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Market Report

Unsteady as she goes

July 2017

The City and beyond:
A curious mix of activity and caution

Executive summary

As Theresa May 'celebrates' her first year in office, it would seem that the UK has an unstable government for the first time in over 40 years. This has created more uncertainty across politics, Brexit, and the economy - making it difficult to predict the impacts on construction. Confidence has been shaken, yet enquires continue to come in. Things appear delicately balanced...

Our *Bright Lights, Dark Shadows* theme of March 2017 has become *Unsteady As She Goes*: perhaps the lights are not quite so bright, and the shadows are a little gloomier, given the political turmoil of the last three months. A suddenly unstable and unsure government has created more question marks about the UK economy and what the country's trading position will look like after its departure from the European Union.

Confidence has certainly been shaken, but that it is not to say that there aren't pockets of optimism. At a macro level, every fundamental issue seems to have a range of scenarios that have been widened by the General Election result. Views across commentators are many and varied.

The outcome of this mix is difficult, if not impossible to gauge (the range of possible scenarios is again reflected in the large range of BCIS TPI forecasts). Because of this, and the fact that nothing has moved in any particular direction enough for an over-riding trend to be established (other than a pervasive uncertainty), we are holding our position on tender price inflation.

The tension between a potentially softening market / the need to fill order books and continuing input cost pressures / the need for financial care leads us to believe that **a tender price inflation forecast of 2% per annum for the next few years** remains an appropriate starting point.

%	2017	2018	2019
alinea forecast	+2.0	+2.0	+2.0
BCIS forecast	-3.9 to +3.5	-6.9 to +3.7	+6.3 to +6.9

Tender price inflation:
London and the South East

Fundamental issues: where are they headed?

	On the plus side...	...but
Global economy	China's growth has accelerated.	Chinese companies are having to de-leverage as the government addresses the build up of debt (see below).
Geopolitics	Europe has become more stable and is showing signs of growth.	Trump, Putin, Middle East, North Korea, IS.
UK economy	A softer Brexit is now more likely, and better for business.	World trade is more difficult than EU trade; the UK's debt is at an historic high.
UK property	Foreign investment is yet to show signs of abating; some funds are waiting for real estate prices to soften before looking for opportunities.	Confidence has been affected by the General Election – so will the UK continue to be as attractive? Chinese investment could well drop off (see above).
UK construction	Short-term pipelines are relatively healthy. There are some large mixed-use projects edging forwards, a plethora of residential schemes and a solid infrastructure pipeline.	Some supply chain finances are reportedly less than healthy; order books beyond this year need to be filled and after a lag could be impacted by lower foreign investment.

The political and economic landscape

Yet more surprises, and even greater uncertainty

A weakened government

What a difference a quarter makes: Theresa May's snap election and call for a proper mandate has injected energy into the opposition whilst stripping her of her authority and removing the Conservative's majority.

Instability reigns with both parties now offering policies and funds for projects that are designed to please. Another General Election, however unappealing, is not out of the question.

Austerity or no austerity?

The government appears betwixt and between a continuation of the UK's deficit reduction programme and investing in keeping the economy going (and the electorate happy) – evidenced by the "shall we, shan't we?" debates over public sector pay.

Brexit: hard, soft or what?

The Election result pulled the rug from under the government's feet as David Davis led his team to the negotiating table. The opposition is divided too as Corbyn cracked his Eurosceptic whip and sacked his front bench rebels. With 70% of MPs considering Brexit to be a bad idea, it is impossible to know just where the UK stands.

EEF Manufacturing Group has warned of a looming Brexit 'tipping point' (sometime in 2018), when UK manufacturers will have to prepare for the worst in the absence of greater clarity from the government. The reckoning could in fact come when MPs get their 'meaningful vote' on the deal (if there is one!) at the end of the negotiation period. Could there even be the ultimate U-turn?

The squeeze is on

Consumer credit is rising, and the household debt-to-income ratio has reached 140%, near its historic high.

Savings are being eroded as the inflation rate of 2.6% dwarfs most of the interest deals paid on accounts.

