NEW LOOK FOR THE GOVERNMENT, BUT FOR THE CONSTRUCTION INDUSTRY THE PAIN CONTINUES

- Government cutbacks will affect health, education and infrastructure workload
- June Budget to bring further cutbacks
- Some movement in private commercial and housing sectors
- Modest growth in workload in 2011 forecast; figures could be revised down wards, dependent on government spending plans
- Oil and steel price hikes starting to have a real effect on market prices
- Finance still difficult to secure, although UK looks attractive to foreign investors
- Developers in London looking ahead and moving on major schemes
- Outside London, private sector workload more likely to be on hold
- Contractors counting on future discounts to win jobs
- Low levels of pricing increases the need for robust due diligence
- Increased risk of business failure as contractors are left with loss making tenders and banks resist bail-outs
- Labour rates stagnant but commodity price increases pushing up contractors' costs.

The coalition government has given us £6.2 billion of cuts, there is to be a review of departmental spending, VAT will probably rise and the Budget is due on 22nd June. How does construction stand?

Not very well, if truth be told. Despite some revival of interest in the private residential and commercial sectors, few parts of the public sector will escape spending cuts. Meanwhile, oil and commodities prices - notably steel - are on the rise.

Overall construction output in the 4th quarter of 2009 fell by 6% compared to the 4th quarter of 2008. Construction new orders in the 4th quarter of 2009 rose by 3% compared with the previous three months, and by 5% compared with the 4th quarter of 2008, although the increase was mainly due to infrastructure orders.

The main workload forecasts, prepared by Experian and CPA, predict a fall in output of around 2.3% this year with a recovery of 1.4% next year. However, these forecasts were prepared before the election. Commentators have noted that £6.2 billion cuts hardly scratches the surface of public sector debt and the next set of cutbacks could be deeper than expected. Initial moves have included freezing school contracts, postponing the 'Procure 21' health initiative, possible scrapping of Local Education Partnership (LEP) procurement, and a reappraisal of government contracts placed by the last government.

House prices have been moving upwards and although private housing workload is forecast to show little movement this year, an increase of around 10% is expected in 2011. Public sector housing, however, will suffer as the government has put all spending by the Housing and Communities Agency (HCA) on hold.

Looking ahead there are signs of recovery in some sectors, although the overall picture is unbalanced and London is expected to outstrip the rest of the UK. There has been a significant amount of pre-planning activity in the

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commercial offices and private residential sectors in London as developers look to take advantage of the lack of Grade A offices and an anticipated uplift in residential values over the coming years. It only needs a few of these major schemes go ahead for there to be a significant increase in schemes being bid in 2011.

Contractors' input costs rose only slightly over the 1st quarter of 2010 with materials' prices up 0.5% and site labour costs up by 0.3%. However materials prices are increasing, oil prices have almost doubled and there are warnings of major stell price rises with Corus adding around 14% to their list prices.

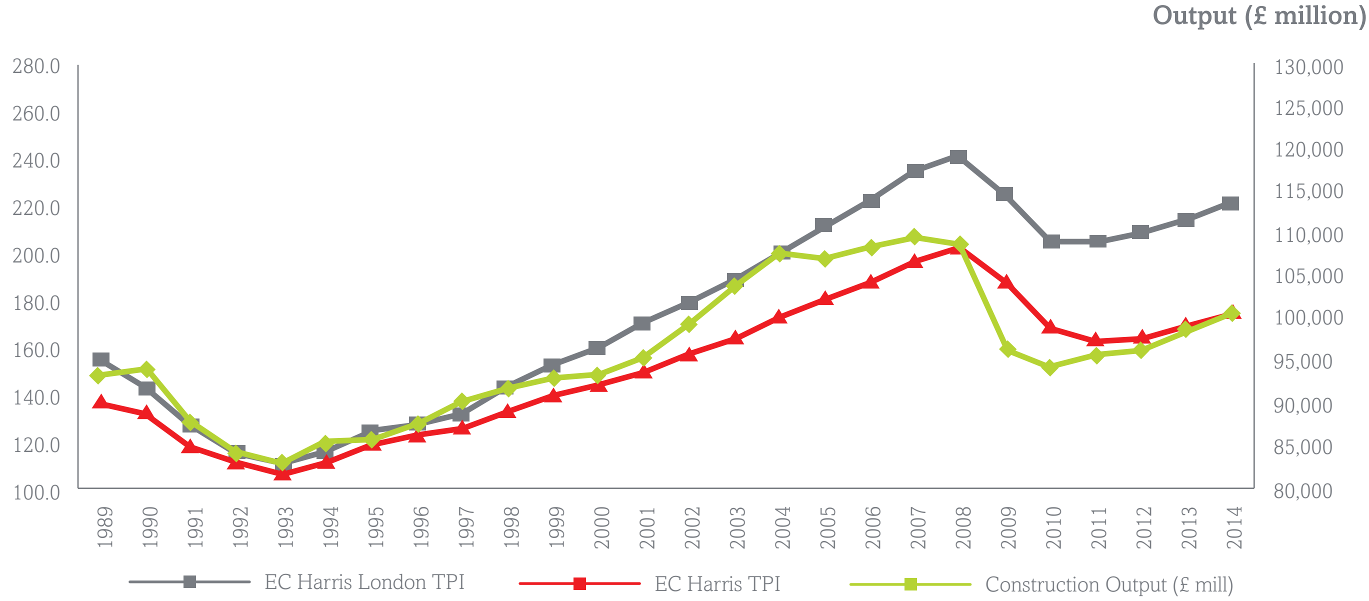
Overall, pricing remains tight and contractors are trying to strike the balance between:

