

## KEY ISSUES FOR 2012

# DON'T LET THE MARKET BEAT YOU

2012 will present some unique challenges for construction and property clients. Constrained funding and an uncertain decision making environment are only two of the factors that will make projects harder to get off the ground - whilst continuing pressure on the supply chain will increase risks associated with project delivery and the operation of assets. Despite the difficult conditions, clients that take positive action should be well positioned to secure value in highly competitive markets.

Clients that do not take these steps risk being prisoners of their markets rather than in control of their destiny.



In this brief guide, Simon Rawlinson, EC Harris' Head of Strategic Research considers the challenging business environment in 2012 and identifies steps that can be taken to retain control.

Looking back at 2011, it is difficult to recall the sense of real optimism driven by prospects for a private sector-led recovery.

2011 will, of course, be remembered for a series of unexpected events of unprecedented scale - war, civil strife, disaster, famine and economic crisis all combined to suck demand out of many economies - distracting politicians and business leaders away from the all-important task of promoting growth.

In 2011, we identified the withdrawal of stimulus, fiscal and monetary tightening and imported inflation as the main challenges facing clients in developed economies. Whilst the threat of inflation is diminishing, the rate of fiscal tightening will accelerate significantly in 2012 - both in Europe and the US.

With a mild contraction predicted for the turn of the year, weak market conditions will present clients with continuing opportunities to secure great value. As ever, a proactive approach to project set-up, procurement and delivery will increase the likelihood of success. However opportunities will be easily missed by clients who are unable to enter the market in the first place. First mover advantage will be a prize worth paying for clients with the means to enter the game.

Accordingly, for our preview of 2012, we focus on steps needed to take control of opportunity as well as to manage risk.

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## 01

### Manage risk more effectively to release investment decisions

▶ **Could an improved risk profile help to secure project investment?**

▶ **What is the issue?**

Difficult market conditions mean that, when it comes to investment decision making, many organisations are being particularly risk averse. Given gloomy forecasts for 2012, there is little prospect for an immediate improvement.

▶ **Why is it significant?**

Projects are hard enough to get over the line without the inertia caused by uncoordinated risk mitigation across the deal map. Tenants cannot commit to pre-lets, whilst developers need tenant interest to secure development finance. In the infrastructure sectors, the need to de-risk investment is affecting affordability. Investors need outturn cost certainty, whilst contractors are finding it more costly to underwrite these commercial risks. Investment is needed in commercial space, housing and infrastructure to boost competitiveness, so how can this log jam be broken in order to meet future demand?

▶ **Actions for 2012**

Stakeholder focus will be critical to drive forward development in 2012. Developers and investors need to achieve high levels of certainty with respect to cost and programme from their supply chains but also need to be able to phase their investment so that exit costs can be minimised in the event of a slowdown. In order to bring forward viable deals, procurement strategies that deliver cost and programme certainty and a fair contractual settlement will rely on a positive approach from the client and supply chain.

## 02

### Secure competitive advantage through gaining access to funding

▶ **Who will secure competitive advantage through access to funding?**

▶ **What is the issue?**

EC Harris' 2011 survey of European property lender's intentions provides plenty of evidence of a declining appetite for lending into the property sector. However, demand for capital for PPP projects is set to increase - the European market was worth €18 billion in 2011, and countries such as the UK and Spain will continue to be highly reliant on private finance to fund public investment.

Bringing financeable projects to market which are responsive to customer need will be a real source of competitive advantage in 2012.

**Why is it significant?**

The current downturn has been finance-led and as the Eurozone crisis has intensified, pressure on bank balance sheets and lending policies has also grown. Major lenders including Soc Gen have announced a complete withdrawal from property, whilst substantial distressed property portfolios have been disposed at a discount during 2011. With many regulatory regimes, including the FSA and Basel III demanding a stronger capital base, competition for funding will become more intense during 2012 and beyond.

