

GLOBAL ECONOMY WORRIES AFFECT INVESTOR CONFIDENCE AND PUSH BACK RECOVERY IN TENDER PRICES

- Output in the UK economy fell in the 4th quarter of 2011 while market confidence has been affected by the Euro debt crisis.
- Construction new orders in the 3rd quarter of 2011 were 13.5% below the 2010 quarterly average.
- CPA forecast indicates new work output will fall by 6.5% this year with a further marginal fall in 2013.
- After some optimism early in 2011, the private commercial sector remains poor.
- The London offices market has potential, but there is a lack of funding and tenant demand has weakened this year.
- Contractors' input costs fell by 0.5% over the past year; materials prices up 4%, site labour rates down 7%.
- Commodity prices fell over the 2nd half of 2011; any increases were absorbed through the supply chain.
- Turnaround in tender prices not expected until the 1st quarter of 2013 for London, late 2013 across the rest of the country.
- Tender prices in London, forecast to fall 0.5% in the year to the 1st quarter of 2013 and then rise by 3.3% the following year.
- Outside London, forecast is for tender prices to fall by 2.8% in the year to the 1st quarter of 2013 and rise by 0.6% the following year.
- Infrastructure tender prices to rise by 1.7% in the year to the 1st quarter of 2013, by 2.2% over the year to the 1st quarter of 2014, picking up to 3-4% increases over the following two years.

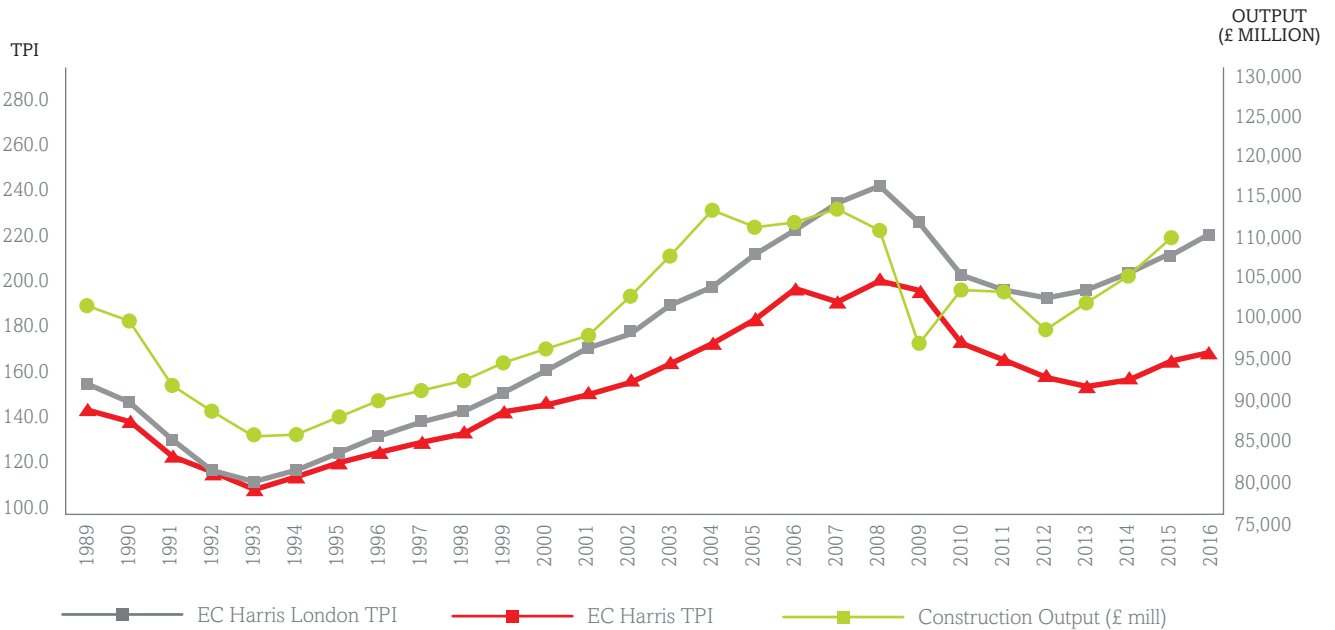
After some optimism early in 2011, the latest Experian state of trade survey shows that confidence across the industry has fallen in recent months and as a result, the recovery in tender price is now not expected until the 1st quarter of 2013 for London and 3rd/4th quarter of 2013 across much of the rest of the UK.