- Covering costs;
- Tendering low enough to secure workload;
- Input cost inflation;
- Allowing for possible sub-contractor failure;
- Allowing for discounts in future buying of sub-contractor services;
- Currency fluctuations on imported products;
- Future reductions of discounts in response to increased demand;
- The need to retain skilled workers when workload picks up.

Current building tender prices show major adjustments, with contractors desperate to secure workload. There could however be a 2-speed movement in tender prices in London; on the majority of small and medium sized jobs there is a limit to how much contractors can absorb cost increases and we believe that tender price inflation in London will move out of the red in the 2nd quarter of 2011 rather that at the end of that year - although the forecast is that prices in the 2nd quarter of 2011 will show no change on the 2nd quarter of 2010. Over the following year, tender prices are forecast to rise by 2.5%, and then by around 3.5% over the following couple of years. However on major schemes (say over £80 million) the supply of contractors/sub contractors is very limited and increases in workload could result in levels of inflation higher than the above.

Recovery across the rest of the country is expected to be slower. Nationally, tender prices are forecast to fall by 3.3% over the next year, but increase by 1.2% in the year to the 2nd quarter of 2012 and by 2.6 - 2.8% over the following two years.

Construction Output v Tender Price Index (June 2010)



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 BERR 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 Index.

Infrastructure

Infrastructure workload is up and the sector is expected to substantially outperform the rest of the industry, but cuts are coming which will reduce workload and, together with increased commodity prices, create a much more competitive market for contractors' services

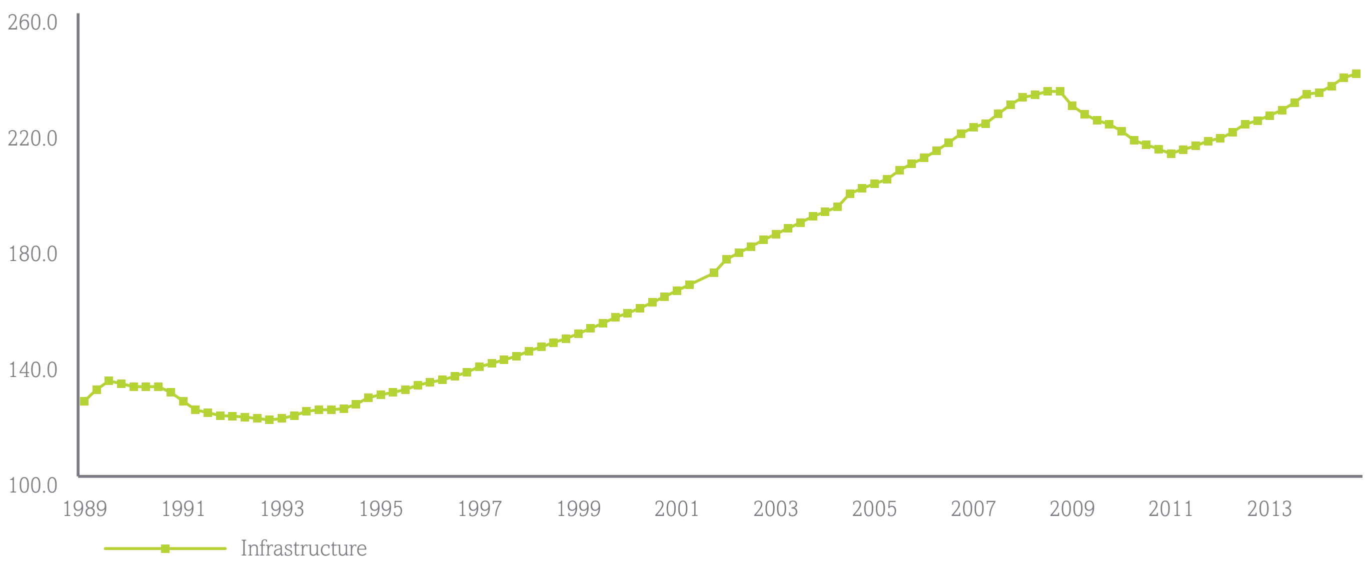
Infrastructure workload figures have been very impressive over the past year and output in the 4th quarter of 2009 was 31% up on a year earlier. New orders figures in the 4th quarter of 2009 were down by 12% compared to the previous quarter, but to put that in perspective, the 3rd quarter figure was the highest ever recorded and the 4th quarter figure was the second highest.

