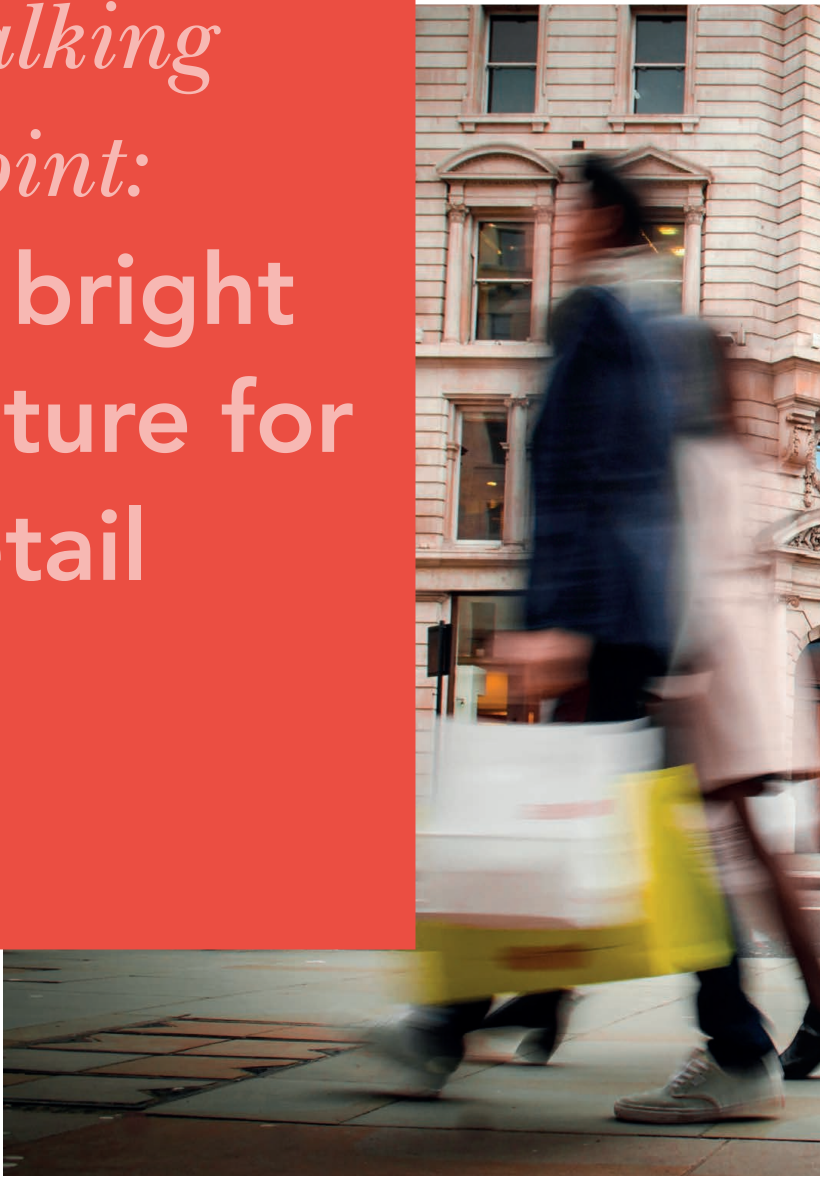
TENDER PRICE INDICATOR

GARDINER &THEOBALD

Talking Point: A bright future for retail



3rd Quarter 2018

TENDER PRICE INDICATOR

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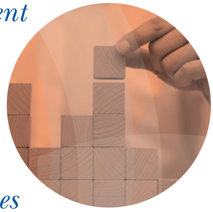
Our Tender Price Inflation report looks at the movement of prices in tenders for building contracts in the UK. The report examines a number of contributing factors including GDP, sterling, oil price, employment levels, input costs and construction output. This is further informed by our market survey responses and contractor consultations.



Following a relatively weak start to the year, construction output increased by 3.3% in the three months to July 2018, driven by growth in repair and maintenance and all new work.

Our forecast for UK average tender price inflation remains unchanged at 1% for both 2018 and 2019.

