

TENDER PRICES COULD FALL BY 25% IN THE CURRENT CYCLE

- *Recession is going to be long and deep and building tender prices will show 3 successive years of fall*
- *Contractors are cutting profit levels while sub contract trade package prices are falling fast due to reduced opportunities and hunger to secure workload*
- *Contracts may be won at cut throat prices resulting in greater numbers of 'claims' and greater risk of contractor failure*
- *Infrastructure workload is more assured and tender prices will fall, but not as much as in the property sector*
- *Clients in long term supply chain relationships with contractors and suppliers will secure greater benefits*
- *Tender prices are expected to fall on average by around 10% in 2009 and by 6% in 2010*
- *Falls of 25% or more could be seen in the hardest hit sectors over the course of the downward cycle*
- *If the market starts to pick up in 2011, clients should be gearing up now to take advantage of low prices*
- *Sterling : Euro exchange rate likely to stabilise at around €1.20 by year end.*

Building Sector

The second half of 2008 saw a significant reversal of predicted tender price increases across most sectors. The combination of this reversal and predicted falls for the next three years will bring tender prices down by at least 20%, with hardest hit sectors showing falls of 25% or more.

Construction activity in the private sector is moribund; in the public sector, with interest in PFI schemes low, education will provide a more steady platform; however it will be difficult to introduce any kind of accelerated programme for public works which will increase workload in the short term. Potential increase in public spending are likely to be adversely affected by the next election, which must occur before June 2010; general elections always trigger a freeze on investment decisions by government and the present circumstances make that a near certainty. Faced with falling order books, contractors are starting to take exceptional steps to secure workload which inevitably includes speculation about future price falls.

There is broad agreement among the main industry forecasters that workload will fall over the next couple of years, with the different views averaging out at cuts of 6.2% in 2009 and 1.9% in 2010; output is expected to move into positive figures in 2011, when an increase of 2.4% is expected.

Building Sector (continued)

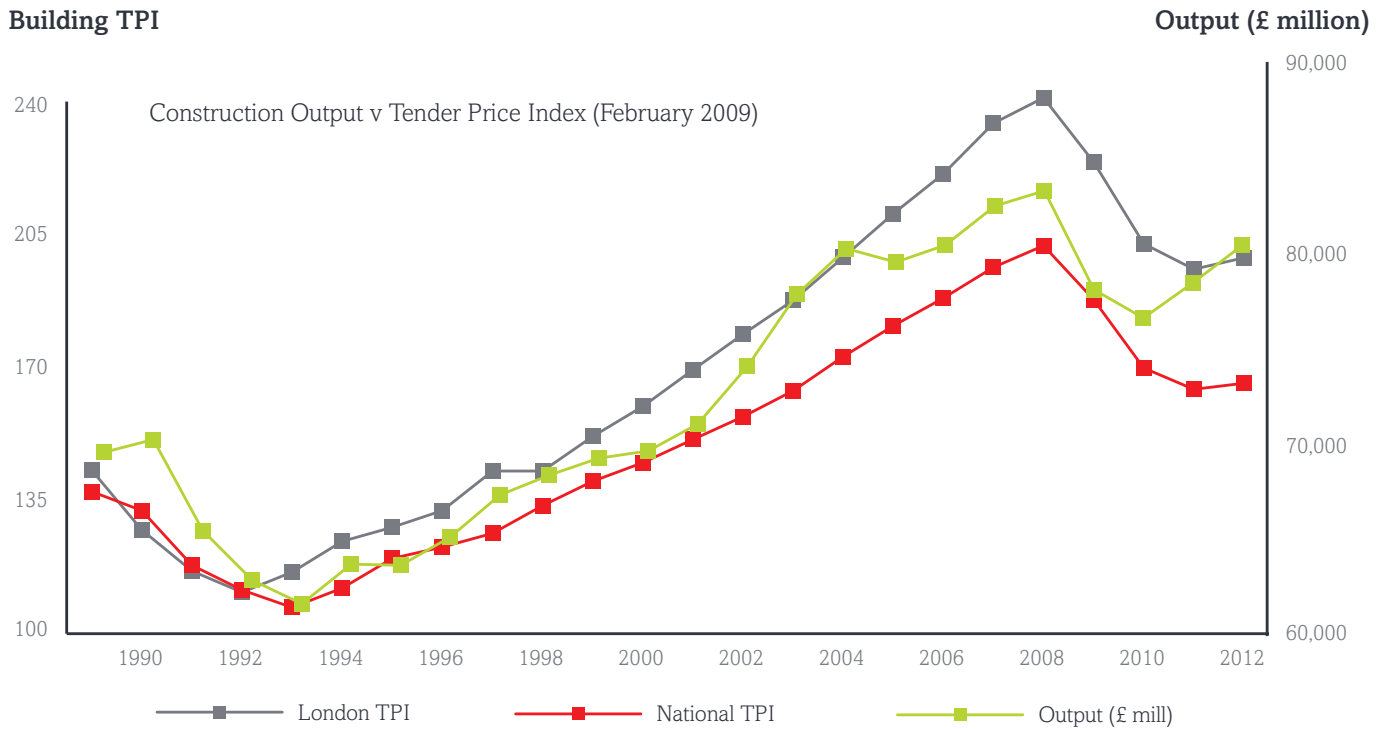
After the roller coaster ride last year, prices for key materials are falling fast and the global recession is bringing world commodity prices down. Mining stocks are under real pressure and the London Metal Exchange has revealed that stock piles of copper and other materials ballooned by 11% in the last month, despite production cuts. Copper, zinc, lead and tin prices have all fallen while steel prices dropped by 70% in the second half of last year.

