WT PARTNERSHIP

REVIEW OF UK CONSTRUCTION MARKET CONDITIONS 3Q 2017

Commentary

Construction activity in the UK has generally held up, to date, with high output rates being maintained against the backdrop of a relatively buoyant UK economy. This is despite the significant geopolitical events that have occurred around the world over the past year or so which, despite creating an air of uncertainty and a transformation in global economic conditions, have not led to any decline in growth.

However, since the snap general election called by Theresa May in May 2017, the Conservative party have lost their overall majority in parliament and were, at the time of writing, attempting to govern as the largest party in a hung parliament. Previous election polls had forecast an increased majority for the incumbent Conservative party and the actual loss of their majority will inevitably lead to a period of political instability and, with Brexit negotiations pulling on government resources to the possible detriment of domestic policy-making, will not provide the stable economic conditions desired by property and other investors. Early indications are that economic and business sentiment has been dented by the general election result.

Most economic commentators anticipate that the UK economy will need be stimulated on the one hand by productivity-related spending already announced by the Chancellor, against the unfinished business of further measures required to reduce the budget deficit. This will all take place against the backdrop of detailed negotiations and ultimately implementing the measures required for the UK to leave the European Union.

The biggest risks of Brexit to the UK construction industry continue to be access to the EU market in respect of labour supply but also possible tariffs on imported materials and components. Theresa May has previously stated that she would like the "greatest possible access" to the EU market but this is likely to fall well short of signing up to the EU's customs union.

The depreciation in sterling since the EU referendum has meant that the cost of imported products, imported materials used in UK manufactured products and fuel/energy costs are rising. The flip side of that coin, however, is that UK property looks relatively affordable to overseas investors, so transactions such as the sale of the Leadenhall building to a Chinese investor may be set to continue.

The Office for Budget Responsibility (OBR) updated their economic forecasts in the Spring budget with GDP growth now estimated to be 2% in 2017, an increase from the 1.4% forecast in the Autumn Statement. However, the forecasts for 2018 and 2019 received a downward forecast to 1.6% and 2.1% respectively which is clearly when the OBR expects the majority of the short-term economic "shocks" from the Brexit vote.

We have made further revisions to our tender price inflation projections since the issue of our last report. Tenders prices are now forecast to rise in Central London by 2.2% in 2017, 1.0% in 2018 and 2.1% in 2019. For the remainder of the UK, tender prices are forecast to rise by 2.1% in 2017, 1.2% in 2018 and 2.3% in 2019.

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Construction Activity

The latest figures from the Office for National Statistics (ONS) issued for April 2017 show that construction output fell by 0.6% in the 3 month period driven mainly by a 0.9% fall in all new work, representing the first 3 month fall in construction output since September 2016.

New work in every individual sector, with the exception of infrastructure, experienced a monthly fall in comparing March 2017 with April 2017 rates. Compared to April 2016 however, there has been growth in public housing of 13.6% but all other sectors show a fall in growth. The private housing sector is the one to watch, given its importance as the engine driver to industry output over recent years. If this sector slows then there will likely be tangible effects to the whole industry.

New housing starts were down by a third in London last year, from 25,200 in 2015 to 17,070 in 2016, according to a new report prepared by Knight Frank. This is being blamed on rising construction costs due mainly to the fall in value of the pound with up to 35% of the total construction cost of a high end residential development being sourced overseas and directly exposed to exchange rate fluctuations. Private housing is also being affected by the introduction of a stamp duty premium on second homes.

Office completions in London during the past six months reached a thirteen year high with 3.9 million sq ft of new space completed in the period, but the amount of new build going up went down. This is according to the latest Deloitte crane survey. The City of London's commercial sector is considerably less diverse than elsewhere in Central London and it is thought that this high level of specialisation leaves it more susceptible to fluctuations in the office market.

