SLOW ECONOMIC RECOVERY THREATENS EUROPEAN CONSTRUCTION GROWTH

Economic growth in Western Europe has been slow and the Eurozone is expected to grow by 1.9% this year and by a further 1.6% in 2012. However the latest figures indicate unemployment across the Eurozone region is running at almost 10%. The slower than expected recovery from recession has hit the construction sector and construction price movements have generally been restrained. Construction prices in the commercial sector in Germany, France and Italy have remained virtually unchanged over the past year and have fallen in the UK. As a result prices in France are approximately 6% higher than in Germany while Italy and the UK are approximately 6% cheaper.

The problem of comparing prices across countries manifests itself in the difficulty in dealing with exchange rates. Construction prices for offices, retail and residential schemes in Switzerland, when measured in Euros - have increased by 10 - 20% over the past year and are now, on average, some 60% higher than German prices. However the value of the Swiss Franc has risen by over 20% against the Euro over the past year, which accounts for most of the price movement; as a result, the price of schemes in Switzerland which are being funded from within the country will not have moved.

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Increasing difficulties in some economies

Economic growth in Germany in the second quarter of 2011 was a disappointing 0.5%. However there are a number of countries across Europe where the difficulties are more pressing. The need to bail out the Spanish, Greek and Irish economies is creating ongoing problems in those countries which will not be solved in the short term. The more immediate effect is cuts in construction costs of approximately, 8% in Spain, 5% in Greece and 14% in Ireland; however Ireland still remains a high cost country with construction prices on average 6% higher than Germany. With the economies of those countries still struggling, and Portugal's debt status reduced, demand for new commercial offices and residential schemes can be expected to fall and we would expect construction costs to continue to fall in those countries in real terms.

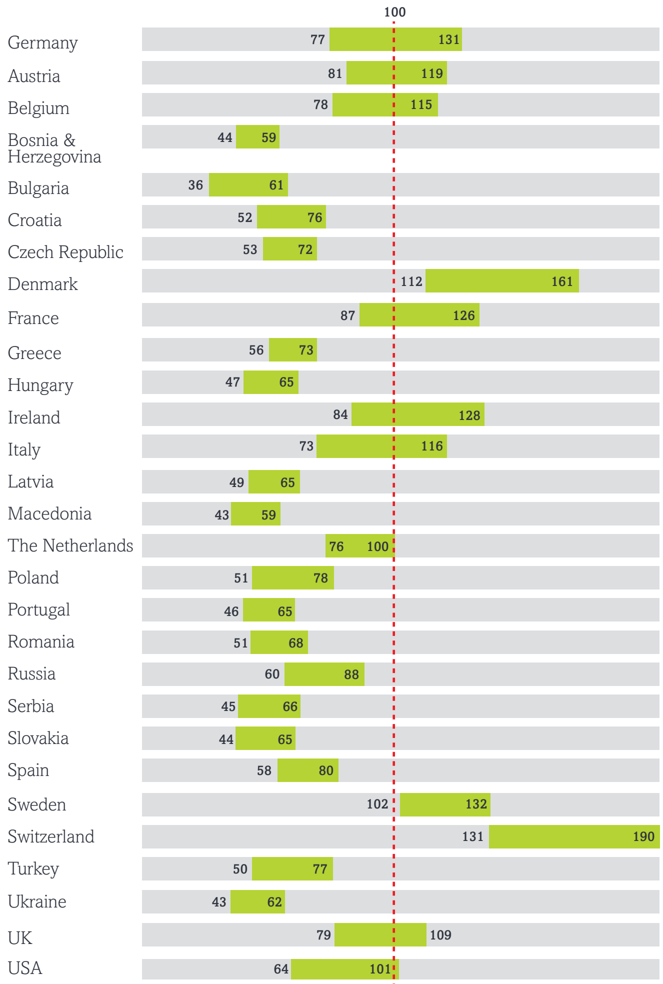
In the UK, the slow economic recovery and the cutback in public spending means that construction orders figures in the first quarter of 2011 were 23% down on the average quarterly figure for 2010. With construction workload down, pricing on major schemes is really keen as contractors look for workload at the expense of profits.

