



Inflation Update

November 2009

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 **sense**

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Hopes that the economy would emerge from recession in the third quarter were dashed by preliminary data to suggest sharp falls in production and quarrying affected by an overall contraction in GDP for the sixth consecutive quarter. However, with the sizeable financial and business services sector flirting with recovery, prospects for the economy in the fourth quarter are considerably stronger. Heavily negative investment intentions, the growing impotence of the public sector and the persisting constraints on the availability of finance make for a bleak medium-term outlook for the industry.

Rationalisation programmes are still underway and operations are continuously under review as contractors and consultants alike prepare themselves for a further deterioration in conditions leading to what promises to be a long haul to recovery. Maintaining a competitive edge is key in an environment where the deflation in input costs has been very modest relative to the steep contraction in tender prices.

Aggressive production cuts in materials markets in late 2008 and early 2009 simultaneously limited scope for price falls and increased pressure on contractors seeking to lower their cost base. Marked differences in the speed of recovery in economies around the world is rapidly emerging as a key future risk to an industry upon which prices of internationally traded commodities impinge. Bottlenecks in supply are certain to lead to rapid inflation in an

environment where emerging Asian economies have weathered the storm with relative ease and the UK's larger European neighbours have emerged from recession in the second quarter of this year.

Competition has been noticeably fiercer in the second half of 2009. For many, forward orders for work in 2010 are significantly down and contractors are becoming increasingly desperate to secure work. To date, contractor insolvencies have remained at a relatively steady level but the risk of insolvency in the supply chain will be elevated throughout 2010 and 2011 as tender prices continue to contract but input costs remain static at best and at worst, increase significantly. It is only a matter of time before some over-extended contractors fall foul of their unrealistic commitments in what is proving to be a particularly unforgiving environment.

Analysis of the recent tender returns within Sense Cost Consultancy and the wider Mace Group, a survey of the Mace Group supply chain and a comprehensive review of industry and wider macroeconomic data suggests that the 10% decline in tender prices recorded in 2009 will be compounded by further contractions in 2010 and 2011 as work becomes more scarce. Annual falls of 5% and 1% respectively are predicted before commercial pressures begin to ease and tender prices record modest growth of 1% in 2012.

Key points

1. Indicators generally point to a stabilisation in the UK economy in the second half of the year but avoiding the worst case economic scenario has come at a cost. Corporate balance sheets have been badly affected, nearly 2.5 million people are unemployed, export markets are subdued and public borrowing has hit a peacetime record of 58% of GDP. Consensus forecasts point to a slow recovery but the fragility of both the consumer and corporate sectors suggests it will be easily destabilised should confidence take a further knock.
2. In 2009 construction output is forecast to decline at the fastest pace since records began, and with orders for new work down by a further 14% in the second quarter, a contraction is also in prospect for 2010. Commercial construction output will bear the brunt of the recession over the next 18 months as the weakness of both the corporate and consumer sectors and financial constraints hit demand.
3. More positively, housebuilding activity has recently shown tentative signs of recovery after reaching a historic low. However, fewer residential property transactions, constrained lending and weaker buy-to-let activity mean that housing market conditions will remain challenging for the foreseeable future.
3. Production volumes of the main materials utilised by the industry are significantly down on 12 months ago. Metals prices, while still lower than their peak 14 months ago, have rebounded strongly in recent months in line with an improvement in the global economic outlook. Data suggests that prices of other construction materials haven't generally responded to the sharp contraction in demand and indeed there are several examples of prices increasing over the year. However, production capacity has been severely curtailed fuelling concern about the likely strength of inflationary pressure when industry demand recovers.

Key points continued

4. Oil prices are back on a par with 2007 and show no signs of retreating significantly. Having started the year at near to \$40 per barrel, prices climbed to \$78 per barrel in October. Analysts warn the upward trend will continue as the global recovery gains momentum.
5. Sterling remains depressed as government debt spirals and fundamental concerns linger about the underlying strength of the UK economy. The Bank of England's current programme of quantitative easing concludes in a matter of weeks and with no precedence to refer to, potential UK investors are understandably unnerved by the prospect. Forecasters are generally pinning hopes on an export-led recovery for the economy as a whole as global demand strengthens. The continued weakness of sterling is pivotal to the success of this central scenario which, while good news for exporters, will only add the woes of those that need to import materials.
6. The construction labour market continues to soften. Official sources suggest 42,000 construction workers were made redundant between April and June and industry commentators have warned that 300,000 jobs could be shed from 2008 levels by the end of 2010.

