

PRICES CONTINUE TO FALL AS THE CONSTRUCTION MARKET REMAINS UNCERTAIN

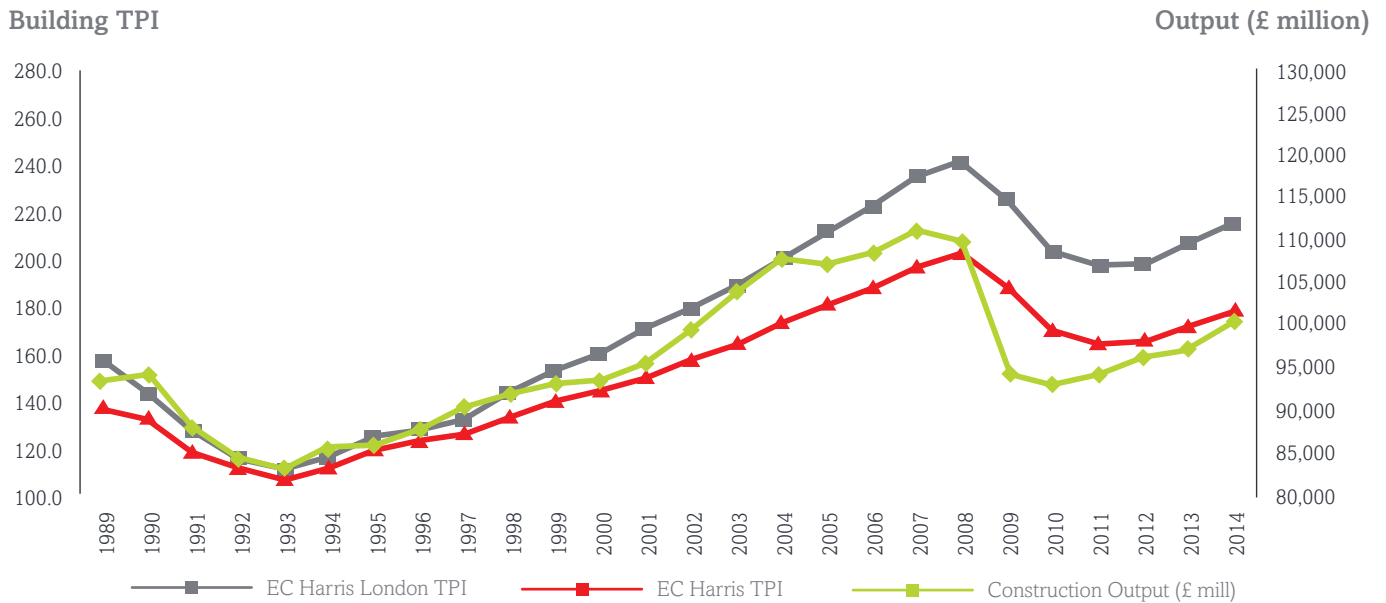
- Market remains extremely tight although parts of the private sector are gearing up for recovery
- Bottom of commercial market may soon be called in London as developers look longer term
- Banks ensuring they have a secure exit strategy and still showing no appetite for any speculative development risk
- Banks are lending still primarily to existing core customers who can offer strong security and a proven track record
- Foreign funds investing in UK markets because of weakness of the pound and lower asset values
- 'Business as usual' approach to framework relationships being challenged. Clients looking for best value
- Private sector to recover in 2011 but balanced by declines in health and education spending
- Materials prices down 17%, labour rates down 7.5%. Contractors reducing profits to secure workload
- Tender prices nationally in the building sector expected to fall 6.0% over the next year and by 1.0% the following year
- London tender prices expected to start to show a marginal rise of 0.5% in the 4th quarter of 2011
- Infrastructure workload to grow by 7 - 8% p.a. over the next 5 years. Infrastructure tender prices to fall by 3.5%

The stock market has shown healthy growth during 2009, the UK economy is almost out of recession, and the private sector, particularly in London, is showing signs of increased activity, although the recent bad news coming out of Dubai has caused jitters in the City. However borrowing is still very difficult; the banks still have no appetite for taking any speculative development risk and have to be sure of a secure exit strategy before they are willing to lend. As a result, development lending is still primarily to existing core customers who can offer strong security and a proven track record of delivery.

Nevertheless, foreign investment and equity funds are becoming increasingly active in the UK real estate market because of the weakness of the pound and the fall in asset values. Where banks have acquired assets there is little danger of a fire sale; the rules on distribution of these assets are still being clarified and it would be in no-one's interest to depress the market through premature selling. Meanwhile some of the major developers in London are looking longer term and having raised cash through sales or rights issues, are looking to invest that money in developments which will start on site before prices start picking up.