However, we have revised down our 2020 UK average tender price annual percentage change from 1.5% to 1%. This is largely a result of lower forecasted growth in the South East and North.

London tender price inflation has been revised up from 0.5% to 1% for 2019 but our London forecasts for 2020-2022 remain unchanged. We have pushed up our regional tender price forecasts for South West, East Anglia, Wales, Scotland and Northern Ireland, with Yorkshire & Humber the only region revised down.

All forecasts assume an orderly Brexit with open market trading conditions.

Our forecasts take account of all sectors and project sizes as a statistical average indicating an overall trend in pricing levels. It should be remembered that individual projects may experience tender pricing above or below the average rate, reflecting the project specific components and conditions.

MACRO ECONOMICS

GDP OUTPUT
ANNUAL CHANGE

▲ *1.2%* ▲

CPI
SEPTEMBER 2018

▼ *2.4%* ▼

RPI
SEPTEMBER 2018

▲ *3.3%* ▲

INTEREST
RATE

▲ *0.75%* ▲

UNEMPLOYMENT RATE
MAY–JULY 2018

▼ *4.0%* ▼

UK
WAGE GROWTH

▲ *3.1%* ▲

Figures are cumulative annual. ▼▲ *denotes movement trend.*

UK economic growth picked up in the second quarter of 2018, with GDP seeing quarter on quarter growth of 0.4% (Q1 2018 Q-on-Q growth was 0.1%). The annual rate of GDP growth has been revised down slightly from 1.3% to 1.2%, with UK growth over the first six months of 2018 coming in at its weakest level since 2011. However, there are encouraging signs that activity strengthened at the start of Q3 2018.

The Consumer Price Index measure of inflation was 2.4% in September, down from 2.7% in August 2018. The fall means the squeeze on wages is easing as UK wage growth hit 3.1% up from 2.6%, the highest monthly rise in a decade.

The Bank of England raised interest rates from 0.5% to 0.75% amid concern that the current low unemployment rate risked re-igniting wage pressure. The Bank's monetary policy committee judged that the dip in output in Q1 2018 was temporary, with the economy bouncing back from the effects of the "beast from the east" earlier on in the year.

CONSTRUCTION GROWTH: FROM STAGNATION TO CONTRACTION

After five years of growth, the Construction Products Association (CPA) is forecasting a moderate fall in construction growth in 2018, anticipating growth for the whole of the year to fall by 0.6%. The CPA has revised its forecast down from stagnation to contraction, with Brexit uncertainty helping fuel the decline in growth, drying up international investment and reducing demand in prime residential, commercial offices and industrial factories.