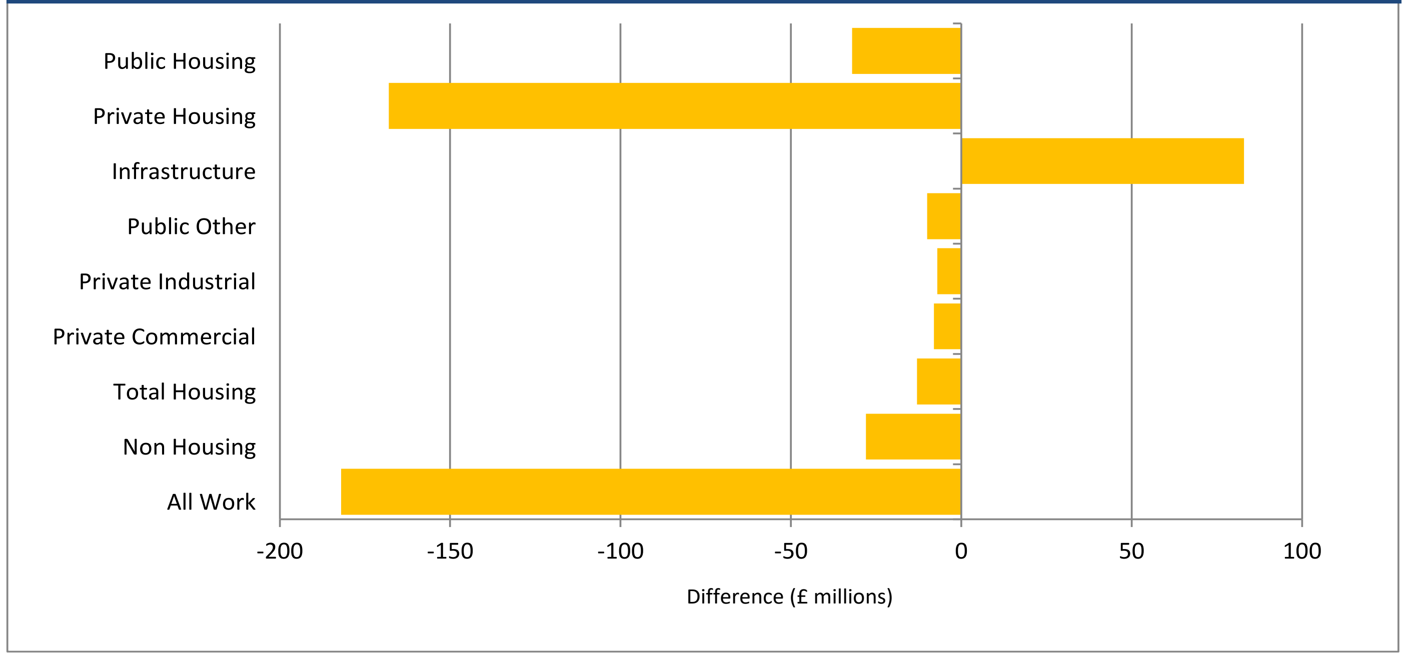
Office development in cities outside of London is anticipated to be less susceptible to concerns about affordability and demand.

The latest report from Markit, with data from the Markit/CIPS Purchasing Managers Index, is estimating that the economy will grow by 0.4% during 2nd Qtr 2017, following growth of 0.2% in 1st Qtr 2017.