Economic background and industry overview

A smaller than expected contraction of 0.6% in GDP in the second quarter of 2009 offered hope that the worst of the crisis is now behind us and independent forecasters generally agree recent evidence points to a stabilisation in the UK economy and a marginally improved outlook for the third quarter and beyond. Survey data is generally reporting a tentative recovery. For example, the latest purchasing managers index for activity in service businesses rose to a two-year high in September and the Confederation of British Industry's state of trade survey, while still in negative territory, has measured an improvement in sentiment in the manufacturing sector in recent months. However, stronger prospects for the second half of 2009 will fail to prevent economic output from contracting at its fastest annual rate in more than 60 years during the year as a whole.

A slow but steady recovery profile is favoured by the majority of independent forecasters reporting to the HM Treasury. However,

Key economic indicators 2009-2011 (annual % change)

	2009	2010	2011	2012
GDP	-4.3	1.2	2.0	2.5
Private consumption	-3.0	0.1	1.3	3.0
Fixed investment	-14.5	-2.6	1.5	4.8
CPI	1.7	1.8	1.6	2.0
Interest rates (Q4)	0.5	1.4	2.6	4.3

Source: HM Treasury, Experian,

significant risks threaten to destabilise this central scenario, not least the rising rate of unemployment which is now at its highest level since November 1996. Probably the greatest risk is the sustainability of a recovery which has ultimately been instigated by public sector intervention. The Bank of England's quantitative easing programme has helped to revive capital markets but its success at encouraging investment and other expenditure has yet to be proven. With current quantitative

easing measures scheduled to end this month, the stabilisers will soon be removed and there is no precedence for how the economy will subsequently fare.

The infrastructure and public non-residential sectors have so far been the construction industry's saving grace in 2009. But with government borrowing already at a historic peacetime high of 58% of GDP and rising, and a general election looming, action to redress the balance is likely sooner rather

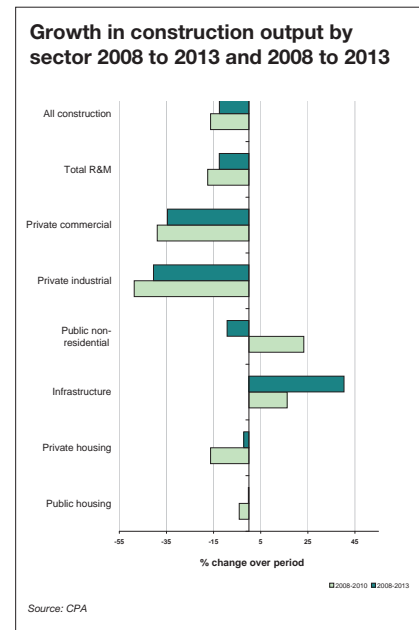
Economic background and industry overview continued

than later. With scope to improve public finances by tightening fiscal policy limited by the potential damage such measures could do to what is proving to be a fragile recovery, aggressive capital cuts in public spending are inevitable. The axe is likely to fall on one or more of the larger publicly funded non-residential programmes currently underway and after nearly two decades of planning, Crossrail's future hangs in the balance once again. Experian expects 2010 to be another relatively robust year for public non-residential construction, with an increase of 8% predicted, before the Olympics completes and the brakes are applied. Prospects post-2010 are less certain. Construction Products Association (CPA) forecasts suggest output will fall by 3.6% in 2011 and that the rate of contraction will accelerate into double digits in both 2012 and 2013.

Orders for new construction work remained down by 14% year-on-year in the second quarter but recovered 25% from the nadir reached in the first. Probably most notable was the revival in the private house-building sector, which strengthened after reaching a historic low. Mortgage approvals

and loans have been rising slowly but steadily since the end of last year and recent trends in prices have been generally upwards. Secured lending remains highly constrained but the Bank of England's third quarter 'credit conditions survey' revealed financial institutions expect some increase in the levels of secured credit available to households over the next three months. With the emphasis on 'some', questions about the true strength of demand linger. Private housing starts are expected to fall to a historic low of 80,000 units in 2009 so it will take many years to get back to pre-crisis levels. Year-on-year growth through to 2013 will increase annual private housing starts to 148,000 units, a level nearly 20% down on the 2007 total.