Over the medium and longer term the level of public borrowing will cast a shadow over public sector investment and cuts in health and education spending could begin early next year. Investment in public housing which was brought forward as part of the government's 2009 stimulus package, means that investment will definitely fall after 2010.

Construction Output v Tender Price Index (November 2009)



Note. The above graph indicates how building tender prices and construction workload figures have tracked each other over the past 20 years together with forecasts over the next 3 years.

The above figures are based on the Construction Output figures produced by the ONS and an average of the forecasts of output, (at constant 2000 price levels) prepared by Experian Business Strategies and the Construction Products Association. The Tender Price Index is the EC Harris National Tender Price Indexes.

Construction activity is expected to remain restrained even after the rest of the UK economy has started to recover. Construction workload figures in the 2nd quarter of 2009 were down 15% on the 2nd quarter of 2008 and new orders for the year to September 2009 were down 22% on the same period a year earlier.

The Autumn 2009 workload forecasts prepared by Experian and Construction Products Association (CPA) indicate that construction workload will fall by 13.7% this year and by a further 1.3% in 2010. Recovery is expected to be slow with an increase of just 1.3% in 2011 and then further rises of between 2.1% and 2.3% over each of the next 3 years.

Despite some increases in world commodity prices materials prices in the UK are now some 17% below their 2008 peak while site rates for skilled labour, currently 7.5% down on last year's rates, will continue to fall as the labour force chases reduced opportunities.

As contractors cut profits to secure jobs there are dangers ahead. The last technical recession came to an end in the 4th quarter of 1991, but insolvencies peaked in 1992 some 56% higher than 2 years previously. The latest figures already

show substantial increase in contractor insolvencies; based on figures for the first 2 quarters of 2009, insolvencies this year are on course to be more than double those of last year.

With workload depressed, the forecast is that tender prices for building work will, on average, continue to fall nationally for the next two years, by 6.0% over the next year and by a further 1.0% in the year to the 4th quarter of 2011. As the industry recovers, tender prices are forecast to rise by 3.5% in the year to the 4th quarter of 2012 and at around the same rate over the following 2 years.

There are some signs that recovery in London will occur sooner than the rest of the country and tender prices are expected to return to positive figures with a marginal increase of 0.5% in the 4th quarter of 2011. Thereafter London tender prices are expected to move ahead of the national average at rates of 3.5 - 4.0% per annum.

Increased workload in the infrastructure sector means that tender prices will not fall as far or as fast as in the building sector and increases are forecast to occur earlier.

Infrastructure

The value of new orders for infrastructure placed in the year to September 2009 is some 37% higher than in the same period a year earlier and infrastructure workload is forecast to continue to grow with output expected to increase by an average of 7 - 8% over each of the next 5 years.

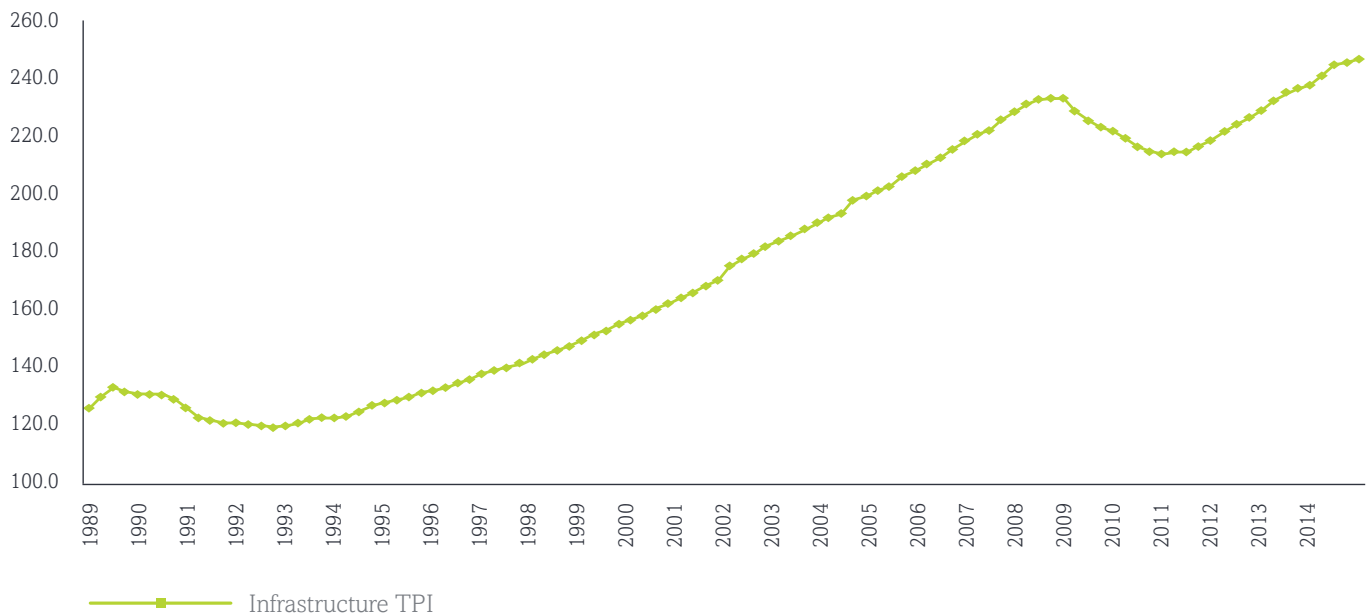
In the water sector there will undoubtedly be some slowdown as AMP4 runs down and before AMP5 ramps up, but this should be relatively short term in duration. In the mean time, orders for water and sewerage have shown a huge 230% increase in the first 9 months of the year with some particularly large contracts in July and August as the water companies hurry to place orders.