The UK economy contracted 0.2% in the 4th quarter of 2011 and economic forecasts continue to be downgraded; the latest Treasury round up indicates growth of just 0.6% in 2012. Meanwhile the shadow of the Euro-zone debt crisis is still casting a very dark cloud over the economies of most of Europe.

Overall construction output rose in both 2010 and 2011, but after some optimism early in 2011 it is now apparent that the construction industry will continue to suffer over at least the next 2 years. The factors driving this include the continued gloomy outlook for public sector workload and broader weakness in the commercial sector - which represents the largest source of contractor workload. Falling tenant demand and constraints on project funding are a major factor in the commercial sector downturn, and the collapse of workload in health and education PFI have also been significant factors. The latest construction workload forecast from the CPA has been further downgraded; new work is expected to fall by 6.5% in 2012 with a further marginal fall in 2013 before recovery of 4-5% p.a. over the following two years.

The workload forecast shows few bright signs. House builders are doing well and the luxury housing market is apparently impervious to the problems facing the other sectors. In the retail sector, steady, if unspectacular, growth is expected despite cutbacks in their store roll-out programmes from a couple of major retailers. The private industrial sector too is expected to grow, but the size of this sector means that it makes little impact on overall activity levels. Other than these specific sectors, it is difficult to see where any future stimulus to workload will come from, with public sector workload expected to fall for 4 straight years including a drop of almost 14% this year.

Construction Output v Tender Price Index (January 2012)



Note. The above graph indicates how building tender prices and construction workload figures have tracked each other over the past 22 years together with forecasts over the next 4 years.

The above figures are based on the Construction Output figures produced by the Office for National Statistics 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 spending increased significantly in both 2010 and 2011 is expected to slowly rise this year and next, but the great ‘unknown unknown’ is what happens after that. The CPA forecast is for continued increases over the next 2 years, but the Chancellor has indicated that he expects the majority of infrastructure funding is to come from the private sector and there is no guarantee that this is going to occur. Any substantial rise in infrastructure workload would undoubtedly create more demand for labour and materials and help to push up building prices.

The latest EC Harris survey of contractors’ input costs showed that costs rose a marginal 0.3% in the 4th quarter of 2011 compared to the previous quarter, but were 0.5% lower than a year earlier. Materials’ prices showed a 4% increase over the year, primarily on the back of a 10% rise in rebar with steel up 4.4%; site labour rates, however continued their downward trajectory and were 7% down on average compared to a year ago.

Factory gate prices fell in December, on the back of fuel price reductions and commodity prices generally fell over the second half of 2011 with potential increases being absorbed through the supply chain. In the marketplace preliminaries for larger schemes are coming in below 10%, while bids on smaller schemes are attracting 12-14%. Overheads and profit levels generally are between 2.5-3.5% in open market bids and work is often being bought at nil

or negative margins. When work does go out to tender, our experience is that prices which have been rigorously market tested are regularly being bettered by 10%.

As a result of the above, the tender price forecasts have again been revised downwards and recovery has been pushed back by a further 6-9 months. Prices nationally are now expected to fall by 2.8% in the year to the 1st quarter of 2013, bottom out towards the end of that year and then rise by 0.6% over the following year, picking up to a further 3.0% in the year to the 1st quarter of 2015.

In London, there was a degree of optimism early in 2011 that proved to be unfounded. The reality of the slowdown in orders and the continued uncertainty about the UK and European recovery means that the nascent recovery has now stalled and tender prices are not expected to pick up until the 1st quarter of 2013. Tender prices are still expected to be 0.5% down in the 1st quarter of 2013 but as workload starts to pick up in London, will rise by 3.3% the following year and by 4.3% over the year to the 1st quarter of 2015.

Infrastructure tender prices are forecast to rise by 1.7% in the year to the 1st quarter of 2013, by 2.2% in the year to the 1st quarter of 2014, quickening to 3-4% over the following 2 years.

As a direct result of the tight market, significant risk transfer opportunities are available at little or no cost premium. However, while the market is very attractive to the relatively small number of clients who are active in the market place, the present level of prices is unsustainable. The consequences for the supply chain of 'buying' work at these levels could be serious problems and clients should be mindful that entry price doesn't necessarily equal exit price.

