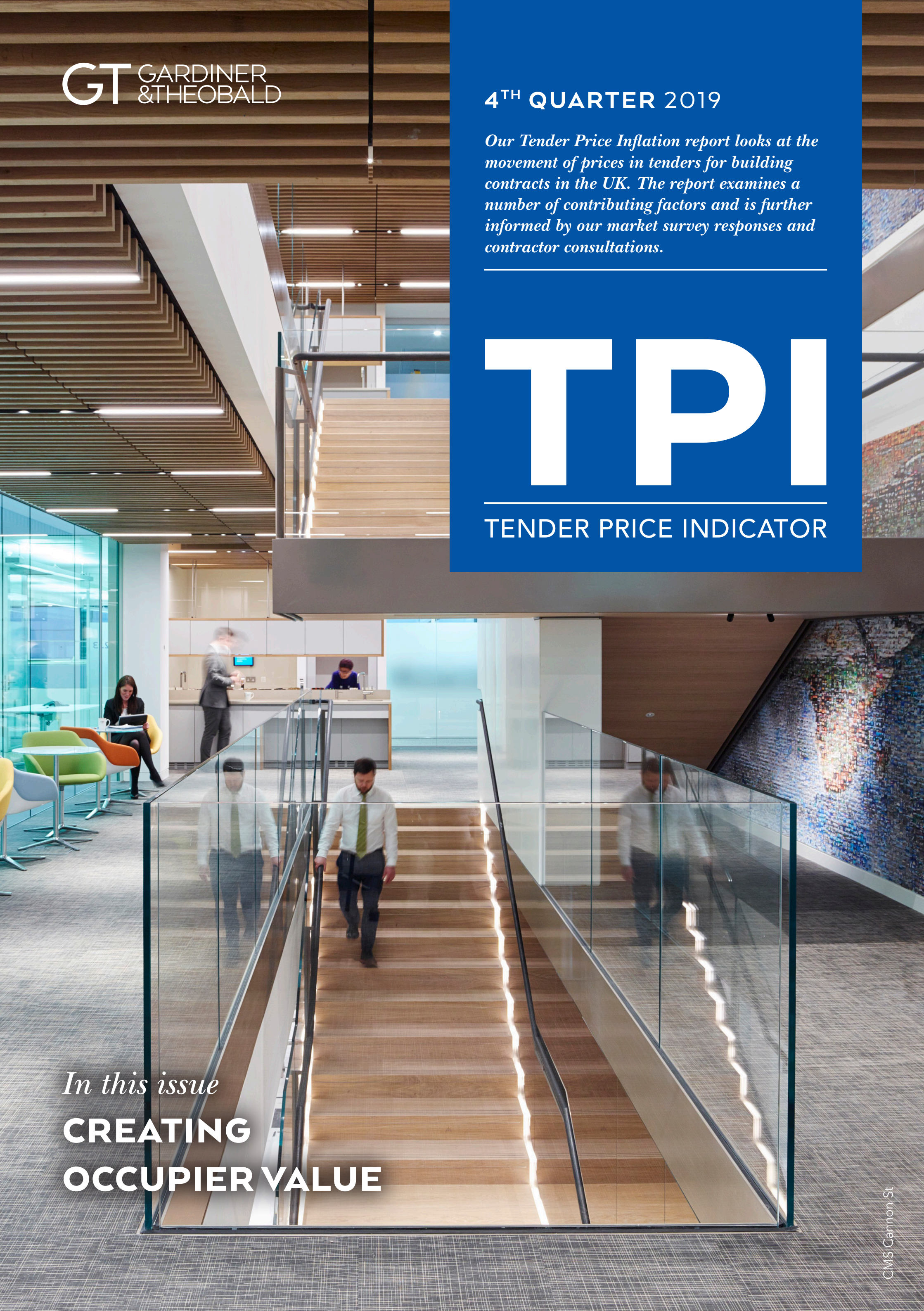
GT GARDINER &THEOBALD

4TH QUARTER 2019

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 and is further informed by our market survey responses and contractor consultations.

TPI

TENDER PRICE INDICATOR



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CREATING OCCUPIER VALUE

CREATING OCCUPIER VALUE

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PARTNER, LONDON

Offices are built for occupiers, both owners and tenants. Without them there is no demand and no reason for us to build them. So in an age of improving wellbeing for occupiers, increasing building sustainability and providing hospitality services to tenants, it is still worth remembering the basics that can add value to an office product and help attract occupiers.