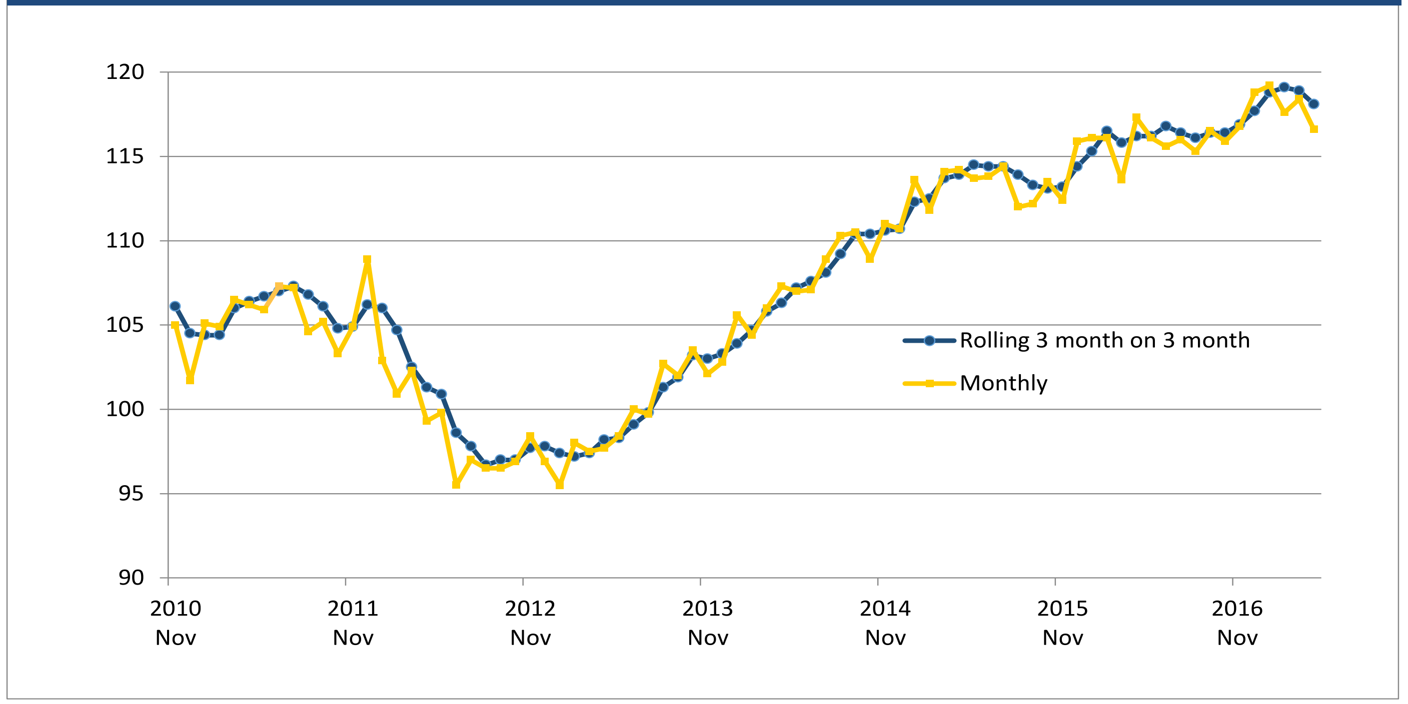
According to CPA/Barbour data on all contract activity, March 2017 witnessed an increase in construction activity levels with the value of new contracts awarded £6bn, based on a three-month rolling average. This is a 1.1% increase from February and a 7.1% increase on the value recorded in March 2016. The number of projects within the UK in March increased by 14% on February, and were 8.1% higher than March 2016.

The majority of the contracts awarded in March 2017 by value were the East Midlands which accounted for 20% of the UK total and which included a rail freight interchange valued at £558 million.

Contributions to the Month-on-Month Volume Growth from the Main Construction Sectors Great Britain, April 2017 Compared with March 2017



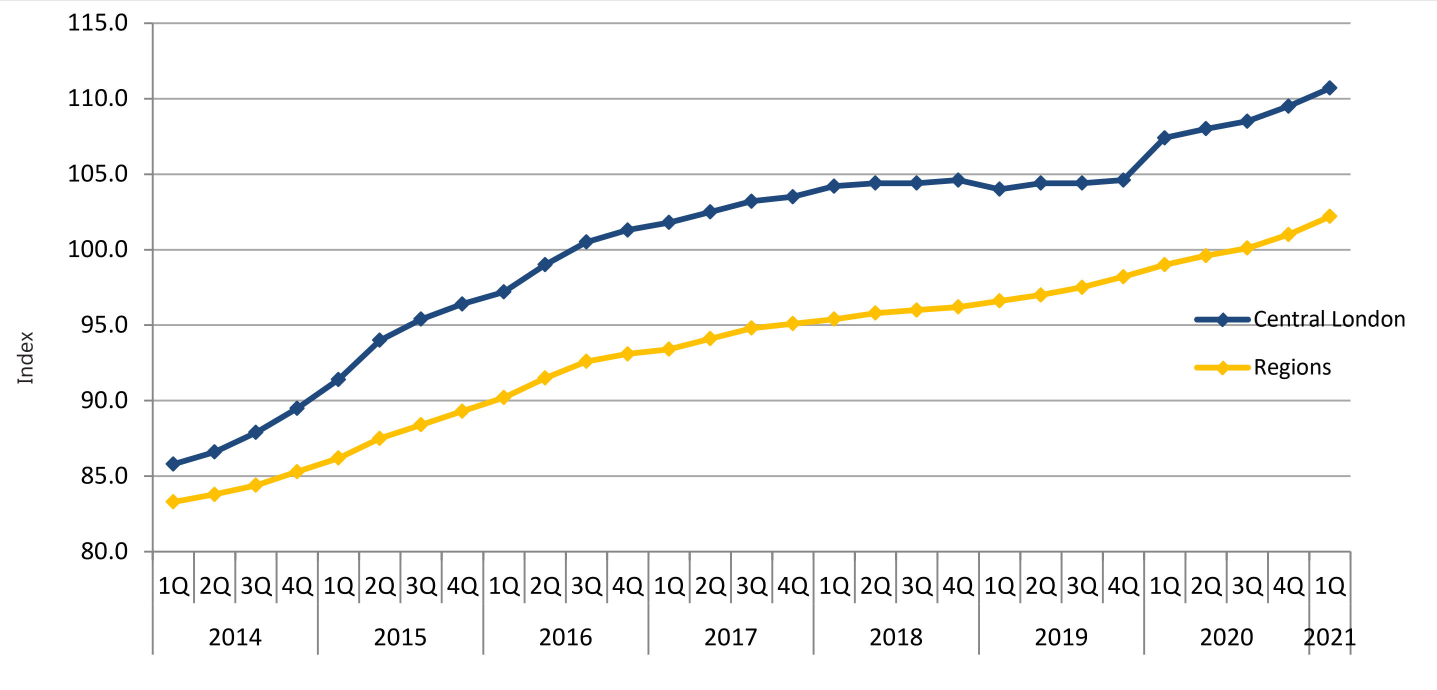
Rolling 3 month on previous 3 month and monthly all work, November 2016
Chained volume measure, seasonally adjusted, Great Britain