Golden shovels:
The groundbreaking ceremony at Chinese developer ABP's £1.7bn development at Royal Albert Docks which is to become an international business centre

Photo: Melissa Page

Britain is struggling with poor productivity, a problem for living standards as costs remain high. With some suggesting that low interest rates are helping to slow productivity, pressure is increasing on the Bank of England to raise the base rate. The Monetary Policy Committee is yet to act upon this pressure: the base rate remains at 0.25%....for the time being.

The tap is still open

Whilst the uncertain backdrop is beginning to affect business confidence and encourage caution, there is no immediate sign of foreign direct investment (FDI) to the UK abating. EY's 2017 UK Attractiveness Survey reveals a robust outlook for this year but with concerns for the longer term. It appears finely balanced, with investors' views coloured by Brexit, yet the UK is still able to attract significant FDI.

Global instability

Maybe it's the instantaneous nature of the news, fuelled by social media, but the world seems to be an increasingly eventful place. Doubts remain about Trump's longevity as he continues his extreme version of presidency, promising retribution to North Korea, holding out on an apparent hand of friendship to Putin and stirring up trouble in the Middle East, among other things.

The crisis in the Gulf rumbles on, with Qatar refusing to bow to the list of demands made by Saudi Arabia, Egypt, Bahrain, and UAE. Britain and other bystanders are hoping for a swift resolution as they grapple with their own problems – all against the spectre of terrorist threats.

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The construction and property market

A mix of uncertainty and caution

There is much activity and many enquiries, yet caution too. The balance of optimism / pessimism depends on clients, sectors and geographies

Some longer-term, mixed use regeneration projects still look positive propositions, the principal question being over their timing. Mass housing is a buoyant sector, in response to the country's chronic needs and in conjunction with infrastructure development. Retail is in a period of change as customer habits develop, and as consumers face a spending squeeze. Commercial offices will be more affected by the confidence of developers and their ability to continue to attract international backers - which might represent a key risk. The regions continue their upward trajectory, supported by the Government's devolution of power and investment in infrastructure such as HS2.

Residential

- The UK's residential sector has been valued at £6.2tn, (or 4% of the value of global property). £1.6tn of this is in London.
- Changes to the stamp duty regime impacted London's prime market - more properties were withdrawn from the market than sold for the first time in seven years and transaction levels have fallen.
- Other compounding issues include a constraint of domestic mortgages and political uncertainty in the second half of 2016. The market remains sensitive to change but the devaluation of the pound has aided attractiveness for international investors.
- Diversity within the housing market was given support in the government's Housing White Paper.
- There are nearly 68,000 build-to-rent homes in the pipeline with nearly 45% outside of London.

Central London Offices

- The City office sector is a key barometer of the UK property investment market and it is propped up by international money flows. In Q1 2017, 44% of investment was from Hong Kong nationals.
- Whilst rents may be starting to soften, yields remain low - underpinned by foreign investment.
- Long term sentiment is generally falling, which could ease foreign investment.
- Lower levels of speculative space are being built.
- Book values and site values are generally high. With high construction costs and questions asked over future FDI, appraisals feel on a less firm footing.
- There is currently an active requirement for nearly 8.6m ft^2 of office space in Central London, 17% more than last year.

Retail

- Consumer confidence is above the ten-year average but growth in volume of sales has been slowing.
- Footfall figures have been falling, forcing many centres and stores to reinvent themselves as a leisure destination and use sales space more efficiently.
- Annually, retail investment was 43% lower in Q1 2017, with numbers of high street stores and shopping centres falling significantly year-on-year, yet warehouse levels have increased.
- Lower overall wage increases and rising consumer debt could reduce confidence. Extra pressure could come from inflation, with changes to rateable values, and higher National Living Wages.

Regions

- Government initiatives are driving a lot of growth in the regions - the Midlands Engine has increased construction output in the West and East Midlands by 24% and 30% respectively.
- Output increased in all regions in the last year, except for the North East, Yorkshire and the Humber, and Scotland which saw falls of between 1% and 3%.
- EY's report shows the Northern Powerhouse and Midlands Engine regional groupings are attracting roughly double the number of projects than at the beginning of the last decade whilst levels in the rest of England are fairly stable.
- Significant concerns exist over availability of skills in some areas.