Office tenants are looking for the most appropriate premises in the right location to attract and retain talent to their business. Their premises must provide flexible and affordable accommodation which allows them to efficiently provide their services while reflecting their brand values.

Headline rents and lease terms will naturally drive the cost of occupation in their chosen workplace, but the cost of the fit-out can also be a differentiator when attracting tenants. Poorly executed base build can impact fit-out costs for occupiers and be detrimental to the comparative value of the premises.

Taking occupier needs into consideration during the base build should not be seen as an increase in cost of the development, but a value-add for occupiers from day one. An occupied office has far greater value than a vacant one. Facilitating the occupier fit-out can go some way to improve efficiency and differentiate between base build products helping to attract the best occupiers to an office development adding value to the asset.

Office buildings tend to be designed from the outside inwards. At the beginning of a project a massing study will determine the volume of space and maximum floor area to generate value for viability. Design work then tends to concentrate on the external envelope and the impact on locality to achieve the first hurdle of planning permission. But there are many detailed constraints and competing factors to be unified to ensure a complete design, such as grid sizes competing with structural zones which then determine space for services installation, and each has a knock on effect throughout the building design.

Developers and contractors are looking to design and construct as efficiently and economically as possible and in the process can often inadvertently compromise the premises for its ultimate occupier thereby impacting its value. Typical examples are cladding brackets connecting to floor plates can foul floor voids.

This requires the raised floor to form a bridge from pedestals with oversized or special tiles where the elevation has complex articulation, which all adds to fit-out costs. Designing Cat A for one typical floor plate is efficient for a base build, but not all floors will be typical and an occupier may find that structural elements clash with air conditioning or areas that can't be accessed further adding to the cost of the fit-out.

Occupiers often want to provide cellular accommodation and partition up to the cladding mullions. If the base build system does not provide for connectivity or interfacing, the occupier is faced with installation issues to solve acoustics, fire and aesthetics in the fit-out.

This is an extract from a longer article.
Visit: **marketintel.gardiner.com** to read in full.

Hogan Lovells

INTRODUCTION

Since our last TPI report some of the lingering, and in some cases paralysing, levels of uncertainty have subsequently been dialled back. The prospects of a change of government, a second referendum and the possibility that Brexit might be cancelled altogether have all receded, however a few big questions remain unanswered as we enter the second phase of Brexit. The UK faces another potential cliff edge if it is unable to secure the ambitious free trade agreement that it desires with the EU during the 11-month transition period (ending on 31st December 2020).

Amid this backdrop construction output growth continues to be resilient, with the 'all work' category maintaining its gradual upward trend since January 2013. Although some sectors (eg private new housing) have struggled in this past year, the latest ONS data shows that new work output in the three months to November was up by 1.1% (or £461m) compared to the previous three-month period. With a degree of confidence returning to the market since the General Election (GE) result in December 2019, many now await to see evidence of the Government's longer-term strategy with regards to housing, infrastructure and planning before moving projects forward.

According to the Purchasing Managers Index (PMI), the decline in construction activity deepened in December 2019 as a result of Brexit uncertainty and spending delays. However it wouldn't be surprising if sentiment improved in the coming months after the Conservatives' 80-seat majority win at the GE. December's **PMI** reading showed output falling in all three major categories of work but civil engineering was the biggest victim, with activity in the sector experiencing its sharpest drop since March 2009.

UK construction new orders saw a marginal increase in Q3 2019 from the previous quarter but remain at a near seven-year low. The GE result may help to get some of the previously stalled projects moving again, helping to buoy up new orders in the coming months, but it's the upcoming Budget (scheduled for 11th March 2020) that could have the most significant effect on construction investment and ultimately new orders as Sajid Javid sets out the details of his promised 'infrastructure revolution'.

TENDER PRICE FORECAST

Apart from a few regional adjustments, our latest tender price inflation forecasts differ very little from those in our last report. A short post-GE spike in confidence is unlikely to be enough to fully open the floodgates for new orders, and we anticipate that at least until the Budget in March, demand and activity in the sector will remain relatively flat. We anticipate market conditions and, to some extent, input costs aren't likely to shift significantly until the Budget spending plans are confirmed and details of a trade deal with the EU begin to emerge.