Industry output is set to record a double-digit decline in 2009 and with the true scale only recently hitting contractors, operating conditions in 2010 will be even more challenging. At the optimistic end of the spectrum, Experian predicts output will fall by a marginal 0.6% in 2010, while a softer view of the housing and infrastructure sectors leads the CPA to forecast a steeper 2% decline. Commercial construction will bear the brunt of



the recessionary impact over the next 18 months. Orders for new commercial construction work were over 50% down year-on-year in the first six months of 2009 as financial constraints and the weakness of both the corporate and consumer sectors hit demand. While current conditions offer opportunities for players operating at the budget end of the market, pursuing expansion plans is proving to be the exception rather than the rule.

Materials

Changing market conditions have only slowly impacted on industry materials prices. The BCIS 'general building cost index' slipped into decline in July 2009, contracting by a marginal 1% year-on-year. Whilst costs are generally expected to continue to fall for the next few months, a return to modest growth is in prospect post-2009 as de-stocking comes to an

end and reduced production levels start to have an impact.

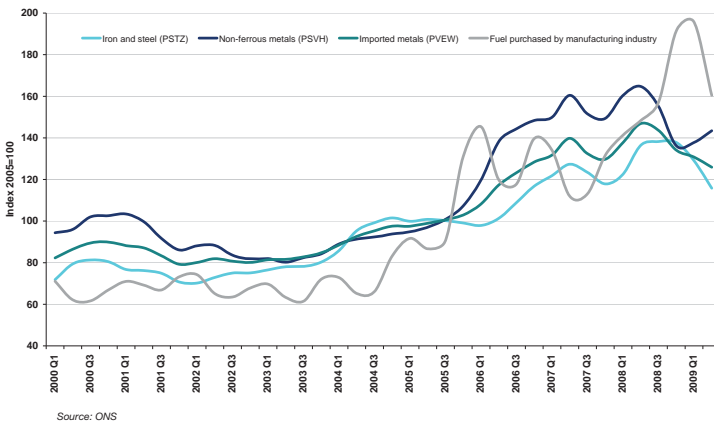
Steel production levels remained sharply down in the majority of producing countries around the world. Over the first eight months of 2009, global production was down by 18.1% according to the Iron and Steel Statistics Bureau (ISSB). Omit China from the comparison,

however, and production was down by 32.4%. In August 2009 22.4% less steel was produced than in August 2008 in all countries excluding China. UK production was down by nearly 40% in the first eight months of 2009, compared to the same period in 2008.

With some emerging markets showing unexpected resilience in

Materials continued

Selected input prices



the wake of the global economic crisis, the outlook for demand for most of the metals commonly used in construction has strengthened in recent months, particularly from mid-2010 onwards. China's continuing strength, for example, was cited as a key factor supporting the surprisingly upbeat third quarter results posted by mining giant Rio Tinto. Global iron ore production was up by 12% year-on-year in the third quarter, a record high. Recent forecasts from the Australian Bureau of Agriculture and Resource Economics suggest global demand for steel will fall by 9.2% to 1,223m tonnes in 2009 but will increase by more than 6% during 2010 as a whole.

World Bank data suggests that after significant falls, metals prices are now generally increasing. Copper prices have risen rapidly in recent months. Leading market players have called the bottom of the market and prices jumped by 18% in August 2009 to \$6,165 per metric tonne, broadly in line with levels in September 2008. Copper futures prices have been rising at a robust rate since early 2009. Steel prices have now stabilised but remained 23% down year-on-year. MEPS data suggests prices were down by nearly 46% over the April to June period, but prices began to increase once again in July, with prices rising by 7%. As

stockpiles waned, Corus' list price for steel sections and plates rose by £25 per tonne in late October, the first increase in 18 months.

Rising commodities prices place contractors that have been forced to take work at low margins in danger. The British Constructional Steelwork Association recently warned that the volatility of steel prices left steel contractors particularly exposed and suggested that one in four firms becoming insolvent as a result wasn't beyond the realms of possibility.