The forecasts prepared by Experian and CPA both indicate substantial increases in workload over the forecast period, averaging at around 11% this year and 9% in 2011. However the forecasts were prepared before the election and before the announcement of government cutbacks. All major items of expenditure in the public sector are under review and even though 60% of infrastructure spending is outside government control, any major slowdowns in road or rail spending (new runways at Heathrow and Stansted have already been cancelled) will create pressure in the sector. The Government is also believed to be reviewing Crossrail with a view to saving up to £5 billion and will also be looking for 'best value'.

On the cost side, higher commodity prices in the infrastructure sector could lead to tender prices increasing sooner rather than later. Countering that is increased competition as a number of construction firms are shifting their focus to try and pick up some infrastructure work and other firms within infrastructure are seeking to transfer skills between different sub-sectors.

Overall, the lower expectations for infrastructure are likely to be balanced by increased input costs with the result that infrastructure tender prices are expected to fall by 0.7% over the year to the 2nd quarter of 2011. The market is expected to move to positive inflation the following quarter and show an increase of 3.2% in the year to the 2nd quarter of 2012 and then rise to 3.5 - 4% over the following couple of years.

Infrastructure Tender Price Index (June 2010)



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

The forecast for tender price inflation across the UK indicates that London will recover before the rest of the country. However regional variations in demand and in the supply of contractors' services mean that tender price movement will vary across the UK over the next two years, see below.

Regional Tender Price Inflation (June 2010)

Commodity Price Rises and Input Cost Inflation - Are We Going To Be Surprised

The recent rises in the prices of key commodity such as iron ore, oil, and copper has lead to a consideration of the direct effect on construction projects. A number of factors have coincided to mean that there is likely to be considerable inflationary pressure on factory gate prices, energy costs and raw materials, with potential rises in some commodities of around 15-20% per annum.

While labour rates are likely to remain depressed in the near future, materials' prices are likely to be especially susceptible to inflation. Worldwide demand is starting to increase in China and India, but the supply chain is unlikely to rebuild capacity until debt is less expensive and confidence in long term order books returns. The slow response of manufacturers, combined with the pressure on factory gate prices, will mean that non-labour elements of construction costs could see super-inflationary pricing for some products.

Undeniably some clients have benefited from tender prices which may be up to 20% lower than the peak prices of 2008, as contractors have been pitching for - and winning - jobs on low or zero margins to maintain turnover. On these jobs price increases down the supply chain could create substantial losses, potentially leading to more corporate failures and/or the return of the more familiar adversarial game of winners and losers in the courts.

We should therefore recognise that the game has changed and may require different solutions. Clients exposed to these volatile market conditions will need to manage the risks, from funding obligations, through the main contractor, and into key elements of the supply chain, to secure their return on investment. Some form of collaboration or transparency between the parties is thus rapidly becoming desirable.

There should be a priority now to spend time in carefully considering how to address the risks, otherwise all parties will loose financially as the misalignment between the original business case and outturn cost increases.

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