Competition between contractors bidding for projects intensified in 2019 as the volume of new schemes failed to replace the number of completed ones. A greater number of contractors bidding on fewer projects will likely keep tender price inflation supressed in the early part of 2020. G&T has found that tendering on small and medium-sized projects in particular are experiencing high levels of competition with larger contractors now stepping down to compete for such projects to fill order books and secure their pipeline towards the end of 2020.

Our weighted UK average TPI forecast shows 1% growth for 2020, rising to 1.5% in 2021, 2022 and 2023. Although confidence and demand are likely to grow in 2020, it will take some time before this translates into new order growth. If the trends from recent months of slowing material price inflation, a strengthening Pound and reduced hiring activity continue, this will act as a drag on input cost inflation this year. Clarity over fiscal policy and whether the UK can negotiate a free trade agreement (FTA) with the EU (and how quickly it can do so) are two of the biggest remaining hurdles. Positive outcomes in these two areas could produce more than just a spike in demand and could bolster long-term confidence to invest and move projects forwards. In this scenario, competition in the sector could loosen and put upward pressure on tender prices from mid-to-late 2020.

The only region adjusted in 2020 is the North West. Annual inflation has been upwardly revised for the next three years as the Manchester city region in particular remains very active with projected increases in activity across several sectors, including commercial offices, higher education, high rise residential and industrial.

TPI growth for Scotland has also been upwardly revised for 2021 from 2% to 2.5%. The localised market in Edinburgh is experiencing a temporary hot spot due to the number of new starts and pipeline projects which is creating a spike in tender prices linked to a small number of key trades where there are resource challenges in Scotland.

INPUT COSTS YEAR ON YEAR (NOV 2018 – NOV 2019)

M&E COMPONENTS	FABRICATED STRUCTURAL STEEL	CONCRETE REINFORCEMENT BARS (STEEL)	READY MIXED CONCRETE
▼ *1.5-2.5%* ▼	▼ *- 4.1%* ▼	▼ *-12.6%* ▼	▼ *0.8%* ▼

MACRO ECONOMICS

UK GDP ANNUAL GROWTH RATE *(Q3 2018-Q3 2019)*	CPI DECEMBER 2019 *(12-month rate)*	UK UNEMPLOYMENT RATE *Aug-Oct 2019*	UK BASE INTEREST RATE
▼ *1.1%* ▼	▼ *1.3%* ▼	◄ *3.8%* ►	◄ *0.75%* ►

In 2022, inflationary growth in both London and the South East has been upwardly revised from 1.5% to 2%. Survey respondents expect that much of the uncertainty around Brexit will have subsided at this point and inflationary growth will return to longer-term averages. Please note our latest survey stradled the GE result. G&T noted more confidence in TPI growth post the GE result.

All 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 published average rate, reflecting the project specific components and conditions.

All forecasts assume that the UK will leave the EU on 31st January 2020 and enter into an 11-month transition period whilst trade negotiations take place and the nature of the future relationship between the UK and the EU is decided.

REGIONAL BREAKDOWN OF CONSTRUCTION OUTPUT (ANNUAL GROWTH Q3 2018 - Q3 2019)

REGION	CONSTRUCTION OUTPUT GROWTH % (Q3 2018 - Q3 2019)
Greater London	3.68
South East	-2.11
South West	2.81
East	5.28
East and West Midlands (Average)	8.58
Wales	1.58
Yorks & Humber	2.46
North West	0.15
North East	31.63
Scotland	16.74
Northern Ireland	*1.45

**NI output growth is between Q2 2018 - Q2 2019*

MACRO ECONOMICS

Q4 2019 GDP data is likely to show that the economy limped through the final quarter of the year after GDP growth in Q3 2019 was upwardly revised from 0.3% to 0.4%. The Bank of England (BoE) is forecasting just 0.1% growth in Q4, anticipating that stalled spending, postponed investment plans and political uncertainty will have led to economic stagnation.

UK GDP grew by 0.1% in the three months to November 2019 as the weakening services and falling production sectors resulted in subdued growth. Somewhat surprisingly the construction sector made a positive contribution to GDP growth, growing by 1.1% in the period. This is now the third consecutive rolling three-month period that the sector has grown, with the latest period showing new work output growth of 1.6% and repair and maintenance growth of 0.3%.

Conversely, December's PMI survey showed a further contraction in activity. In fact, only twice in 2019 (January and April) did the PMI reading manage to show an expansion in activity, but the most recent survey revealed that business confidence rebounded to a nine-month high as a result of the greater clarity provided on Brexit. Respondents noted that this had the potential to boost clients' willingness to spend and increase order books in 2020.

