GARDINER & THEOBALD

4TH QUARTER 2018

Our Tender Price Inflation report looks at the movement of prices in tenders for construction contracts in the UK. The report examines a number of contributing factors including GDP, sterling, oil price, employment levels, input costs and construction output.

TPI

TENDER PRICE INDICATOR

In this issue

WE REPORT ON THE GROWTH OF THE BUILD TO RENT SECTOR

A GOOD TIME TO INVEST IN BUILD TO RENT?

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Over the last five years, the total number of Build to Rent (BTR) units completed, under construction or in planning has increased six-fold. With steady growth every year since 2013 and more than £2bn of investment per annum since 2017, experts predict that the BTR pipeline could double to 200,000 units in the next two years. No wonder this new asset class within the private rented sector has become increasingly attractive to investors, developers and house builders.

Home ownership in the UK is in decline. A lack of affordable ‘for sale’ housing stock has seen the number of UK private renters double over the past decade. The private rented sector accounts for 20% of all UK households and the trend is set to continue with many predicting that in 20 years’ time more people will rent in the UK than own their own homes.

BTR has caught the attention of large financial institutions keen to back big scale construction projects. New purpose built BTR stock delivers net income yields at a premium level compared to more traditional, mature investment portfolios. BTR rental growth in London has averaged 3% over the past year in stark contrast to falling residential rents for mature ‘buy-to-let’ stock over the same period.

The BTR model offers fairly stable, long term income and has become attractive to pension funds and insurance companies who have the capital to invest in large scale apartment buildings and construction projects.

Forecasters predict institutional investment in BTR will increase by as much as 180% over the next five years as demand for BTR is likely to grow faster than supply.

BTR is moving towards critical mass with 132,000 units either completed, under construction or in planning in the UK. This activity level is split equally between London and the regions based on completed units to date. Regional activity tends to be concentrated in the North West and Manchester where more than half of all residential planning permissions are in the private rented sector. Comparing the statistics to the previous year shows a 33% increase in schemes under construction and a 22% increase in schemes in the planning system.

The majority of BTR completed in the past few years centre around well designed, efficient buildings and delivered with stringent cost control measures in place, offering the market a more affordable private rental product with good amenity spaces. One such scheme is Middlewood Locks in Salford where G&T is engaged as cost and project manager. In London, G&T is advising on Argent Related’s emerging Brent Cross South scheme where the masterplan includes for 6,700 new homes of which a significant number will be BTR, due to be delivered in phases over the coming years.

Supported by a solid upswing in institutional investment, BTR could well underpin construction activity in the residential sector for many years to come. It might also fill some of the voids in development and construction activity left by slowing ‘for-sale’ schemes as a result of market uncertainties. It looks like the BTR growth trend is here to stay.

INTRODUCTION

"Construction output surprised many towards the end of 2018. In the year to November 2018 construction output (All Work) in the UK grew by 3.4% despite unparalleled levels of political uncertainty."

The IHS Markit/CIPS data for December 2018 posted above the crucial 50.0 no-change value for the ninth successive month in December, showing that the sector is expanding albeit at a slower rate than the previous two months.

Subdued demand conditions were a factor behind slightly softer output growth in December 2018, but business confidence among contractors is mixed as a result of higher anticipated government infrastructure spending, with work on civil engineering projects increasing at their fastest pace for over one-and-a-half years.

Despite the political uncertainty that persists surrounding Brexit, optimism rebounded to an eight-month high in December - its highest since April 2018. Whilst investment decisions are certainly being delayed for commercial development projects, firms are clearly hopeful that the Government's commitment to deliver large-scale infrastructure projects will increase total new work output.

TENDER PRICE FORECAST

Our UK average tender price inflationary forecast for the next four years (2019-2022) remains unchanged from our previously published forecasts in our Q3 TPI report.

We are forecasting 1% tender price growth for both 2019 and 2020, increasing in the longer term to 1.5% in 2021 and 2022.

