gradually and there is optimism that the pent-up demand for housing will lead that sector out of recession in 2011 and demand for good quality office space may consolidate the trend in 2012. With total construction activity improving only slightly in 2011, prices are forecast to rise 1–4% by the end of 2011.

03 / HOT TOPIC 10 KEY FACTORS AFFECTING DEMAND IN 2010

1 The quality of recovery Economic recovery throughout the western world is likely to be slow. Strong headwinds include high unemployment, cautious consumers, low investment and public-sector retrenchment. A double dip recession could still take place, and there is talk of a "www" recession – a roller-coaster of economic stimulus and retrenchment.

2 Mixed fortunes UK construction is expected to continue to shrink in 2010, although infrastructure and housing should have a better year. Limited private investment and public sector deficits will hold back growth throughout Europe. Infrastructure investment in emerging economies could grow rapidly, creating pressure on the availability of some raw materials.

3 Faster growth in Asia and other emerging economies Brazil, India, China and other Asian economies have emerged relatively unscathed from the downturn. These countries are expected to grow at a much faster rate than Western economies. The UK is unlikely to benefit greatly from growth in the emerging economies, as most of our exports are to the US and EU.

4 Uncertainty This year will contain many "known unknowns": the forthcoming election, changes to credit-ratings, currency fluctuation, the effect of the removal of the financial stimulus and the commencement of fiscal tightening, as well as an increased terrorist threat. "Exogenous growth shock" (meaning suddenly falling demand from outside one's own economy) may become as overused as "green shoots" or "too big to fail" were in 2009.

5 Addressing the budget deficit It is now recognised that the UK's debt has to be addressed. The timing, speed and scale of the switch from stimulus to retrenchment is the big question to be answered in 2010. A spending hiatus after the election has the potential to be damaging for UK construction at a point when revival may be just about to commence in the private sector.

6 Construction suffers a double whammy from the withdrawal of stimulus and the start of spending cuts Aggressive fiscal stimulus in countries including the UK, US and China has included substantial additional capital investment in construction. In the UK, funding has also been brought forward

from the 2010/11 tax year. But a 20% reduction in the future capital investment programmes is now on the cards.

7 Industry consolidation Merger and acquisition will be back on the agenda as strong firms position themselves for the upturn. The dark side of consolidation, a combination of low margin work, poor cash flow, scarce capital and the consolidation of banks' loan books, may result in a stream of failures. The loss of capacity could be a main driver of rising costs during 2010/11.

8 Inflation ... and deflation Deflation was one of the greatest concerns of many economists during 2009, as it threatened to introduce a vicious circle of falling prices, wages and demand. The overall economy may have escaped this fate but construction in many markets, including the Gulf, Ireland, North America and the UK, has suffered severe cuts in prices. In the UK, construction prices are, as mentioned before, 17% less than their peak and still have some way to go before supply and demand return to balance. Elsewhere in the economy, inflation has remained, and with VAT back at 17.5% and the effect of 2009's energy price cuts falling out of the system, the UK's consumer price index is likely to hit 3.5% in the first quarter.

9 A bad year for the pound ... and the euro? Sterling is likely to be dogged by sovereign debt concerns during 2010, with some commentators speculating that the pound and the euro will reach parity. Devaluation could be good for the UK's net trade balance, but bad for construction, as most of its imports are denominated in euros. However, with sick economies such as Greece, Ireland and Spain locked into the eurozone, the attractions of the euro as the reserve currency of choice could also take a battering.

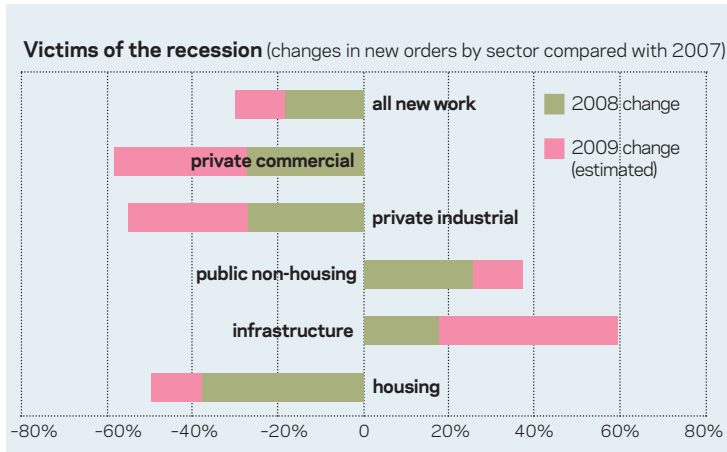
10 Global agreement or discord? Stalled World Trade Organisation talks will resume in 2010, as will efforts to get a binding carbon reduction deal following the disappointments of Copenhagen. With the urgent multilateral action required on banking regulation and other elements of the fall-out from the credit crunch, the success or failure of the world's diplomats and negotiators will play a key role in 2010, if global recovery and our sustained prosperity are to be built on firm foundations.

04 / ACTIVITY INDICATORS

The CIPS/Markit purchasing managers index for construction for December recorded its 22nd successive month of contraction. In contrast, the latest figures from the Office for National Statistics showed a 2% rise in total construction output in the third quarter of 2009, compared with the second. This was the result of a 10% increase in repair and maintenance work, a figure in which commentators have expressed disbelief. The volume of new work fell by 4%, a figure much more in line with other surveys and perceived wisdom.