Consumer price inflation (CPI) fell to 1.3% in December 2019 - its lowest annual growth rate since December 2016 and undershooting the BoE's inflation target of 2%. Declines in the inflationary measure come amid the backdrop of a stalling economy and a tough Christmas trading period. Average weekly earnings (total pay) rose at an annual pace of 3.2% in the three months to

MANUFACTURING OUTPUT

▼ *-1.9%* ▼

MARGINS

◄ *Flat* ►

CONSTRUCTION INDUSTRY
Average Weekly Earnings
(Annual Growth to Oct 2019)

▼ *4.1%* ▼

OIL PRICES (BRENT CRUDE)
(As of 15th Jan 2020)

▲ *US$64.5 bbl* ▲

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

RPI DECEMBER 2019
(12-month rate)

▼ *2.2%* ▼

UK WAGE GROWTH
(Year-on-Year three month Average to Oct 2019)

▼ *3.2%* ▼

October 2019 – down from an annual growth rate of 4% that was recorded in the three months to July 2019. Over the period construction saw the highest estimated growth in total pay (5%), exceeding growth in the finance and business services sector (4.3%). This corresponds with our TPI survey responses, several of which noted that construction labour costs continue to rise amid the ongoing skills shortage. Although the UK unemployment rate remains at its lowest level since January 1975, vacancies have fallen for 10 months in a row and pay growth rates slowed as businesses erred on the side of caution in their recruitment plans.

CONSTRUCTION OUTPUT

Construction output in the 11 months to November 2019 was up by 2.2% compared to the same period in 2018. New work activity has been particularly strong, growing by 3.1% over the same period.

Output also increased by 1.1% in the three months to November 2019 compared with the previous three-month period. For new work output, all sectors other than private new housing (which saw a fall in output of 0.4%) grew in the three month period. New public housing and private industrial work grew by 4.5% and 6.2% respectively whilst new infrastructure work grew 3% on the previous three months. Public new work output growth languished once again as investment in public sector buildings was dialled back prior to the GE. Unsurprisingly, households were seemingly reluctant to spend over the three-month period as private housing repair and maintenance was the worst performing sub-sector with output falling by 1.9% compared to the previous three-month period.

Whilst construction industry output figures paint a picture of resilience it remains to be seen whether this growth trend can be sustained. Poor new order data (which is tantamount to construction demand) could supress workloads and output growth in the coming months. New orders actually fell by 15% in 2018 compared to the previous year from £54.8bn to £46.3bn. This doesn't bode particularly well for 2020 construction output figures but there may be a number of projects that could quickly be converted from new orders to shovel-ready projects (ie output) with relatively little lag between the two events.

The Construction Products Association (CPA) has cut its forecast for output growth in 2020 from 1% to 0.5%. Despite concerns over the delivery of some major projects, the CPA anticipates that infrastructure will be one of the primary drivers of output growth 2020. A raft of projects is currently in the pipeline and many more are likely to be announced in Q1 2020, prompting the CPA to forecast a 3.7% rise in infrastructure output growth.

NEW ORDERS

New orders remained stubbornly low in Q3 2019, producing the second lowest 'All New Work' value since the second quarter of 2013. The residential sector was the best performing sector by a considerable margin in Q3, with 'All New Housing' new orders growing by 8% from the previous quarter. Infrastructure and other public new work continue to struggle, with new orders having declined by 7% and 10% respectively in Q3. Both these struggling sectors however have received funding pledges in the Conservative party manifesto and are likely to bounce back in 2020 once spending details have been revealed in the next Budget.

According to the latest IHS Markit/ CIPS latest PMI reading, new orders continue to decline at an alarming rate. Although August 2019 still holds the 10-year record for the biggest contraction in new orders, construction companies recorded a marked reduction in new business volumes in December. The PMI survey also found that commercial work continues to decline as investors opted to postpone spending decisions ahead of the GE.

Arguably the sector has been the most exposed to the recent political uncertainty, so assuming that the UK can negotiate a positive trade deal we would expect the sector to stabalise towards the end of this year and
into 2021.

After speaking with several contractors G&T found that many expect the market to be busier in 2020, with some going as far as saying that they expect an unprecedented number of projects to be tendered during the year. However, most said that this was unlikely to materialise until Q2 2020 at the earliest.

INPUT COSTS

MATERIAL COSTS

Corresponding with a slowing of new orders, construction material price inflation has softened in the last quarter.