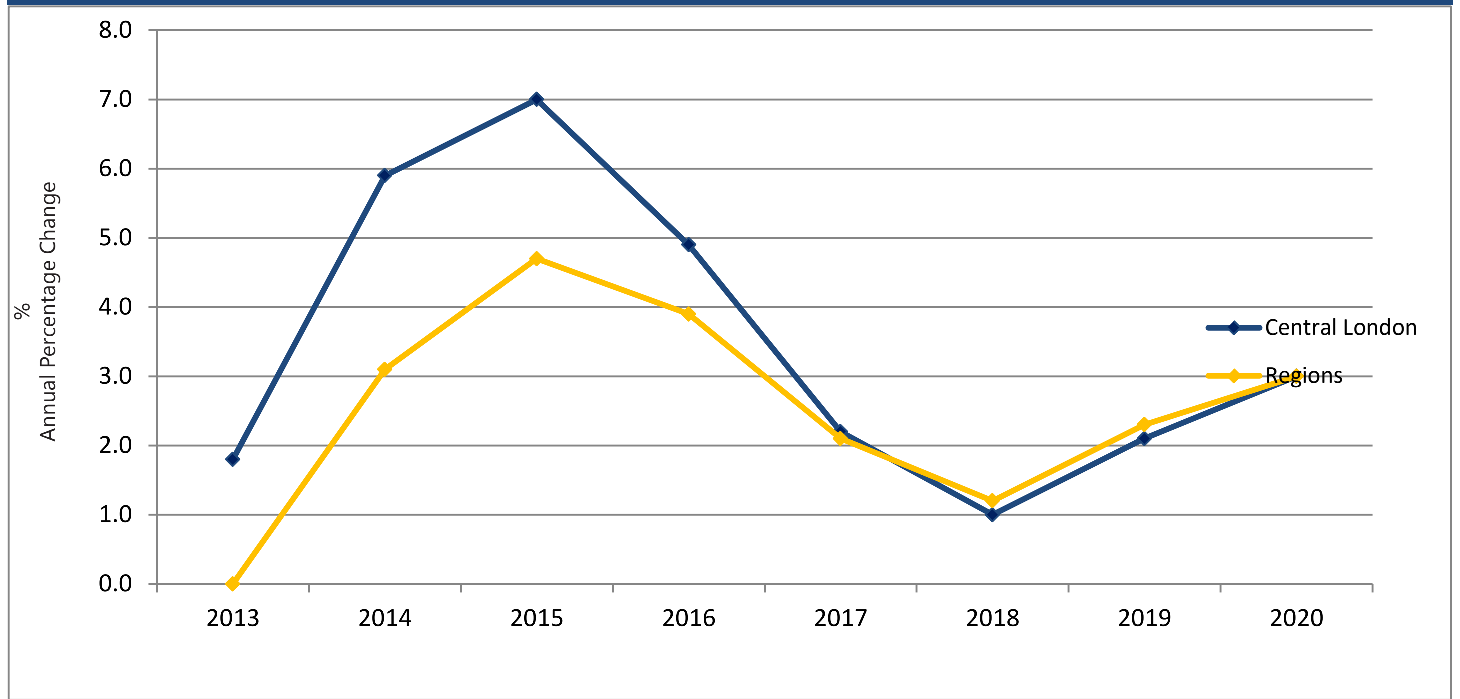
Source: Construction: Output and Employment - Office for National Statistics