Despite the disappointing GDP figure for the second quarter of this year, the German economy is still expected to expand by 3.3% this year and by a further 2.1% in 2012. Running against the general downturn in the global economy, the German construction sector is developing at a stable pace. The positive development is based on the residential sector, where incoming orders and approvals have been very healthy. However, the general economic slowdown might influence the development in the commercial sector, where the outlook is less bright. The public sector, supported by investments from public stimulus packages during the global downturn, is suffering as public investment currently is being reduced.

Eastern Europe

In Eastern Europe, there are more signs of recovery with economic growth in the new members of the EU expected to be 3.0% this year, followed by a further 3.6% increase in 2012. The economies of both Poland and Russia are expected to grow by 4.2% this year with a further 4.2% in 2012 for Poland and 4.5% for Russia. Construction price in Russia rose by 9% over the past year, according to the EC Harris figures; in contrast, construction prices in Poland fell by around 5% and construction prices in the country are approximately 35% cheaper than in Germany and running at a similar rate to prices in Greece and Croatia. The fall in prices in Poland comes despite the increased investment in major infrastructure works in the country, including the

European cost comparison graph



The bars in the graph above show the range of costs that can occur in each country compared with costs in Germany - shown as the base of 100.

ongoing preparation for the Euro 2012 Football Championship which has involved the building or refurbishment of five major football stadia. Poland has been able to take advantage of large injections of structural funds which have been directed primarily towards roads infrastructure improvement projects.

Increasing Regional Differences

International investors have traditionally considered the whole of Central and Eastern European (CEE) as one market, but the activities of recent years have proved that this approach should be revisited. Neither local currency nor the internal markets behave the same in every country of the region and there is a big difference between some of the smaller markets such as those of the Baltic States, which are heavily dependent on foreign investment and the larger ones such as Poland and Russia where there are strong domestic markets and well established export industries.

After an almost complete freeze of investment in CEE since the credit crunch, institutional investors are showing increased interest in acquiring commercial properties across all sectors. Although the level of interest is at a considerably lower level interest than the gold rush experienced three or four years ago, it is seen as a symptom of regained confidence in the CEE market. Due to the natural limitation of built assets supply on the market, investors are starting to consider different forms of forward purchase and are even willing to take on part of the development risk as joint venture partners, an approach which can be seen as demonstrating confidence in the market.

The former Soviet satellite states and the countries which made up Yugoslavia are the cheapest in Europe, with costs, on the whole running at a level of around 55% of German costs. As noted earlier, Croatia is one of the exceptions to that rule, while prices in the commercial sector in the Czech Republic are running at a similar rate, at around 60 - 65% of German prices. While both countries are outside the Euro zone there has been little variation in their currencies against the Euro which might affect the comparison.

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Elsewhere in the world

Looking beyond Europe the recovery from the financial shocks of 2008 is taking some time to shake out. In the USA the long drawn out process involved in agreeing the federal budget and the removal of the country's 'AAA' status has created all sorts of pressure and the country is having to face up to the problem of dealing with its high levels of debt. Construction cost in the US are 17% below those in Germany and the depth and the duration of the recession has put a severe strain on contractors' working capital.

The Middle East is showing signs of recovery with a number of specific sectors and markets benefitting from the Arab Spring. The UAE has seen a restructuring of debts which should increase the appetite for external investment with renewed interest in some sectors. Pricing in most of the region is grouped quite closely and is on the whole around 10% below German costs. Bahrain is the most expensive of the GCC countries with prices around 6% below German prices; at the other end of the scale, prices in Saudi Arabia are around 55% of those in Germany.