The latest ONS data show that the 'All Work' construction material price index fell by 0.6% in the year to November 2019 – the slowest annual growth rate since 2015. In the month of November alone construction material prices fell by 1.5%.

The Pound has strengthened significantly since our last TPI. Trading at around 1.10 at the end of July 2019, the Pound has risen by 6.4% to around 1.17 to the Euro at the time of writing. Reduced inflationary pressure for imported construction materials will provide some relief to contractors who are experiencing rising labour costs and downward margin pressure.

Looking at the inflation of specific materials, prices for fabricated structural and steel and rebar fell by 4.1% and 9.3% respectively in the three months to November 2019. The cost of imported sawn or planed wood also fell over the period prices are now 10.4% lower than they were in November 2018. Falling demand, lower key commodity prices and the appreciation of the Pound, have all factored into the recent declines in material prices and will help offset other rising input costs.

LABOUR

Average weekly earnings (AWE) in the construction industry continue on their long-term upward trend, and have increased by 4.1% in the year to October 2019. In the three months to October 2019 AWE in the construction sector were £651 per week – up from £620 per week (or 5%) in the same three month period a year earlier. This significantly outstrips wage growth for the economy as a whole, which rose by 3.2% over the same period.

Rising earnings are putting significant upward pressure on labour costs but the number of job vacancies are falling and our TPI data indicates that some contractors are pausing hiring plans. With low demand and new orders in decline it would be fair to assume that we'll see less upward pressure on pay growth in 2020.

Our TPI survey indicates little has changed in terms of the expected supply of skilled labour over the next six months. The vast majority of those responding (57%) expect a shortage of skilled labour, with 28% taking a more neutral view on labour supply. Several noted they were seeing shortages in finishing trade packages such as drylining but also in MEP. Bricklayers were also reportedly becoming scarcer as national house builders take up more of the available supply.

PROFITABILITY AND SUPPLY CHAIN

There were no significant changes to OH&P and preliminaries from tender returns in the past three months. Average OH&P remained stagnant at around 5-6% and preliminaries around 14-15%.

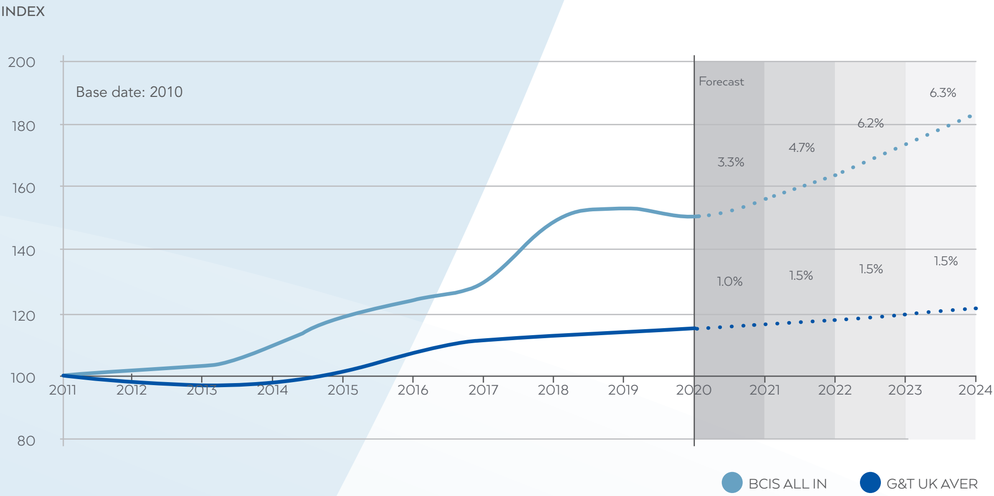
Over the next 12 months, a significant proportion (23%) of survey respondents are expecting OH&P to fall from current levels, but most (57%) still expect OH&P to remain unchanged. Until the suppress demand from the months leading up to the GE is unblocked, competition could tighten further and lead to supressed profit margins. For now, contractors continue to chase work which is likely to keep OH&P in check.

Despite the majority expecting little change to preliminaries in 2020 (63%), a higher ratio of respondents (23%) now believes that preliminaries will increase this year compared to our previous TPI report. Rising wage costs are thought to be the key driver of these higher preliminaries.