Tender Price Inflation Forecasts

WT Partnership - Tender Price Inflation Trends



WT Partnership - Tender Price Inflation Forecast



There continues to be some divergence in opinion amongst construction cost consultants on the extent to which the decision for the UK to leave the European Union, and the subsequent general election and hung parliament, will impact on tender prices. However, there is general consensus that tender price inflation will slow during 2017 before bottoming out in 2018.

However it is widely accepted that input costs will continue to increase due to a rise in material costs, largely resulting from the devaluation of sterling, and also rising labour costs due to the acute skills shortage.

This predicted cost increase poses the greatest risk to the commercial and residential sectors, where dollar or euro dominated expenditure makes up 20-30% of costs. These increased costs are expected to continue to eat away at Contractor margins even as prices fall. Contractors' coffers may not have improved enough since the recession to insulate against the short-term damage to workloads caused by the Brexit vote, the general election and subsequent hung parliament. Partly due to this, Contractors are unlikely to resort to "buying work" again but instead, may redeploy staff and take on only projects they can get for the right price.

The critical period is envisaged to be following the triggering of Article 50, the impact that this has on market confidence and the extent to which the pipeline of work continues to flow through. There are significant regional variations in the UK on tender price inflation which is usually as a result of large infrastructure projects being built out and is leading to increased competition for resources at a regional level.

As mentioned in the summary, WT Partnership has made some minor revisions to our tender price inflation projections since the issue of our last report. Tenders prices are now forecast to rise in Central London by 2.2% in 2017, 1.0% in 2018 and 2.1% in 2019. For the remainder of the UK, tender prices are forecast to rise by 2.1% in 2017, 1.2% in 2018 and 2.3% in 2019. As previously mentioned, labours shortages and weak sterling are driving up prices and offsetting the ongoing uncertainty caused by Brexit and the general election. The tender price inflation forecasts are still very fluid and could yet be subject to wide fluctuations as the full implications of Brexit and subsequent general election become apparent.

Procurement

Current procurement activity, particularly in London, continues to suggest an increased appetite for bidding ahead of an anticipated fall in demand due to Brexit. This is expected to become more apparent during the latter half of 2017 and into 2018 which provides a window of opportunity for anybody wishing to construct over this period.

Two stage procurement, usually design and build, continues to dominate on larger projects despite the well documented risks to cost and programme that have been encountered on some projects over recent years. There seems to be more of an appetite by Contractors to provide some upfront cost certainty on the earlier packages in the construction contract. Issues relating to the balance of risk in two stage procurement still need to be addressed.

As previously mentioned there has been a small but significant resurgence of single stage tendering taking place in London, particularly on lower risk and fully designed out projects.

There is no evidence that tier 1 contractors are moving significantly away from their post-recession position on the allocation of project risk and continue to favour repeat business with trusted clients in sectors with which they are familiar. High end residential projects are particularly seen as high risk with a smaller pool of contractors available who would consider procuring on a design and build basis.

Main Contractors' profit margins appear to be extremely variable and some are beginning to worry about a loss of projects as Brexit begins to bite.

The widely-publicised comments by Steve Pycroft of MACE recently will have a fair amount of resonance with a number of companies in our industry. MACE reported a profit of £10m on a turnover of £2Bn and Mr Pycroft is of the view that input costs cannot continue to grown at the rate they have been without something having to give.

Similarly the recent well-publicised travails of two Tier 1 Contractors also point to legacy issues related to taking on significant D&B risk, when opportunities were scarce, only to find yourself very exposed when the sub-contract market moves against you.

It still holds true that a well set up project and procurement strategy with a developed, co-ordinated and de-risked design, smartly presented to the market with active engagement of the supply chain will avoid some of the extreme outcomes that have been seen in the market over recent times.

Economic Indicators

Unemployment

Unemployment at 1.53 million and a jobless rate of 4.6% which has not been lower since 1975. Unemployment forecast for 2017 at 4.9%, included in the Spring budget, has improved from that set out in the Autumn Statement at 5.2%. Unemployment is now forecast to be 5.1% in 2018.