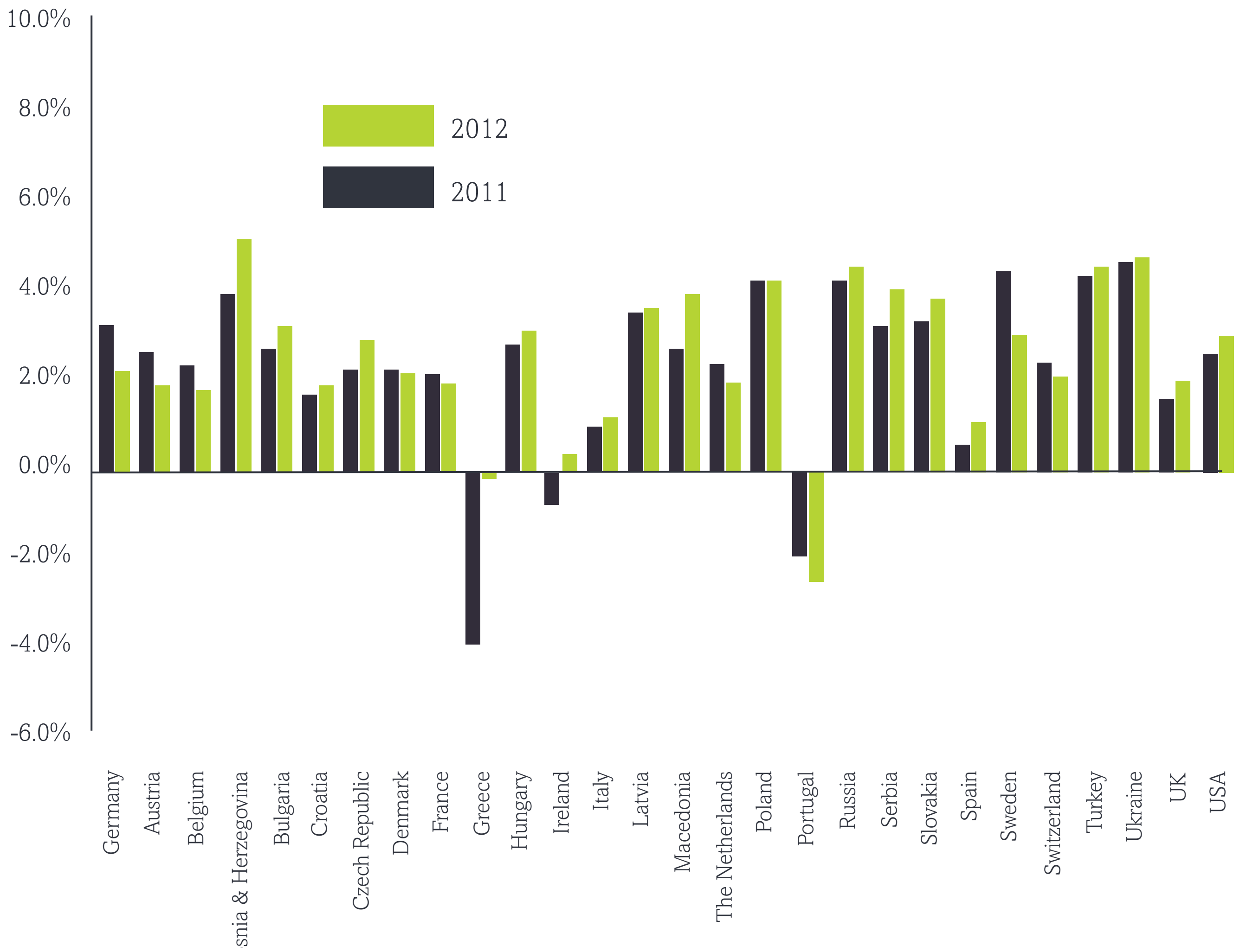
China and India

China and India are now the two main drivers of economic growth across the world and it is fortunate therefore that the Chinese economy is expected to continue to grow at around 9% p.a. with growth in India not far behind. However, both countries are seeing high levels of inflation which have led to higher interest rates and the possibility economic slowdown which would have an adverse effect on the construction sector.

Overall construction prices for commercial offices across the region show huge variations. India and China are low cost countries with prices running at 70% and 60% respectively below German costs. According to the EC Harris survey Japan remains the most expensive country in the region and construction costs are 16% above German prices. However the survey took place before the March Tsunami which can logically be expected to push up construction prices as the country starts to rebuild.

Overall pricing levels in Singapore and Hong Kong are now fairly similar, running approximately 15% below those in the Germany, with continuing strong demand in these two regional rivals helping to maintain tender levels.

European Economic Growth 2011-2012



Commodity Prices

Commodity prices across the world have risen significantly over the past 12 months and steel, copper and oil prices have been close to all-time highs. For contractors tendering on a fixed price basis on commercial offices, retail and residential schemes, the risks can be substantial as they could be exposed to large pricing risks where procurement has not been finalised, with resultant risks to clients.

Recent worldwide price increases have been driven by a number of common factors:- increased demand across the world, as countries/regions recover from the recession; the growing role of the BRIC countries as consumers and difficulties in supply.

However there are signs that the worst of the commodity prices rises are now behind us. Oil prices are already some 10% below their peak and prices falls are expected across a number of key commodities in 2012 and 2013.

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