Infrastructure

The Autumn Statement, indicates that Government is looking to boost the economy through continued and marginally increased investment in infrastructure. However, the stimulus of the highways and rail investments is unlikely to see any increase in demand for construction in the short term which will, at best, maintain a steady state.

Infrastructure workload increased by 10% in 2011, following the 26% increase in 2010. The 2011 figures indicate major increases in spending on rail and electricity although output on roads fell while the water sector increased by 8%.

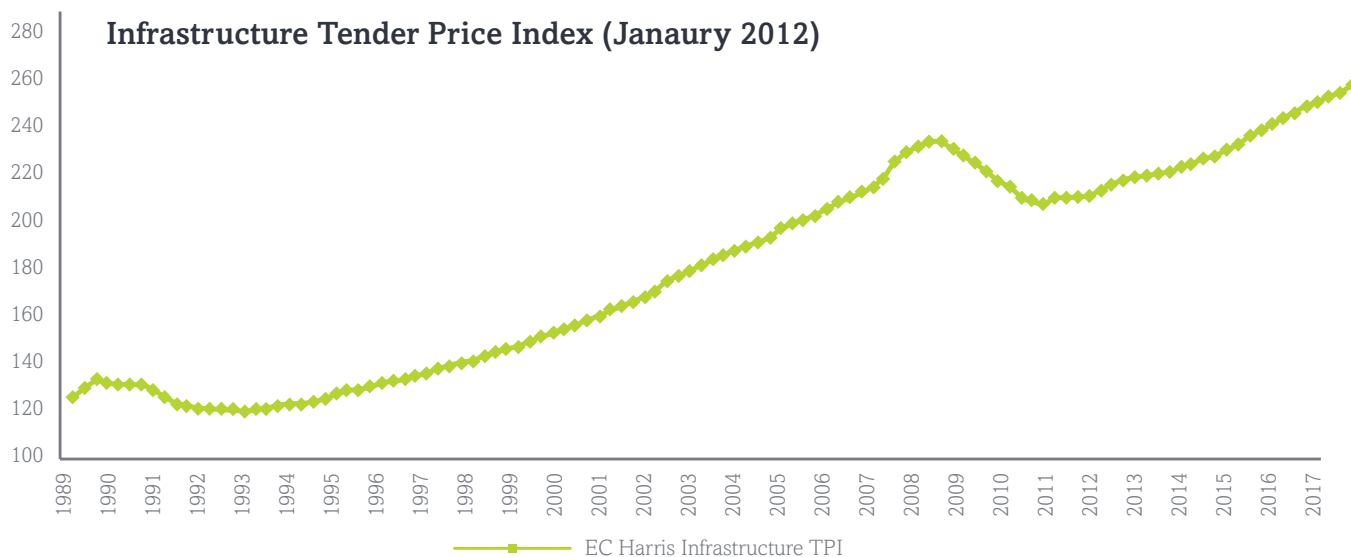
Looking ahead, the CPA forecast indicates that Infrastructure workload is expected to rise by 1.6% in 2012 and by 2.4% in 2013 before picking up to show increases of 8.3% and 6.3% over the following two years. A slowdown in the water sector sewage is expected with spending on roads also showing

major falls. The rail sector, in contrast, is forecast to rise by 20% this year and by a further 13% in 2013. Expenditure on the electricity sub-sector is expected to show spectacular increases over the next 3 years with year on year increases in orders of 20%, 30% and 32%.

As detailed earlier, the 'unknown unknown' is where the money is going to come from. The Chancellor's bullish Autumn statement about infrastructure spending indicted that the majority of the infrastructure funding is to come from the private sector; the timing of this injection of capital is unclear and not everyone in the industry believe that this is likely to occur.

Whilst order books look reasonable for 2012, the outlook beyond, post Olympics, looks more uncertain. What we can expect to see is more aggressive pricing to secure future work, with little, if any profit margins being applied. Continued efficiency drives by contractors will see overheads challenged, again pointing to increased competition. Pressure will continue to deliver more for less - as part of the 'Infrastructure Challenge' - with regulated and public authorities looking to sweat their assets further, to delay any short term investment.

As a result of the above, the expectation is that the infrastructure tender prices will rise by 1.7% in the year to the 1st quarter of 2013, by 2.2% over the following year, rising to 3-4% over the following 2 years.



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.

Insolvencies and how to avoid them

The consequences of 'buying' work at extremely low levels is an obvious increase in the risk of insolvency through the supply chain.