As workload continues to fall, the pressure is increasing on employers to reduce their wage bills which will see a combination of redundancies and pay cuts for some time to come.

In our last bulletin, in November of last year, we predicted tender prices would fall by at least 5% across all sectors in 2009 with a move towards 10% in specific areas. Since then however, the world recession has deteriorated, bank bailouts have increased and construction workload in other regions of the world have been badly hit.

In the short term, therefore, price falls in the property sector look set to reach the 10% level very quickly over the year to the 1st quarter of 2010, with further falls of around 6% the following year and a further fall of 1% in 2011. Thereafter prices are forecast to start to flatten, and pick up with increase of 3.5% over each of the next 2 years - with 4.0% increases in London.

Building TPI



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, the OGC and the Construction Products Association. The Tender Price Indexes are the EC Harris National and London Tender Price Indexes.

Infrastructure Sector

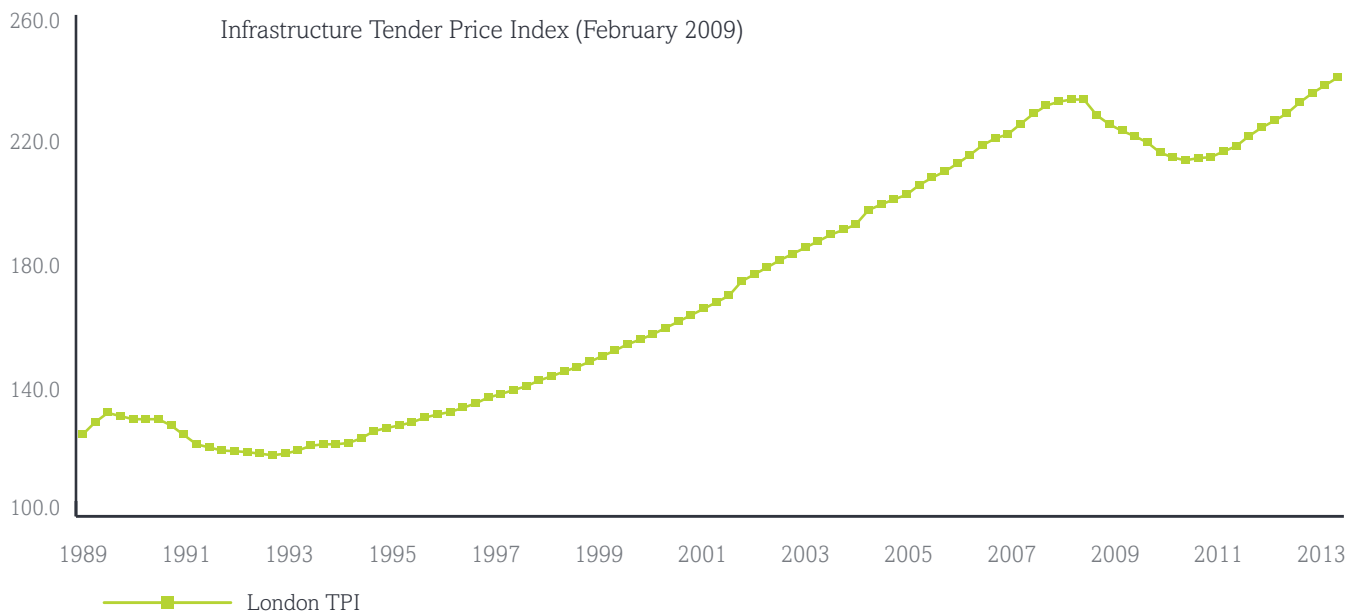
Although infrastructure orders figures slowed towards the end of last year, even a modest 4th quarter of 2008 should see the year end total for 2008/9 some 15% - 20% up on last year. The workload forecasts for the infrastructure sector indicate growth of around 10% this year and up to 20% in 2010, indicating that the sector should be insulated from the fall in demand which is hitting the property sector.