Although we anticipate slightly higher tender price inflation than previously forecast in the North West, Yorkshire & Humber and Scotland in 2019, this is offset by lower forecasted growth in Wales and the North.

The wider economic and political climate hasn't substantially changed since our last TPI report and therefore our UK average outlook remains static.

However, all forecasts continue to assume an orderly Brexit with open market trading conditions being retained.

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

UK economic growth picked up in the third quarter of 2018, with GDP seeing quarter on quarter growth of 0.6% (Q2 2018 Q-on-Q growth was 0.4%). However monthly GDP data indicates that economic growth in the last quarter of 2018 is set to slow.

A slowing global economy, ongoing US-China trade tensions and Brexit has meant that uncertainty persists in abundance. UK GDP slowed to 0.3% in the three months to November 2018 driven by weak manufacturing output and consumer demand. The construction and services sectors were the main drivers of GDP growth in the three months to November 2018. In fact, GDP from construction in the UK increased from £27.9bn in Q2 2018 to £28.6bn in Q3 2018 – an all-time high.

The Consumer Prices Index (**CPI**) 12-month inflation rate was 2.1% in December 2018, down from 2.3% in November 2018. Falling fuel prices contributed a 0.14 percentage point drop in the 12-month rate. Inflation in 2019 is forecast to fall below the Bank of England's 2% target, improving household purchasing power.

INPUT COSTS YEAR ON YEAR

M&E COMPONENTS	FABRICATED STRUCTURAL STEEL	CONCRETE REINFORCEMENT BARS (STEEL)	READY MIXED CONCRETE
▲ *2.6%* ▲	▲ *7.9%* ▲	▲ *1.6%* ▲	▲ *1.3%* ▲

MACRO ECONOMICS

UK GDP ANNUAL GROWTH RATE (Q3 2018)	CPI DECEMBER 2018	UNEMPLOYMENT RATE SEPT-NOV 2018	INTEREST RATE
▲ *1.5%* ▲	▼ *2.1%* ▼	◄ *4.0%* ►	◄ *0.75%* ►

CONSTRUCTION OUTPUT

Construction output recorded an all-time high in November 2018, with the total value of construction output exceeding £14bn for the first time since records began in 2010.

The ONS' seasonally adjusted output figures show that in the year to November 2018 infrastructure and private new housing performed strongly, growing 11.2% and 9.5% respectively. At the opposite end of the scale private housing repair and maintenance was the worst performing sector, decreasing by -8.2% year on year.

Although picking up slightly towards the end of 2018, private commercial new work output continues its overall downward trend. Brexit had a particularly negative impact on the UK offices sector as investors consider the current levels of economic uncertainty are too high to justify the long-term investment in new space.

G&T expects construction output to be maintained next year but this will be heavily dependent on regional private house building and major infrastructure projects offsetting falls in sectors such as private commercial.

REGIONAL BREAKDOWN OF CONSTRUCTION OUTPUT (ANNUAL GROWTH Q3 2017 - Q3 2018)

REGION	CONSTRUCTION OUTPUT GROWTH % (Q3 2017 - Q3 2018)
Greater London	-0.95
South East	12.92
South West	-3.05
East	-4.11
East and West Midlands (Average)	11.68
Wales	27.89
Yorks & Humber	3.72
North West	16.76
North East	-7.71
Scotland	-11.43
Northern Ireland	2

NEW ORDERS

For the first time in a year new orders saw positive growth, rising by 3.4% in Q3 2018 from the previous quarter to £11.075bn. New orders for public non-residential work (excluding infrastructure) saw the strongest quarterly growth, rising by 32% in Q3.

However, total new orders for all new work over the last 12 months (Q3 2017-Q3 2018) are down substantially by -30.7%. Brexit uncertainty has clearly impacted UK companies' willingness to commit to new projects in sectors dependent on high upfront investment for

MARGINS
◄ *Flat* ►

CONSTRUCTION INDUSTRY
▲ *Weekly earnings 4.2%* ▲

MANUFACTURING OUTPUT
▼ *-0.9%* ▼

OIL PRICES (BRENT CRUDE) (AS OF 22nd JAN 2019)
▼ *US$61.5 bbl* ▼

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

RPI DECEMBER 2018
▼ *2.7%* ▼

UK WAGE GROWTH
▲ *3.4%* ▲

a long-term rate of return. This will translate to lower output in commercial offices and prime residential.