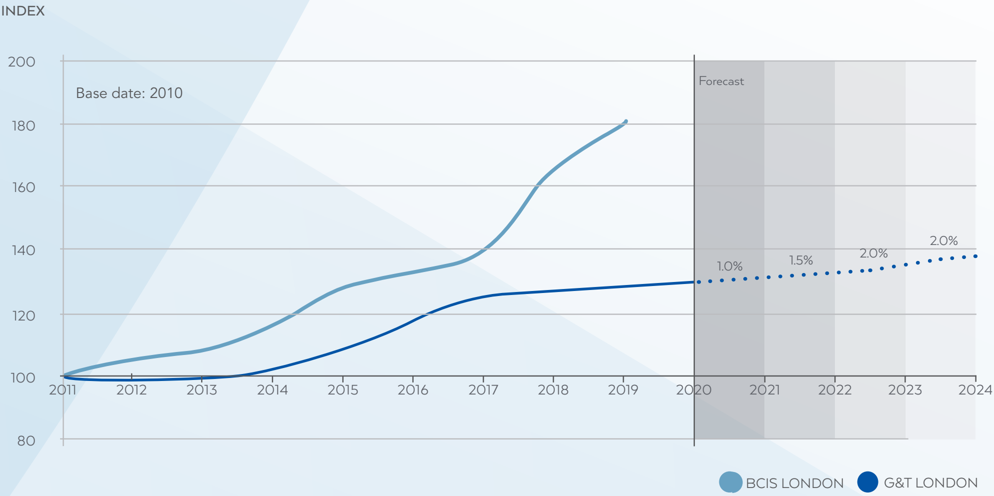
Now that a portion of the political uncertainty has been removed in the wake of the GE result, it is unlikely that tender price inflation will fall in 2020. We anticipate a modest rebound in construction demand to pull tender price inflation upwards in 2020, but the picture will become significantly clearer as the year progresses. Contractors' workloads are likely to improve in the second half of the year as investment conditions become more favourable and more details are provided on the Government's infrastructure agenda. Consequently, G&T would expect most upward inflationary cost pressure to surface in Q3 and Q4 2020 as competition for work lessens.

TENDER PRICE TREND

TENDER PRICE TREND **"ALL UK TPI"** Q4 2019



TENDER PRICE TREND **"LONDON TPI"** Q4 2019



Note: BCIS does not publish regional forecasts.
Regional BCIS data for Q3 and Q4 2019 was 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.

TENDER PRICE CHANGE

TENDER PRICE ANNUAL PERCENTAGE CHANGE Q4 2019

%	2020		2021		2022		2023	
Regional forecasts	Now	Last	Now	Last	Now	Last	Now	Last
Greater London	1.00	1.00	1.50	1.50	2.00	1.50	2.00	N/A
South East	1.00	1.00	1.50	1.50	2.00	1.50	2.00	N/A
South West	1.50	1.50	1.50	1.50	1.50	1.50	1.50	N/A
East	2.00	2.00	2.00	2.00	2.00	2.00	2.00	N/A
Midlands	2.00	2.00	1.50	1.50	1.50	1.50	1.50	N/A
Wales	1.00	1.00	0.50	0.50	0.50	0.50	0.50	N/A
Yorks & Humber	1.00	1.00	1.50	1.50	1.50	2.00	1.50	N/A
North West	2.00	1.50	3.00	1.50	2.00	1.50	2.00	N/A
North East	1.00	1.00	1.50	1.50	1.50	1.50	1.50	N/A
Scotland	2.00	2.00	2.50	2.00	2.00	2.00	2.00	N/A
Northern Ireland	1.50	1.50	1.50	1.50	1.50	1.50	1.50	N/A
UK Average (weighted)	**1.00**	**1.00**	**1.50**	**1.50**	**1.50**	**1.50**	**1.50**	**N/A**

Note: 2023 is a 10-year short-term average market forecast

COMPARISON OF PUBLISHED FORECASTS FOR TENDER PRICE CHANGE

	G&T UK AVER.	BCIS UK AVER.	G&T LONDON	AECOM LONDON	ARCADIS LONDON
	Q4 2019	JANUARY 2020	Q4 2019	Q4 - Q4	Q4 2019
			% CHANGE		
2020	1.00	3.33	1.00	0.90	1.00
2021	1.50	4.69	1.50	1.80	3.00
2022	1.50	6.16	2.00	N/A	5.00
2023	1.50	6.33	2.00	N/A	5.00

Note: All figures relate to year on year quarterly changes

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