Tender pricing in infrastructure will be more protected than in the property sector since civil engineering contractors are more likely to be in long term relationships with their clients and skilled labour tends to be employed on a more long term basis. However some cuts in labour rates can be expected while materials' prices are falling, although prices

have been increasing for European based specialist products due to the Euro/Sterling exchange rate. Contractors can further cut their costs by 'sweating' their construction plant - which forms a large proportion of contractors' costs on infrastructure schemes.

There may be some pressure from new entrants into the market but clients have suffered from dealings with non-specialists in the past and may be reluctant to go beyond their normal list of contractors. Overall the expectation is that despite smaller margins in the infrastructure sector, the reduced cost base means that contractors will be adjusting their prices downward and falls of around 5% are expected over the next year with an easing to a fall of 3% - 4% the following year before a pickup of around 2% in 2011.

Infrastructure TPI



Tender price indices

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.

Key factors in market trends

Exchange rates

Sterling has taken a battering over the last year and currently trades at around €1.10. The fall in the value of the pound means that tender prices on schemes which include a high proportion of European sourced components may not fall as much as other schemes. To illustrate the point we looked at a scheme costed in mid 2008 when the pound was approx €1.26 and where 20% of the materials were procured from the Euro Zone; purely as a result of the exchange rate movement the scheme would now cost 2% - 3% more if tender price movements were ignored. Looking ahead, tender price forecasts are based upon exchange rates recovering to around €1.20 at year end.

A good time to build?

For public sector capital works programmes there is no doubt that the likely significant reduction in construction costs will allow the Government to achieve more from an increasingly strained public purse, whilst, at the same time, implementing Government policy in terms of housing, education, health and infrastructure delivery. The challenge for the private sector is to understand how best to benefit from the current level of pricing. Where funding is in place and the end user or business case is already aligned, there is no doubt that there is an opportunity to benefit. On the majority of private schemes however, where there is a need to attract scarce funding and assess end user demand, there has been a paradigm shift in how developers appraise schemes and how lenders and investors assess risk and business cases. This will move towards testing viability over an 'out turn cycle' and timing and valuing developments on a much more sophisticated basis. The aim will be to benefit from reductions in construction costs whilst delivering developments to a recovering market. Waiting until the market recovers before committing to spend will probably mean losing the window of opportunity for maximising the benefit of low construction costs.

Claims and insolvency

Inevitably contractors/suppliers securing work at low or negative margins will use whatever contractual mechanisms are available to make a profit once contracts are let. This will generally revolve around claims for time, cost or both resulting from inadequate and uncoordinated design information; great care is required to avoid providing contractors with opportunities to inflate outturn costs.

There is always a greater risk of contractor failure in a tight market and even the best run businesses can fail through cash flow difficulties or others' non performance. Whilst the nature of the contractual arrangements may afford some protection, (i.e. passing the risk to others) this will not always be possible and comes at a cost. Even where 'protection' is in place this is unlikely to address the full economic consequences of contractor/supplier failure. Similarly, the protection afforded by bonds/guarantees may be inadequate and the potential loss of warranty protection also needs to be considered.

Supplier relationships

The temptation for many clients will be to force suppliers to reduce contractually committed prices. Whilst there may be scope for adjustment in some circumstances, forcing suppliers to reduce their price to loss making levels is unsustainable.

The recession should, however, reinforce the need to forge stronger supplier relationships to drive improved performance in time, quality, productivity as well as cost. We fully expect that a strong, well managed supply chain will be a differentiator in the fight to secure the limited funding available in the future.

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