MARKET CONDITIONS

Construction market conditions appear to be stable and fairly balanced. Whilst lower value/ low risk contracts are still being competitively tendered due to an abundance of contractors at this level, higher value contracts with higher risk are seeing less competitive tendering as there are only a limited number of contractors with adequate capacity.

In current market conditions, OH&P and preliminaries are unlikely to increase over the course of the next 12 months. Contractors will be keen to win work and fill their order books in order to secure turnover.

Whilst some contractors are bullish saying that Brexit will have little impact, we have noticed that many are still cautious about committing to fixed price contracts and opportunities are taking longer to convert, whilst a steady flow of new enquiries continue, we expect overall workload in 2019 to be more or less static, with any new work taking capacity of completed projects.

INPUT COSTS

MATERIAL COSTS

The latest ONS data shows that construction material prices continue to creep upwards. The All Work indices show that material prices increased by 5.1% in the year to October 2018 – a slightly lower increase than in the same period a year earlier (5.8%).

The materials experiencing the greatest price increases in the 12 months to November 2018 were imported plywood (12.9%) and imported sawn or planed wood (11.5%), with the cost of fabricated structural steel also increasing 7.9% in the year to October 2018.

Upward inflationary pressure on imported materials has largely been the result of a weak pound. In the event of a no-deal Brexit the value of sterling could be pushed down even further. Equally, if a withdrawal agreement is reached, the pound could rally, alleviating some of the upward pressure on material price inflation.

There are reports of materials being stockpiled or pre-bought to mitigate some of the risk of a no-deal Brexit which would likely result in delivery delays and possible additional costs at the border.

The ability of contractors to absorb further increases in material costs is limited. A no-deal Brexit that would see the UK resorting to WTO rules would inevitably put further pressure on contractors to raise tender prices.

LABOUR

Average weekly earnings (**AWE**) in the construction industry have increased by 4.2% year-on-year since November 2017 to £627 per week. However, earnings growth eased towards the end of 2018 perhaps signalling that wages are approaching the limit of what companies are prepared to pay.

Wage growth continues to be driven by a shortage of skilled labour putting cost pressure on contractors. The Government has made it clear that EU nationals currently working in UK construction (approximately 7% of the UK construction workforce and 28% of the London construction workforce) will not be expelled, but unskilled EU labourers seeking to work in the UK are unlikely to be granted a visa under the UK's new immigration strategy.

Our TPI survey results indicate a marginal skilled labour supply shortage for the next six months. With workload expectations in 2019 set to remain broadly unchanged from current levels it's likely that upward pressure on AWE will remain.

PROFITABILITY AND SUPPLY CHAIN

We have seen a backlog of schemes with planning approval that are ready to be built, but with high construction prices and an anticipated downturn in the EU/global economy, these are not progressing.

Any short-term reduction in projects moving forward will likely impact future workload from 2020 onwards, putting downward pressure on tender prices. However, with margins already stretched as a result of absorbing higher material and labour costs, contractors (especially tier 1) are unlikely to resort to aggressive tendering.

An analysis of G&T'S TPI market survey shows that 67% of respondents expect main contractor OH&P to remain flat over the next 12 months. With the heightened level of uncertainty it is difficult to see any inflation of OH&P on current levels.