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Our forecast

A curious uncertainty and a certain instability

The heightened political and economic uncertainty of the past few months presents increasing challenges for UK industry and businesses, not least construction. The number of variables and the range of opinions on how things will pan out means that it is not a consistent picture across the country, in different sectors or at various tiers of the contracting market.

It's changed, but what does it mean?

Our previous Market Report (Bright Lights, Dark Shadows - March 2017), was published against a long-running theme of uncertainty, but also persistent input cost pressures. Then, we forecast tender price inflation of 2% per annum for 2017, 2018 and 2019, with increased costs in the supply chain, exacerbated by continuing labour supply and chronic skills issues, proving to be one of the key trends driving our prediction of positive inflation at this level. Steady growth in the UK economy helped to maintain business confidence and hold up tendered margins. At that point in time, a softening but relatively resilient London commercial market, and a surge in mixed use / volume residential projects was supporting output, together with some conviction in pipelines.

The key question now is: to what extent will an easing demand (and resultant impact on contractors' margins) be offset by the effects of further cost increases, which are aggravated by a weakened currency?

The lack of any clarity on Brexit - the UK does not even seem to know what it wants from the negotiations – means that the extent to which labour shortages become more acute is very difficult to gauge. It is thus too early to call what real impact Brexit will have on UK construction demand and prices.

Increased hunger

It is evident from recent tender returns, market testing and supply chain feedback that there are gaps developing in order books and some contractors are actively seeking new opportunities, particularly for 2018 and beyond. There is now a significant trend on relatively smaller projects for tenders received from both main and trade contractors to be within pre-tender estimates. These tenders indicate a return to competitive pricing levels, generally through a cutting of margins rather than reduced labour and raw materials costs.

At trade contractor level there are more firms indicating an increased hunger for work, with a sharpened keenness to get on tender lists. Main contractors perhaps remain more circumspect, though only marginally so and there are projects with the attributes of scale, longevity and client profile that are receiving their close attention.

But financial warning signs

Many parts of the industry have seen corporate losses (like Carillion's £845m hit) and consolidation (such as the recent purchase of Byrne Brothers), together with stories – reported and rumoured – of financial ill health. Further profit warnings or M+As, should they occur, will only fuel speculation and cause contractors and suppliers to take even more care in what they take on, and at what price.

There is no substantive evidence that contractors' appetite for risk has changed significantly: risk allowances remain at comparatively high levels for large-scale design and build projects, accompanied by an ongoing reluctance to accept greater risk transfers. However, there is evidence of some contractors taking a more relaxed view of procurement strategies, away from what has been a quite rigid insistence upon a two stage approach. Some are actively offering a willingness to consider single stage contracting (or that is the message emanating from some). On the client side, there are more instances of construction management being given a proper airing at procurement reviews, though its suitability would seem to be driven by contemporary capabilities as much as anything. Some clients will inevitably be drawn to single stage contracting but it is not a panacea for the procurement challenges which are currently being faced. A more rounded and considered approach is needed, with a balance struck between certainty, risk and influence.

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Our forecast: a hold position

All of this adds up to a curious uncertainty and a certain instability in the industry - yet with some cause for optimism - reflecting those same features of the general economy and political state of affairs. It feels finely balanced, and nothing has moved enough in any direction for us to change our previous forecasts. **We are therefore holding our position of 2% per annum tender price inflation in London and the South East, until we are prompted otherwise. There is clear evidence of a 1% movement in the first half of this year, in-line with this forecast.**

As before, there is a distinct possibility of certain projects in particular sectors attracting more competitive prices and wholehearted responses. The attraction of securing income from such projects will drive larger contractors to reduce margins and find other areas of savings that will negate the impact of underlying inflationary pressures on tender prices.

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A culture of constant learning

Applying learning from both live projects and research studies, and feeding them into each other, is how we try to ensure that our clients and their teams get the best possible advice from us. This is why we have been committed to research from the day we launched.

Whilst data and information are the lifeblood of our business, we understand that they alone do not represent knowledge – which requires analysis, insight and questioning.

For these reasons we involve everyone at alinea, and we share our desire to innovate across borders: of discipline, geography and perspective. That way, we can learn from each other.

We also like to hear what you think and welcome any views you might have. Do please feel free to contact any of us.

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