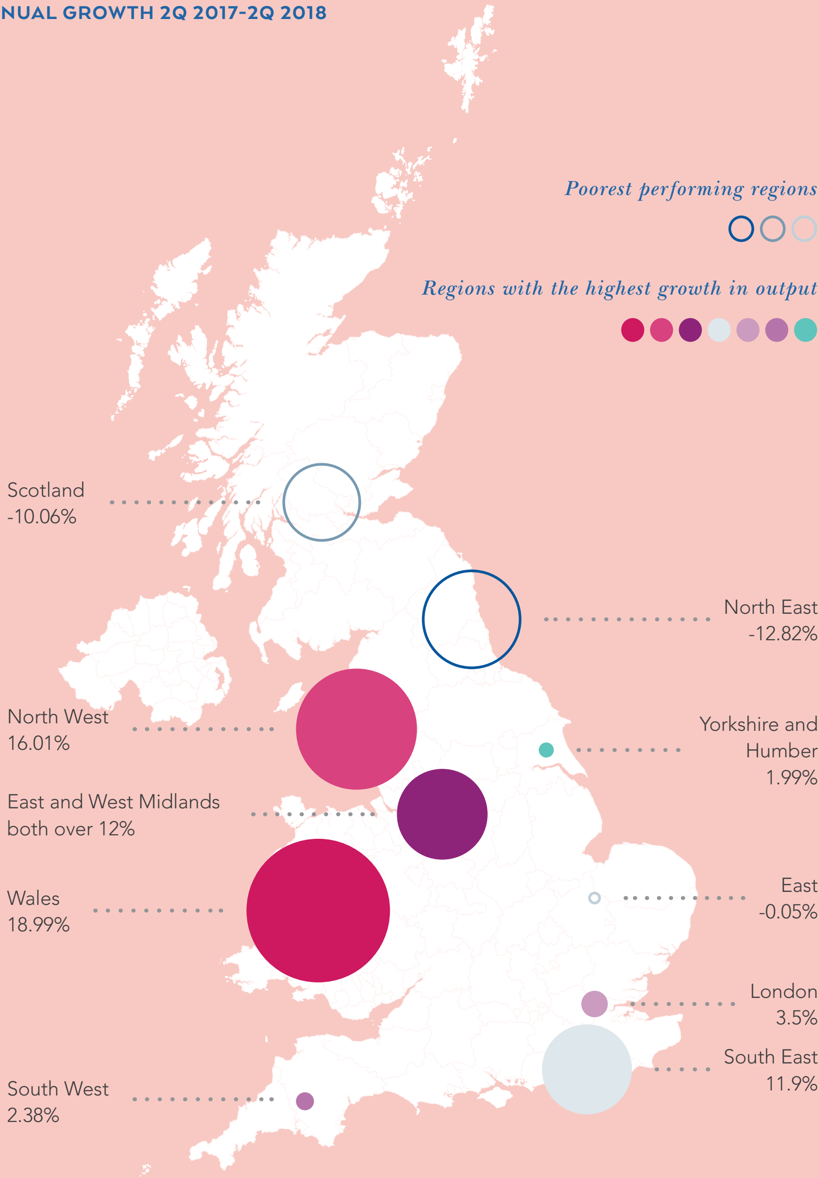
The CPA believes that there was an element of playing catch-up in Q2 2018 after the demise of Carillion and the bad weather in Q1 2018. UK construction lost £1bn of work because of these two events, but it is estimated that the majority of the work will be recovered over time.

Private housing output, which has been revised up from 2% to 5% in 2018 by the CPA, and infrastructure remain the main drivers of growth for the construction industry as a whole. Without these two sub-sectors construction output would fall by 3% in 2018.

At the other end of the scale, commercial is expected to see sharp declines in 2018 and 2019, with the offices sub-sector forecast to fall 20% this year and a further 10% in 2019. The CPA also forecast retail to be another poor performer.

REGIONAL BREAKDOWN OF CONSTRUCTION OUTPUT

ANNUAL GROWTH 2Q 2017-2Q 2018



The UK construction PMI reached a 14-month high in July (55.8) but subsequently fell in August and September. Civil engineering was the worst performing sub-category of construction work, with activity in decline, but housebuilding and commercial construction continued to increase at a solid pace.

So while the rate of construction output has slowed since July, new order books are strengthening which is creating mixed signals for the near term outlook.

CONSTRUCTION OUTPUT:

Other than a slight dip in Q1 2018, London construction output has remained fairly flat over the last 12 months. Brexit uncertainty continues to impact international investment in high-end residential and commercial office projects. However, new private housing, infrastructure projects and private repair and maintenance work has helped London achieve output growth in the past 12 months.

Our regional tender price forecasts reflect these differences.

INPUT COSTS - YEAR ON YEAR

M&E COMPONENTS

▲ *3.6%* ▲

FABRICATED STRUCTURAL STEEL

▲ *9.4%* ▲

CONCRETE REINFORCEMENT BARS (STEEL)

▲ *13.8%* ▲

READY MIXED CONCRETE

▲ *0.7%* ▲

OIL PRICES (BRENT CRUDE) (AS OF 2nd OCTOBER 2018)

▲ *US$84.6 bbl* ▲

CONSTRUCTION INDUSTRY

▲ *Weekly earnings 3.0%* ▲

MARGINS

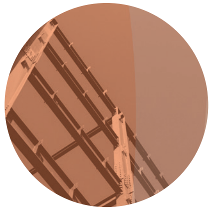
◀ *Flat* ▶

MANUFACTURING OUTPUT (PMI)

▼ *2.4%* ▼

Figures are cumulative annual. ▼▲ denotes movement trend.