TENDER PRICE CHANGE

TENDER PRICE ANNUAL PERCENTAGE CHANGE 4Q 2018

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

Note: 2022 is long term average market forecast
**Corrected from previous TPI report (Q3 2018)*

COMPARISON OF PUBLISHED FORECASTS FOR TENDER PRICE CHANGE

	G&T UK AVER.	BCIS UK AVER.	G&T LONDON	AECOM LONDON	ARCADIS LONDON
	4Q 2018	JAN 19	4Q 2018	3Q - 3Q	4Q 2018
			% CHANGE		
2019	1.00	3.79	1.00	1.40	2.00
2020	1.00	3.95	1.00	1.50	3.00
2021	1.50	6.73	1.50	1.90	3.00
2022	1.50	6.03	2.00	N/A	3.00

Note: All figures relate to year on year quarterly changes

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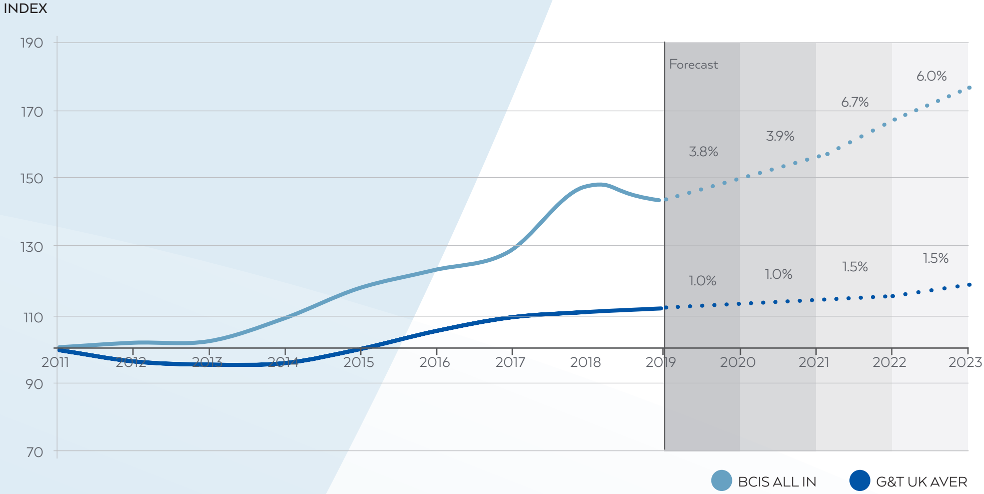
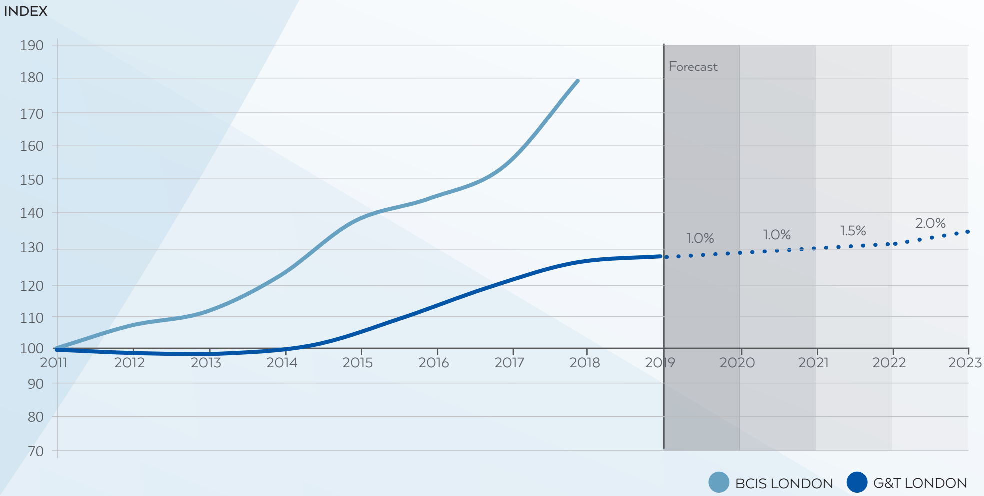
TENDER PRICE TREND

TENDER PRICE TREND **"ALL UK TPI"** 4Q 2018



TENDER PRICE TREND **"LONDON TPI"** 4Q 2018



Note: BCIS do not publish regional forecasts.
BCIS Q4 2018 data not available at the time of publication.

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.