**Action for 2012**

The continuing switch from debt to equity finance has implications both on returns available to project participants and also for the acceptable project risk profiles. Equity finance is currently focused on high quality assets, so only projects in the best performing sectors and locations will be successful in the current market. Clients need to focus on prime opportunities and should take steps to ensure that projects are fully specified for their markets to attract JV partner interest. Optimising the size or phasing of projects to minimise the call on increasingly costly debt and equity funding will also increase project returns.

A more diverse range of investors is entering the market, so establishing relationships with a wider range of players will be a good step in 2012.

## 03

### Keep an eye on developments in PPP funding in infrastructure

**Creative solutions are needed to make essential infrastructure schemes affordable under a PPP model - look out for innovative approaches in 2012.**

#### ► What is the issue?

Continuing investment in legacy infrastructure has emerged as a key issue in connection with the sustained competitiveness of developed economies. The UK alone has a pipeline of £250 billion of infrastructure investment - with precious little additional public money available to fund it. PPP will play a growing role in funding infrastructure, but in order to provide this support, projects will need to be attractive to funders and lifetime costs will need to be reduced.

#### ► Why is it significant?

Private investment into infrastructure has had a pretty bumpy ride. The PFI model has been criticised for being too expensive for the public-sector end-user, whilst long-term investors in operational infrastructure assets have not met their performance targets. Infrastructure has the potential to offer attractive long-term returns but risks associated with constructing the asset - or over-paying for an operational asset - will continue to deter investment. Innovative approaches to project funding and development risk allocation could encourage greater institutional engagement in PPP funded projects.

#### ► Actions for 2012

Keep an eye out for developments driven by national Governments as they seek to create opportunities to unlock PPP funding. Progress dealing with investment blockers including planning, business engagement and access to project funding may all take place during the year, so take opportunities to be involved in consultations. New sources of funding are also likely to be discussed - including tolls and other sources of direct income.

## 04

### Speculative development could unlock opportunity in 2012

**With a diminishing supply of commercial projects, developers able to build to deliver in 2014 and 2015 are likely to do well.**

#### ► What is the issue?

Commercial development markets are currently under-pinned by pre-lets. EC Harris' 2011 lenders survey confirmed a growing preference for pre-lets as security for commercial property lending. With tenants facing high levels of uncertainty in connection with workload and staffing levels, the pre-let pipeline is diminishing and the development cycle is stuck. Customer need is for space in 2014/15 without up front commitment. What can the industry do to deliver this?

#### ► Why is it significant?

The industry knows that forthcoming lease breaks should deliver significant relocation opportunities in London and other key locations in 2014/15. However, with funding and pre-letting markets frozen, there is a risk that the momentum of the cycle will be lost. Tenants could opt for second-hand space - potentially reducing the effectiveness and long-term investment value of property portfolios. New office product will need to be delivered speculatively if tenants and investors are to have access to optimum property assets.

#### ► Actions for 2012

In previous downturns, developers and investors with a counter-cyclical strategy have done well. Despite weakening market sentiment, large developers are currently active, but looking forward, commercial markets need a more varied product pipeline - creating opportunities for customer-focused players that are able to secure alternative sources of finance in current challenging markets. Project selection needs to be spot-on to secure funding and long-term confidence around letting strategy. Mixed use schemes that can generate an early income stream - and which deliver demonstrably top-quality, performance enhancing space - represent the best investment opportunities for clients who are able to take an entrepreneurial position in what are very difficult markets.

## 05

### Prepare for the impact of deflation on construction and FM markets

**Many forecasters anticipate a double-dip in 2012 - what could this mean for built asset clients?**

▶ **What is the issue?**

Most countries in the Eurozone are expected to endure a mild recession in early 2012. For the 'Club-Med' countries, 2012 could see a much more severe slowdown. The construction and real-estate industries have not recovered from the 2008 recession - and few are fully prepared to deal with a second round of contraction. Project delivery risk and supply chain insecurity are likely to increase this year.