Over the year to the third quarter, total new work fell 13% in constant price terms, and by more than 20% in cash terms. The total for 2009 also looks like being 13% lower than for 2008 in real terms. In the last recession, the largest annual fall in new build output was just 4.8% in 1991. However the early eighties recession was marked by a fall of 14% in 1980, followed by a further 10.5% fall in 1981, before making a 7% recovery in 1982.

The volume of new orders obtained by contractors in 2009 suggests that on-site activity in 2010 will continue to fall. In the first 11 months of 2009, the volume of orders at constant prices was almost 14% lower than for the same period of 2008. Last year total orders in the private commercial sector was more than £6bn less than 2008 and more than £1.1bn less than 2007.



Forecasts in comparison (year-on-year % change)

| | Experian | | | CPA | | |
|-----------------------|-------------|------------|------------|-------------|------------|-------------|
| | 2010 | 2011 | 2012 | 2010 | 2011 | 2012 |
| Housing | 3.4 | 9.3 | 8.6 | -7.4 | 4.9 | 2.2 |
| Infrastructure | 11.0 | 7.0 | 2.0 | 7.2 | 4.2 | 4.1 |
| Public non-housing | 7.0 | -6.0 | -16.0 | 5.9 | -5.0 | -13.5 |
| Private industrial | -2.0 | 2.0 | 6.0 | -1.8 | 5.9 | 9.8 |
| Private commercial | -17.0 | -1.0 | 8.0 | -15.1 | -1.1 | 4.3 |
| Total new work | -1.2 | 1.9 | 1.2 | -4.1 | 0.5 | -0.5 |

These figures reflect a 44% fall in constant prices compared with 2008, or 59% compared with 2007, and illustrate why the UK construction industry has fallen so quickly into its present desperate state.

In constant price terms, the private commercial and housing sectors accounted for 69% of new orders in 2007: last year that proportion had dropped to 44%. In 2007 the value of private commercial orders was more than double that of the public non-housing sector. Last year, orders in the public non-housing sector were more than 20% higher than in the private commercial sector, illustrating the complete reversal in their fortunes.

Fortunately not every sector has suffered as severely as the private commercial, industrial and housing sectors. The chart shows that new orders for infrastructure and public non-housing work have grown strongly over the past two years.

Outside of these two sectors, workload in 2010 is set to fall further. Experian Business Strategies and the Construction Products Association have recently released their winter 2009/10 construction output forecasts (see table above). Neither are particularly optimistic regarding the industry's short-term prospects. Both agree that new work output in 2010 is likely to decrease further on top of last year's sharp reduction. But Experian is relatively optimistic, forecasting a further fall this year of just 1.2% in total whereas the CPA fears that a further 4.1% drop is on the cards. The main difference in the forecasts lies in the anticipated speed of recovery of the housing sector. Experian is hopeful that it will grow 3.4% this year but the CPA foresees a further drop of 7.4%, with growth not returning until 2011.

05 / BUILDING COST INDEX

The building cost index continued to record a fall over the past year (-0.3%), but has been rising since July as materials prices reversed their downward trend from the first half of 2009 and rose quite sharply in the second half.

Labour

Labour wage agreements remain frozen for most operatives, although the third part of a three-year agreement for electricians came into effect on 4 January, lifting directly employed electricians' wages 5%.

Materials

Figures from the Office for National Statistics show that construction materials prices fell for nine consecutive months until July, but have been rising since. Over the four months to November, prices rebounded 3%. The increase has been led by a surge in the price of imported timber and boards: softwood rose 23% between June and November last year, as demonstrated

in North Africa and the Middle East.

The price of coated roadstone and asphalt rose towards the end of last year in response to the rise in oil prices from below \$40 a barrel in February 2009 to more than \$80 a barrel now. Forecasts for 2010 vary widely, but many predict that prices will pass \$100 a barrel by the spring. Higher oil prices will increase production and transport costs throughout industry. The second half of last year saw something of a disconnect between UK gas and crude oil prices, but gas prices now seem set to rise sharply.

Suppliers and makers of aggregates, cement and ready-mixed concrete have announced price increases for January 2010. Increases announced this time last year were mostly unable to be maintained. Some capacity has since been taken out of the market, but it remains to be seen whether this year's price increases can be made to stick.

The decline in steel prices in the end of 2008 stopped in late summer and some small

recovery occurred in late autumn. However the momentum was not able to be maintained. World steel production in 2010 is expected to be 10% up on last year but most of it will be because of demand in China and India. Demand in western Europe is likely to remain muted for some time yet preventing any significant price increases.

Non-ferrous metals had a remarkable 2009: prices for copper, zinc and lead more than doubled, with aluminium not far behind. Copper prices in sterling terms have passed their pre-recession high. The rebound has been attributed to strong demand and restocking in China, exacerbated by production cuts.

Price prospects for 2010 remain strong as demand from economies outside of China is expected to grow robustly, although less so for aluminium owing to the high volumes of existing stocks. Nickel prices have not recovered to near 2008 levels and this year's price will be determined by increase in demand from China relative to an expected oversupply.