Despite increased material and labour costs, there were higher levels of construction output in Q2 2018.



The ONS construction material price indices (All Work) show that year-on-year (August 2017 to August 2018), material prices increased by 5.6%. The materials experiencing the greatest price increases in the 12 months to August 2019 were imported plywood (24.1%) and concrete reinforcing bars (13.6%).

Steel also contributed heavily to the inflation of material prices, rising 8.9% since August 2017. Oil prices have also been pushed higher and are now trading at a four year high (US$84.6 bbl as at 2nd October 2018). These inflationary pressures will begin to feed in to tenders.

The majority of construction materials come from Europe. Whilst some materials are manufactured in the UK, currently there is not sufficient capacity to support the size of the UK construction industry.

At the moment, the risk of a disorderly Brexit is fourfold:

1) Possible delays in getting materials into the country through borders

2) The risk to cost if sterling drops as a result of a 'no deal' Brexit (i.e. the cost of materials increase)

3) Albeit perhaps not an immediate risk, there may be issues if EU accredited materials do not suit our legislation and standards, or vice versa

4) The risk of seeing a shortage in skilled construction labour could push up wages, adding pressure to construction costs

INPUT COSTS

LABOUR RATES

Average weekly earnings (AWE) in the construction industry have increased by 3% year-on-year since July 2017 to £613 per week.

AWE in the construction industry broadly moved in a similar pattern with AWE in the manufacturing sector. However, despite being level with AWE in the manufacturing sector at the beginning of 2017, AWE in the construction industry experienced a greater rise throughout the year. As a result of the overall increase in 2017, construction finished the year as the second-highest earning sector in the UK.

The growth in wages has been brought about by an acute shortage of skilled labour. Wages for in-demand trades like joinery have increased by as much as 20% in a single year. Clearly, this scale of cost pressure on contractors cannot be sustained without endangering profitability.

With a significant proportion of construction workers in the UK coming from EU nations, there remains a real risk that the skills crisis could be exacerbated after Brexit. Recent reports indicate that the Government intends to continue welcoming skilled workers into the UK, but it is unclear whether this would include construction workers of all skill levels. If not, this could add to cost pressure.

Operational challenges also remain, including wage inflation, skills retention and a tight labour market. Our survey indicates a higher than average demand for skilled labour for the next six months. With new order books strengthening, workloads are likely to continue on their upward trajectory, leading to robust job creation.

UNEMPLOYMENT

The UK unemployment rate fell to 4% in June – down from 4.2% at the beginning of the year, the lowest level since April 1975.

ONS data shows that employment in the construction industry experienced a steady increase since 2014, which continued in 2017, with construction employment increasing by 3.8% compared with 2016. Construction employment at the end of 2017 equated to approximately 1.32 million (860,000 of which were self-employed).

Construction-specific employment is concentrated around London (14%), the South East (15%) and the North West of England (12%), with employment levels remaining relatively lower in Wales (4%) and the North East (3%).

The East and South West of England saw the most notable increases for construction-specific employment in 2017, growing 7.6% and 7.3% respectively when compared with 2016. In contrast, only Yorkshire and the Humber experienced negative growth, with construction-specific employment falling 3.9% in 2017.

PROFITABILITY AND SUPPLY CHAIN

Our analysis of tenders and market survey show that in the past three to six months, we have seen very little movement in overheads and profits (OH&P) and main contractor preliminaries. Going forward, our survey results indicate that market conditions over the course of the next six months will experience intermediate levels of activity. We expect contractors’ workload in the same period to see a slight decline as some projects are put on hold while final Brexit talks take place.