The roads sector has seen a quickening of pace and there is now some urgency to getting work under way before the general election is called which will effectively see orders halted for some time. Roads orders in the first 9 months

of 2009 showed a 32% rise over the same period of 2008, including a big increase in the 3rd quarter of the year. The rail sector too has seen increased expenditure and the ongoing workload forecast remains very healthy, with work under way on London Thameslink and the Manchester Metrolink extension. The long term forecasts all assume that Crossrail will be going ahead and preparatory work is already in place with the main contracts due to be placed in 2010. Even if Crossrail is put on the back burner, this is likely to mean a scaling down or longer construction period, rather than outright postponement.

Despite the rising workload, infrastructure tender prices are expected to fall by 3.5% over the next year; prices are expected to bottom out in the 4th quarter of 2010, show positive growth figures in the 2nd quarter of 2011 and finish that year with an increase of approx 2%. Further ahead tender price inflation is expected to pick up and increase by around 4% per annum through to 2014.

Infrastructure Tender Price Index (November 2009)



Tender price indices (graph above)

Contractors' market prices are made up of their input costs for labour, materials and plant plus their allowances for preliminaries, overheads, profit, head office overheads, etc. While some of these costs are fixed, there is considerable latitude for contractors to mark up or mark down prices according to their perception of the market and the state of their order books. Contractors tender prices will also reflect the state of the market in reflecting the rates that they pay for labour on site. Historically, when there is an abundance of work around, contractors' tender prices will tend to rise faster than costs since they will be paying higher rates for their labour; they will also respond to increased activity by raising their profit margins. Conversely, when work is at a premium, labour rates on site will be lower, discounts on materials will be greater and profit margins will be cut.

The movement of the Tender Price Index reflects market conditions within the industry and as such it represents the change in prices that clients can be expected to pay.

Regional variation

Construction new orders in the UK in the 3rd quarter of 2009 were 5% down on the 3rd quarter of 2008 but showed no change against the previous quarter's figure. However there remain huge regional differences with London and the Northern region showing the largest falls, while orders picked up in the West Midlands and the North West.

Focus on the North West

Construction new orders in the North West increased by 21% in the 3rd quarter of 2009 compared to the 3rd quarter of 2008 although the rise was primarily down to infrastructure orders more than doubling in the quarter. Elsewhere public sector housing increased by almost 50%, but all other sectors continued to show substantial falls.

As elsewhere in the UK, feedback from private sector clients in the region is that there is still a shortage of money available from the banks to fund developments. Workload in the public sector is under pressure with local councils undertaking efficiency drives to cope with falling incomes.

In Manchester there is perceived to be an over-supply of city centre residential units together with both in and out-of-town offices/retail units, resulting in few opportunities for further development within these sectors. The short term view on construction workload is that it will remain 'steady', although here as elsewhere there are concerns with regards to public sector workload after the Election.

In Liverpool the commercial district has benefitted from the 'Liverpool One' led renaissance but the completion of this and a number of other schemes have increased the amount of Grade one offices on offer at very competitive rents. Public sector work programmes are still continuing, although most Local Authorities are undertaking efficiency drives as they are also feeling the pinch. Contractors are continuing to feel the downturn and are reducing their workforce; when recovery comes, those contractors who have become leaner and more resilient will benefit as schemes come to market.

Regional Tender Price Forecast (November 2009)



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