Inflation

Inflation as measured by the Consumer Prices Index, rose to 2.9% in May 2017, the highest annual rate in four years, and is largely due to rising air fares and the fall in the pound. Rising prices for clothing, vehicle excise duty and electricity also played a part, but a fall in the price of petrol and diesel slightly offset this, The Bank of England is now predicting that the cheaper pound will push prices higher, particularly raw material and fuel costs, and they anticipate that inflation will rise above 2% this year, which is higher than its previous forecast of 1.8% made in November 2016. It expects inflation of 2.7% in 2018, which is well above the Bank of England's target rate of 2% and suggests that domestic inflation is beginning to run ahead of itself giving a challenging time for British households, particularly with real wages falling.

Interest rates

Interest rates were reduced from 0.5% to a new record low of 0.25% on 4th August 2016 largely as a response to the initial shock of the EU referendum vote. This low interest rate has continued to be held although many analysts are predicting a rise before the end of 2018.

Brent crude oil prices

Brent crude oil prices had plummeted from a peak of about $116 a barrel in June 2014 to c$32 in mid-February 2016. Prices still remain volatile as evidenced by the falling out by oil producers with Qatar and brent crude oil was c$46 a barrel in June 2017, a seven month low.

Gross domestic product

The preliminary estimate of GDP for 1Q 2017 is 0.3%, while positive, is the lowest quarterly value since the same time a year earlier. The slower growth rate was attributed to a decline in consumer spending and a weakening of the services sector although, importantly, construction grew by 0.2% between the quarters.

Sterling

Sterling again weakened in the immediate aftermath of the UK general election result. This follows a period of recovery since Brexit and it is anticipated that currencies will be subject to significant fluctuations as long as the political uncertainty remains. Sterling was c$1.26 against the dollar and c€1.14 against the Euro in June 2017.

FTSE 100 & FTSE 250

The FTSE 100 & FTSE 250 indexes have both charged into the bull-market, despite the sharp depreciation of sterling and the FTSE 100 index in particular has surged more than 20% since its February 2016 nadir. Economists have urged caution on this as around 75% of earnings from London's blue chip companies come from outside the UK.

Corporation tax

Currently 20% in the UK is mooted to be reduced in the future to c15%, which would be by far the lowest corporation tax of any major economy. US is currently 39% and Germany 29%.

VAT

Rate for the UK remains at 20%.

Public sector net borrowing (PSNB)

The Government, in the Spring budget, estimated a revised borrowing requirement of £58.3bn for this fiscal year (up from £46.5bn). This figure for next year also increased from £21.9bn to £40.8bn.

UK average house prices

Increased by by 5.8% over the year to January 2017 continuing the strong growth seen since the end of 2013 according to the ONS.

Input Costs

Wage inflation

It is not yet clear if the construction industry will be able to negotiate special arrangements for the retention of unskilled and semi-skilled workers from EU countries, as part of the post-Brexit negotiations with the EU. Any hint of future labour market restrictions could lead to an early scramble to secure already scarce industry resources. According to the ONS, 12% of construction workers in the UK (27% in Greater London) come from the EU (excluding UK) but this is widely thought to underestimate the actual proportion. It is thought that on current requirements, an additional 225,000 new recruits will be required by 2019 to meet demand and to avoid significant wage inflation. Pay, including bonuses, rose at an annual rate of 2.3% . The Construction Product Association (CPA) is still reporting specific difficulties in hiring bricklayers, carpenters and plasterers.

Commodity and material price inflation

Commodity and material price inflation picked up in 4th Qtr 2016 and 1st Qtr 2017 and is having an impact on Contractors as the recent drop in the value of the pound hits import prices. This is particularly acute in the cost of imported raw materials but also in imported construction technologies such as cladding, central plant, lifts, etc. Looking ahead material costs could potentially rise further when the UK leaves the EU and needs to negotiate new trade agreements, which could potentially result in higher import duties and tariffs. Construction prices are experiencing greater upwards pressure from rising input costs and the probability of price falls over the short term remain slim.

Steel and iron ore prices

Steel and iron ore prices remain historically low with iron ore and copper costs in particular having plummeted recently.

Oil prices

Oil prices have been at historically low levels which has helped keep a lid on inflationary pressure on input costs.

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