▶ **Why is it significant?**

Demand for construction and FM is forecast to fall significantly during 2012 which will increase pressure on supply chains. Many contractors' work pipelines are weakening from 2012/2013 onwards - potentially increasing competition for available work. Prices offered in competitive procurement have stabilised at a significant discount to the peak of the market in 2008, leaving margins wafer thin. At the same time Eurozone woes have reintroduced currency fluctuation as a business risk. Projects secured at deeper discounts could be storing up trouble for the future. Now, more than ever, clients need to keep their eye on the outturn price - not just the price of entry.

▶ **Actions for 2012**

Effective procurement strategy in 2012 will rely on good quality market intelligence and well designed packaging of projects to manage risk and deliver value. In particular, clients will need a better view of their second tier suppliers. The contractual chain will only be as strong as its weakest link. Smart work packaging - hiving off higher risk early activities such as below ground works into separate packages may reduce risk exposure for principal contractors - enabling good value bids to be secured for other works. Smart procurement should avoid passing any unnecessary costs to the supply chain and should encourage suppliers to eliminate avoidable risks such as currency fluctuation.

## 06

### Building Information Modelling - Time to get on the bandwagon?

**Building Information Modelling was the talk of 2011 - can clients secure some benefit in 2012?**

▶ **What is the issue?**

Use of Building Information Modelling (BIM) improves information quality and enables design and asset information to be shared and reused. BIM has received a significant boost in the UK and USA through Government mandate. As BIM becomes more widely adopted, clients should be considering how they can organise their projects and programmes to take full benefit of the potential for BIM-enabled project and asset management.

▶ **Why is it significant?**

The momentum given to BIM by Government provides a powerful and potentially one-off opportunity to shape how BIM could be implemented and how it adds value. Clients across all sectors should take advantage of increased momentum to secure additional value from their projects.

▶ **Actions for 2012**

Clients should understand basic BIM concepts and invest some time to explore how BIM could benefit their business from their own perspective. Designers and contractors use BIM to generate optimised design and to de-risk construction, but there may be other areas where a BIM-enabled approach could benefit the client if a project-wide or programme-wide structure was in place. Follow the Government's example and consider how standards might make projects more efficient, and how BIM-based processes could contribute to streamlining asset management and operational performance.

## 07

### Sustainability - two steps forward, one step back

**Sustainability investment has become mainstream but government support is being withdrawn - what steps should clients take in an uncertain environment?**

▶ **What is the issue?**

Steady progress towards the development of reduced-carbon economies have been interrupted by political and economic uncertainty during 2011. On the positive side, there has been substantial progress towards a global climate change agreement, together with major initiatives in the UK such as the Green Investment Bank and the Green Deal. However, a series of reverses, such as the reduction of subsidies for some technologies such as PV, and increased carbon taxation are reducing incentives and are introducing complexity into leasing markets.

▶ **Why is it significant?**

Even whilst there is growing evidence of user demand, the pure economic case for sustainable investment continues to be difficult to demonstrate. Weak, short term economic conditions could lead to assets being commissioned that do not deliver optimum long-term sustainability performance. This could result in early obsolescence as markets and countries progress towards a low carbon future.

▶ **Actions for 2012**

A key action during 2012 will be for clients to ensure that their buildings perform as they are intended to - commissioning and building operations should be reviewed to ensure that designs deliver their promises. Also, high energy costs and some aspects of carbon taxation will encourage organisations to consolidate assets - with wider benefits for their CRE strategy. Sustainability, business efficiency and effective asset management should go hand in hand in 2012.

## 08

### Make your built assets work harder as a business driver

**As organisations need to respond to an accelerating pace of change, it may be time to review the effectiveness of built asset management planning.**

▶ **What is the issue?**

Given the uncertain economic environment, businesses are responding rapidly to opportunity or consolidation through the rapid mobilisation of people and technology. Similarly, as labour costs rise rapidly in emerging markets, decisions on where clients should invest or sustain a presence become more multi-dimensional. Real estate costs make up a significant portion of business overhead and tend to be managed less actively than people or other mobile assets. Can asset management make a greater contribution to business performance?