Historic trends tell us:

- Construction insolvencies rise as the market recovers - the consequence of buying work at unsustainable levels
- Protection provided against 2nd or 3rd tier insolvencies through a main contractor shield will not deliver the project on time and may create commercial difficulties, regardless of the protection.
- Even well run businesses are susceptible to insolvency.

The introduction of an updated Construction Act in October 2011 will enforce stricter payment regimes on main contractors but could increase the pressure on the finances of main contractors as they chase cashflow with highly competitive bids.

Tell tale signs of contractors/sub-contractors in difficulty include:

- Increases in claims by or against the contractor
- Difficulties in obtaining bonds
- Non-availability of parent company guarantees
- Market intelligence/feedback
- Attempts to overvalue works/cash collection
- Falls in productivity
- Removal of plant or equipment from site
- Sub-contractor payment difficulties
- Negotiating unrealistic improved payment terms.

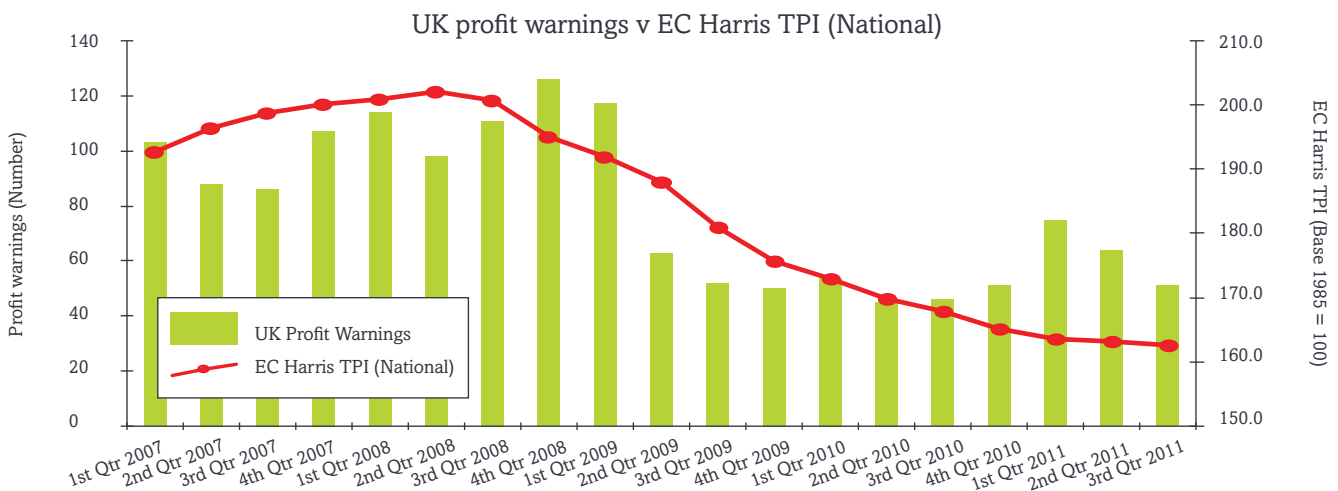
Safeguards

Although it is not possible to safeguard against all potential pitfalls, there are a number of sensible and prudent actions that can be taken. These include:

- Make sure that designs are robust and co-ordinated and appropriate procurement and contracting strategies are in place
- To avoid giving grounds for claims, clients should buy what they intend to build
- Look out for preliminaries and margin erosion, which will inevitably lead to reduced management/supervision. Clearly define management, control, quality expectations
- Pay close attention to selection, analysis and recommendation processes in relation to tendering. Lowest bids can show signs of desperation. Credit checks tend to access historic data. Know the market and use all available resources to interrogate the supply chain. However, be sensitive, avoid setting hares running.

Once in contract:

- Look out for contractors trying to front load cash flow
- Surveyors should only value works properly executed and not overvalue - even if pressurised to do so. Care should also be taken in valuing materials off-site. If payments have to be made, the appropriate insurance/vesting agreements should be in place
- Make sure all insurances are in place
- Have a clear path established for powering bonds, warranties, parent company guarantees, etc
- Resist requests for advance payments. If necessary procure advance payment bonds or similar protection
- Make sure at the outset that all Preliminaries costs are allocated appropriately to fixed / time related categories. Adjust Preliminaries and other time-related costs if delays occur and are not backed by formal time awards.



Source: Ernst and Young and EC Harris

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