TENDER PRICE TREND "ALL UK TPI" 3Q 2018

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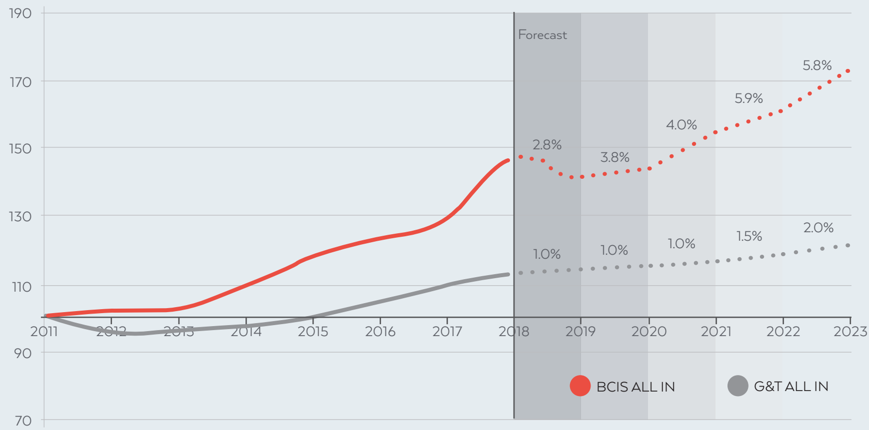

TENDER PRICE TREND "LONDON TPI" 3Q 2018

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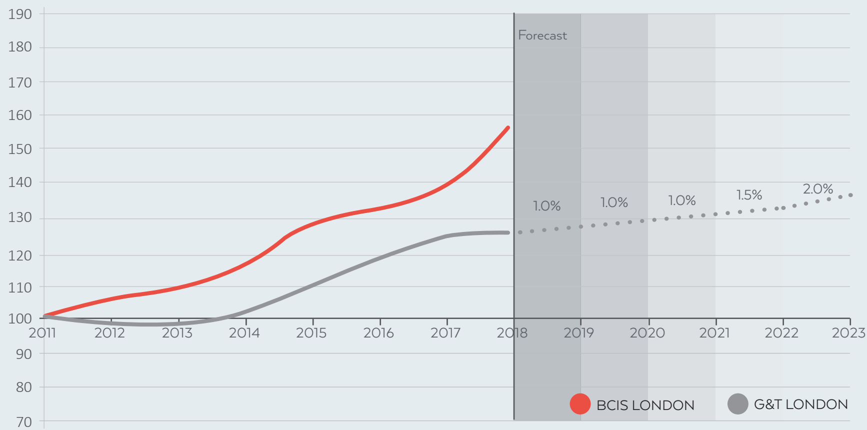

Note: BCIS do not publish regional forecasts

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%	2018		2019		2020		2021		2022	
Regional forecasts	Now	Last	Now	Last	Now	Last	Now	Last	Now	Last
Greater London	1.00	1.00	1.00	0.50	1.00	1.00	1.50	1.50	2.00	2.00
South East	0.50	0.50	0.50	0.50	0.50	1.00	1.00	1.50	1.50	2.00
South West	0.50	0.50	1.00	0.50	1.00	1.00	1.50	1.50	1.50	2.00
East Anglia	1.00	1.00	2.00	1.00	2.00	1.50	2.00	2.00	2.00	2.00
Midlands	1.00	1.00	1.50	1.50	1.50	1.50	2.00	2.00	2.00	2.00
Wales	0.50	0.50	1.00	0.50	1.50	1.50	2.00	2.00	2.00	2.00
Yorks & Humber	1.00	1.00	0.50	1.00	1.00	1.00	1.00	1.50	1.50	1.50
North West	2.50	2.50	2.00	1.50	1.50	1.50	1.75	1.75	1.75	1.75
North	1.00	1.00	1.00	1.00	1.00	1.50	1.50	1.50	1.50	2.00
Scotland	1.00	1.50	1.50	1.50	1.50	1.50	2.00	1.50	2.00	2.00
Northern Ireland	1.00	1.50	1.50	1.50	1.50	1.50	1.50	1.50	2.00	2.00
UK Average	**1.00**	**1.00**	**1.00**	**1.00**	**1.00**	**1.50**	**1.50**	**1.50**	**2.00**	**2.00**