▶ **Why is it significant?**

As businesses consolidate and operate across a range of locations and management structures, there are increasing opportunities for business-wide asset management to help make best use of corporate real estate, contributing to enhanced group performance. However, exploiting these opportunities requires a joined-up, business-wide approach. Can new asset strategies be implemented when businesses have so many short term challenges to deal with?

▶ **Actions for 2012**

Clients need to become asset managers as well as asset users. In doing so, clients should develop a joined-up view of their full portfolio of assets. This applies particularly to organisations that either have extensive leased property assets or extensive capital tied up in land and buildings.

## 09

### **Don't wait for the end of a lease to relocate in order to improve performance and save money**

Rising tenant demand for space will be as important in unblocking commercial markets as speculative development over the next year or two. Tenants have the opportunity to secure great deals and to improve their business environment and processes.

#### **► What is the issue?**

Business relocation can provide a one off opportunity to introduce a step-change into an organisation's culture, business processes and use of space. When EC Harris relocated into new offices in 2006, significant changes to ways of working were introduced. Despite significant investment, benefits case targets were delivered within 20 months - over a year ahead of programme. In current markets, uncertainty is holding back many organisations from investment in new space - postponing the securing of wider business benefits that will be essential to remaining competitive in future years.

#### **► Why is it significant?**

Poor business conditions mean that great deals continue to be available for occupiers that have the ability to relocate. Slow take-up rates are also suppressing demand for new speculative commercial space - creating conditions for a supply/demand imbalance in the future. Organisations that can move now - possibly ahead of a lease break - could secure significant benefit and will create the platform for all-important business change.

#### **► Actions for 2012**

All businesses should review their space use to consider what business improvement could be accelerated. Furthermore, organisations that have a lease-break opportunity in the next 2-3 years should review whether there is a business case for an early move based on projected rental deals, rent-free periods and the acceleration of business benefits. Given the current commercial building pipeline, delay until the date of the break may result in less favourable long term occupancy costs.

## 10

### **Celebrate the 2012 Olympics and Paralympics - demonstrating the skills, expertise and innovation available within our industry**

It is 2012 at last and even if Great Britain doesn't win its share of medals; the industry has demonstrated how to deliver a complex programme to time and budget.

#### **► What is the issue?**

It is time to celebrate! Despite technical challenges and controversy around budgets and legacy, the 2012 Olympics infrastructure has been delivered to time and programme. What can clients and project teams learn from this success?

#### **► Why is it significant?**

Looking forward, clients will be asked to deliver more complex and challenging programmes - making better use of assets, reducing carbon impacts and overhauling significant elements of obsolete infrastructure. All of the lessons that can be taken from the Olympics, related to programme management, procurement, supply chain and risk management should be shared and adopted as widely as possible.

The legacy of the Olympics should extend to the way that clients and the industry operate as well as new assets and infrastructure in London's East End.

#### **► Actions for 2012**

Clients need to be ready for the Olympics and the disruption and opportunity it might bring. 2012 could see the UK's biggest ever experiment in flexible working, as London gears up to deal with over five million visitors to the capital. In addition to the short term adjustments, everyone involved in construction and real estate should consider how the ways of working and principles adopted on the 2012 project could be applied more widely. We should all also ensure that we set aside enough time to participate in and celebrate the once in a lifetime event that the Olympics is sure to be.

**2012 commences with great uncertainty and promises to be a very challenging year in property and infrastructure. There will be many winners at the 2012 Olympics in London this summer - the product of meticulous planning, thorough preparation and flawless execution.**

**A similar approach may prove to be necessary to deliver success with Built Assets in the European markets this year.**

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