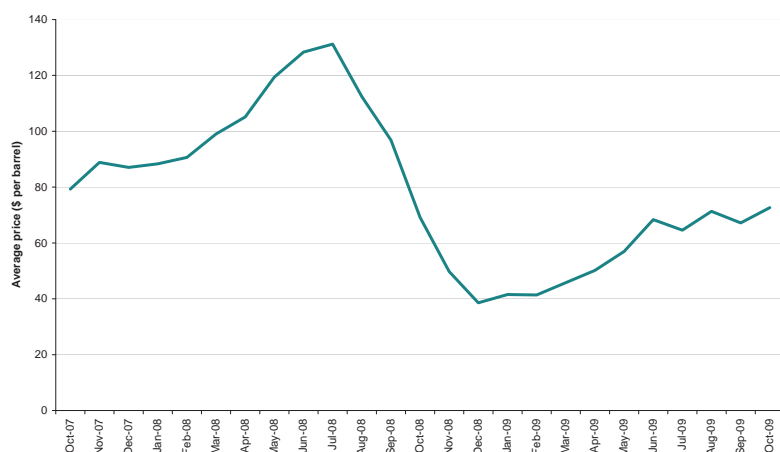
Brick production levels in the second quarter were 36% down on the same period in 2008 and provisional figures for July suggest a further contraction could be in

store in the third. Prices, however, were 10% higher in August 2009 than they were 12 months previously as manufacturers steamed ahead with planned price increases, opting to reduce volumes as opposed to margins.

Aggregates demand has fallen to its lowest level since the Minerals Products Association's records began. Compared with the same period of 2008, sales volumes of crushed rock and sand and gravel aggregates fell by 29% and 27% respectively according to data from the Minerals Products Association. Sales of cement were down by 32% and ready-mixed concrete by a steeper 37%. Looking to the future, levels are expected to stabilise in the second half of the year.

At a September meeting, OPEC members agreed to leave current production levels unchanged but noted that market fundamentals remained weak. Oil prices, however, have been rising fairly consistently throughout 2009 and in early October peaked at \$78, significantly higher than in late 2008 and early 2009 when prices often dropped below \$40 per barrel. Higher oil prices are here to stay according to some analysts who believe recent increases

OPEC Reference Basket (monthly average price)



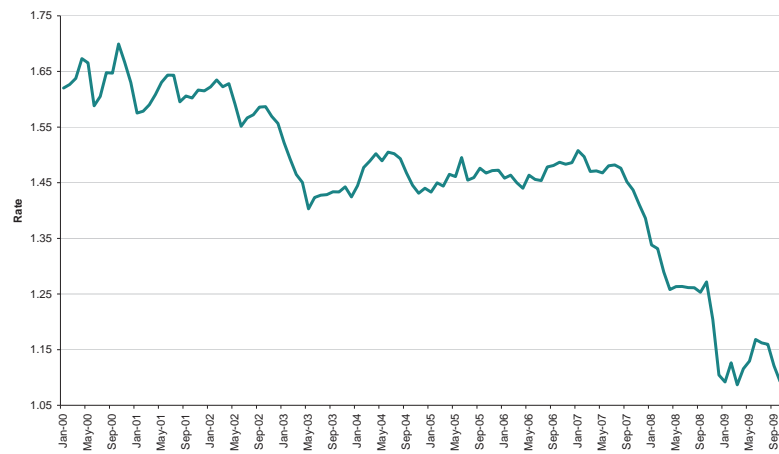
Source: OPEC

Materials continued

are the beginnings of a gradual transition into higher price ranges.

The UK economy may be showing more resilience than initially expected in the wake of the crisis but compared to the Eurozone as a whole, the contraction has been relatively steep and more prolonged. Recent data, for example, suggests the French and German economies both exited recession in the second quarter, and this combined with fears about spiralling public debt, further depressed sterling in October. The euro/sterling exchange rate averaged just 1.08 through to mid October, lower than an average rate of 1.12 in September and significantly down on a long-term average of 1.5.

Monthly average euro/sterling exchange rate



Source: Bank of England

Labour



Jobs in construction fell by 2.6% year-on-year in the second quarter to 1.3 million, broadly in line with the average contraction across all industries. The redundancy rate dropped to its lowest level in nine months but at 27.9 per 1,000 employees, remained very high compared to the long-term average. There were 42,000 construction worker redundancies during The second quarter and industry training body ConstructionSkills has warned

that by the end of 2010, 300,000 could be lost from 2008 levels.

Average industry earnings, excluding bonuses, however, continue to record modest growth. Earnings, excluding bonuses, climbed 0.4% year-on-year in June. Include bonuses in the comparison, however, and the average fell by 1.6% over the year. Again it is necessary to note that for a transient industry like construction, official household surveys such as the labour force survey, provide more of an indication of trends rather than an accurate gauge.