Note: 2022 is a long term average market forcast

COMPARISON OF PUBLISHED FORECASTS FOR TENDER PRICE CHANGE

	G&T UK AVER.	BCIS UK AVER.	G&T LONDON	AECOM LONDON	ARCADIS LONDON
	3Q 2018	SEP 18		2Q-2Q	3Q 2018
	% CHANGE				
2018	1.00	-2.78	1.00	1.60	2.00
2019	1.00	3.81	1.00	1.90	2.00
2020	1.00	3.98	1.00	1.80	3.00
2021	1.50	5.88	1.50	N/A	3.00
2022	2.00	5.83	2.00	N/A	3.00

Note: All figures relate to year on year quarterly changes

Well there's a surprising title at a time when barely a day passes without a gloomy headline about the retail sector. The demise of traditional shopping habits, the rise and rise of online, shrinking profits for department store operators, retailers seeking to renegotiate leases, the questionable use of CVAs, crippling business rates and developers rethinking their plans for shopping developments are just some of the challenging factors that the retail world faces. Of course that all has an impact on retail assets, development and construction.

Steven Bennett
PARTNER, LONDON

So where's the bright future in all of that?

As with all parts of the construction industry there are ups and downs, but of all the construction sectors we are involved in, the retail sector has never failed to adapt. There is no doubt that the advent of the digital age in retail has inspired a significant rethink on how the online world interacts with physical retail stores. However that challenge of omni-channel integrated retail has been coming for ten years and has really manifested itself in the past couple of years with the advent of online purchasing coupled with same or next day delivery.

Social media and smart phone shopping is here to stay, but people are ultimately social creatures and physical retail and leisure schemes bring people together for experiences. One of the most prevalent online retailers Amazon has recognised this and has trialed its physical Amazon Go store. This uses artificial intelligence, cameras, motion sensors and a link to shoppers smart phones to enable an automated check-out process. Most recently they have suggested that 3,000 physical Amazon Go stores are planned.

In China there have been online convenience stores for some time and new food concepts seem to be emerging. Technology will inevitably enhance physical retail in the very near future by improving the experience through bespoke offers and discounting, augmented reality allowing you to visually and digitally "try on" clothes. This can avoid a physical need to check out as well as facilitating delivery of the goods you've purchased before you get home thereby allowing you to carry on with the next part of your leisure and retail experience unhindered.

So how will all of this affect construction and development of retail? Back to the change and adaptation point, the physical assets will have to evolve to accommodate and incorporate this new technology. That might be larger or smaller physical stores, certainly an increased requirement for digital connectivity in the shopping centres and high streets, along with a re-think about how storage of goods works to facilitate the best possible customer service rivalling online for flexibility and availability of stock and sizes.

Without a doubt there are places where there is just too much or the wrong type of retail, particularly in high streets and there has to be a re-purposing to maintain vibrancy in these areas. The obvious change, and one that is already happening in some places, is the change of retail to residential and this can be an opportunity for incorporating higher quality retail spaces within a development to support new communities. Last mile delivery to help with the huge demand for retail distribution will also be a consideration for the change of use.

In the ongoing evolution of retail, forward thinking and dynamic owners, developers and local authorities (with their mandate to create and maintain employment in their town and city centres) are already active in embracing the future retail challenge and will be well placed to maximise opportunities that this rapidly changing market presents.

Whilst the challenges of property valuation, business rates and disruptive technology are here and looming large, we know that ultimately retail will evolve and adapt, just as it has for the hundreds of years since shops first existed. With that will come the evolution of the physical store and a more integrated and connected service in our towns and cities.

A bright future for retail indeed.

Key Contacts

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Our advice is to review each project on its own merits. This forecast publication must be treated as a guide only, being that it is based on averages of various types and sizes of projects across a region, ascertained through our latest market research. The quality, both of design and desired end product, procurement route (particularly ownership and transfer risk), delivery timescales, complexity of design and desire of contractors to tender should be carefully considered in project specific estimates and their outturn cost.

Suitable allowances should be made for project specific designs, site conditions and local market conditions, which should be reviewed regularly with your Gardiner & Theobald team to determine the appropriate base cost.

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