Wage agreements for some specialist contractors were already in place before the phrase 'credit crunch' had been coined. Electricians in direct employment will see their wages rise by between 4.5% and 5% next year. Other specialist unions, however, are

struggling to reach agreement for 2010 in the prevailing climate. Members of the Joint Industry Board for Plumbing Mechanical Engineering Services in England and Wales, for example, have yet to agree to employer proposals to freeze wages in 2010 and links any settlement for 2011 to movement in the retail price index.

In its annual survey, The Fees Bureau found that professional fees have been severely hit by the downturn. The average rate for a sole principle in a quantity surveying firm fell by 17% between 2008 and 2009 and by 10% for an associate. Architects fees have been more moderately affected according to the Bureau. Hourly pay for associates contracted by 4% but no change was recorded in rates for sole principals.

Outlook UK

While indicators suggest the economic recession has bottomed out and business confidence is gradually returning, investment intentions remain subdued, and financiers are still jittery about lending to support capital investment. In its autumn forecast, the Ernst & Young 'Item Club' noted that while the Bank of England's programme of quantitative easing has helped revive the capital markets, there has been little follow-through into investment and other expenditures. Instead companies have taken the opportunity to repay debt and de-leverage. Similarly, the household sector has used low interest rates as an opportunity to repay debt. Essentially, when presented with the choice, both the consumer and household sectors have opted to save and shore up their relative positions rather than spend. While a real recovery in bank credit markets is necessary to industry recovery, how long it takes for the prevailing mindset of potential construction clients to change is equally important.

We reiterate our belief that along with what is undoubtedly an excellent opportunity for clients to procure work at very competitive rates comes greater risk. On occasion, opting for the lowest price while making adequate provision for future claims will be in a client's best interest. At other times, the risks and the probability of them occurring will be too great and a higher initial price will ultimately yield the more favourable outcome. A realistic stance that enables clients to benefit from the current favourable conditions without inadvertently increasing exposure to poor quality workmanship or contractor liquidation may ultimately mean the difference between a successful project, that demonstrates good value for money, and a costly mistake.

Analysis of the recent tender returns within Sense Cost Consultancy and the wider Mace Group, a survey of the Mace Group supply chain and a comprehensive review of industry and

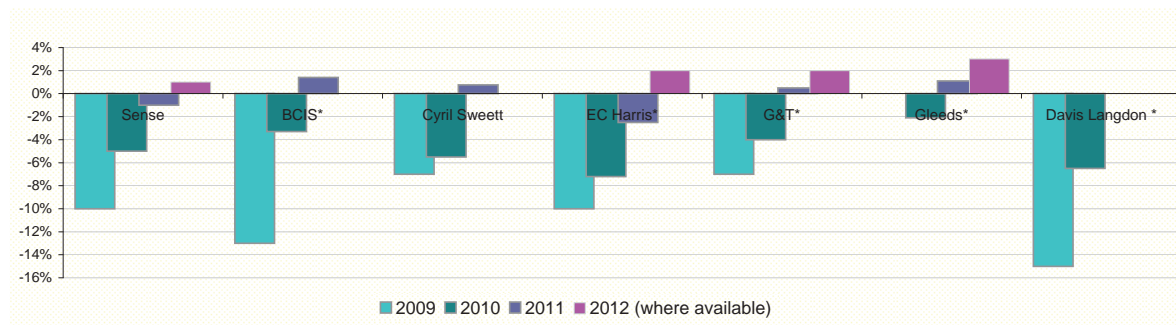
wider macroeconomic data, suggests that the 10% decline in tender prices recorded in 2009 will be compounded by further contractions in 2010 and 2011 as work becomes more scarce. Annual falls of 5% and 1% respectively are predicted before commercial pressures begin to resurface in the marketplace and tender prices record modest growth of 1% in 2012.

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Annual tender price inflation forecast (UK) - a selection of cost consultant forecasts



Note: ** rolling forecasts from 3Q 2009 to 3Q 2010 etc

The Sense construction tender price projection is informed by tender returns from live projects, out-turn cost-data from Mace Group, feedback from the group's supply chain, a review of third party forecasts of general price inflation, and macroeconomic and construction industry analysis.

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