



# Tender Cost Update

June 2010

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 **sense**

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**‘A significantly accelerated reduction in the structural deficit over the course of the Parliament.’ (Coalition Government Agreement)**

**The new Coalition Government provides the vital stability and direction necessary to foster global confidence and stimulate private sector investment. At the same time the cuts in public sector spending sever the lifeline that heightened public spending has offered many during the sharpest and deepest contraction in private sector activity on record.**

**Construction might still be in recession in the UK, but elsewhere activity has strengthened significantly. Demand for raw materials internationally is at a level that current production levels are failing to satisfy. Wages have started to increase, and potential efficiency savings maximised.**

**The next 12 months are likely to be even more challenging than the last for contractors. Prices of some commodities are already on a par with their pre-Lehman peak, but demand has further**

**to fall. Tender pricing will continue to be fiercely, and unsustainably, competitive and insolvencies are certain to rise. Clients, therefore, should proceed with caution to ensure they minimise their future risk while procuring quality work at very competitive rates.**

**Analysis of the recent tender returns within Sense cost consultancy and wider Mace, a survey of the Mace supply chain and a comprehensive review of industry and wider macroeconomic data has resulted in Sense maintaining its January forecast for tender price inflation in 2010 at -5%. However, recent political developments have weakened medium term demand prospects for the industry, and prices are now expected to decline by a further -2% in 2011 before stabilising in 2012 with 0% predicted. Tender prices are not expected to return to growth until 2013 and even then only a marginal 1% increase is anticipated.**

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## Key points

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1. Economic indicators remain mixed. GDP continued to grow in the first quarter of 2010, albeit modestly as exceptionally poor weather conditions constrained activity, but unemployment continues to rise, inflation remains stubbornly above target, the trade deficit is widening despite the protracted weakness of sterling against both the euro and dollar, and aversion to risk continues to govern credit markets. The agreement between the Conservatives and the Liberal Democrats might have been met with cautious optimism initially, but the emergency budget, which is to be delivered on 22 June, will be the Coalition's first real test.
2. With no discernable recovery in the private sector in prospect before the second half of 2011, demand conditions over the next 12 months will remain tight for contractors. Independent industry forecasters anticipate a further contraction in industry activity in 2010 of around 3% but the timing and severity of public sector capital spending cuts will be crucial. The Comprehensive Spending Review in autumn will outline in detail the fate of just over 40% of industry output over the course of the next Parliament.
3. Gloomy as the outlook is for the industry as a whole, positive signs are beginning to emerge from the commercial sector. Some projects shelved when the global recession hit are now being reconsidered. Finance remains a significant constraint but the UK continues to attract foreign investment. Newly completed space coming to market in 2010 is predicted to fall to an historic low and in recent months there has been a realisation among occupiers that availability will be limited post-2010. Rents have started to increase and are forecast to rise by around 15% in 2010, partly regaining the significant 35% fall in rents during the downturn.

## Key points continued

4. A strong resurgence in materials price inflation emphasises the significance of the demands of emerging economies on limited supplies of raw material. The prices of some metals are already back at their pre-recession peak and as emerging economies continue to develop, the strain on the world's finite supply of resources can only increase.
5. As the traditional annual benchmark pricing system for iron ore is replaced by individual negotiations on a quarterly basis, analysts fear greater price volatility is inevitable, and iron ore prices are forecast to rise by between 80% and 100% over the next 12 months. The World Steel Association warns that steel producers are unlikely to be able to absorb increases on this scale and the price of crude steel could rise by up to 15%. Even before the introduction of the new pricing system, pressure on raw materials prices has been mounting. Corus, one of the world's top ten steel producers, announced that transaction prices for structural sections will increase by £80 per tonne from 30 May.

## Economic background and industry overview

Exceptionally poor weather conditions in early 2010 failed to derail the economic recovery as some commentators had feared. While the provisional estimate suggests GDP growth slowed to 0.2% in 2010 Q1, subsequent revisions are likely to be upwards. Overall services growth slowed to 0.2% from 0.5% in the last three months of 2009, but within this, growth in business and financial services accelerated. The manufacturing recovery continued and only construction and hotels, distribution and catering remained in recession. Recent survey evidence continues to point to growth in the second quarter of 2010 and the consensus among independent forecasters contributing to the HM Treasury's Forecasts for the UK economy points to a 1.3% increase in GDP this year.

After the deepest contraction in economic activity since the 1930s, recovery will be slow, protracted and fragile and easily destabilised. Post-2010 the outlook is stronger but consumer sentiment will be

**Key economic indicators 2010-2012 (annual % change)**

	2010	2011	2012
GDP	1.3	2.1	2.4
Private consumption	0.5	1.6	2.1
Fixed investment	-2.0	2.9	3.4
CPI	2.1	1.7	1.9
Interest rates (Q4)	0.8	2.1	2.8

Source: HM Treasury, Experian,

constrained by weak income growth and an uncertain jobs market. With the outlook so fragile and finance still expensive and difficult to secure, businesses will be reluctant to invest. Consensus forecasts suggest a further year of below-trend expansion is in prospect in 2011 before growth accelerates, significantly weaker than the recovery from the recession in the early 1990s.

Prospects for business investment are extremely fragile, and crucially for construction,

business investment contracted by almost 25% year-on-year in 2009 Q4, significantly more rapid than in any of the past three recessions. Credit availability is still constrained, and expensive, compared with the situation before the financial crisis and the latest Bank of England Lending to Businesses survey indicated that overall lending to businesses contracted by £0.8 billion in February. Once again it is small and medium enterprises that are encountering the greatest constraints.

# Economic background and industry overview continued

Sterling's protracted weakness against both the euro and dollar started to boost exports in early 2010 and the UK trade deficit narrowed. In February the UK's deficit on trade in goods and services was £2.1bn, significantly less than the £3.9bn deficit recorded in January. However, with Greece's financial demise placing yet another hurdle in the path of the Eurozone recovery, prospects for the UK's main trading partner remain fragile. Emerging markets continue to surge ahead of their European and American counterparts. The Chinese and Indian economies are forecast to grow by 9.5% and 7.6% respectively in 2010, with equally strong growth in prospect for 2011.

Falling so close to the election, the chancellor's recent budget was always going to be heavy on politics and light on substance. While it reaffirmed a pledge to halve the level of public sector borrowing (which grew by more than 130% in 2009 and continued to rise in early 2010) in four years, detail on how this could be achieved was limited. Public sector net investment, which is tantamount to spending on construction, will fall modestly from £56.6bn in 2009/10 to £53bn in 2010/11. A step in the right direction this might be, but quite simply it is a drop in the ocean compared to what is required.

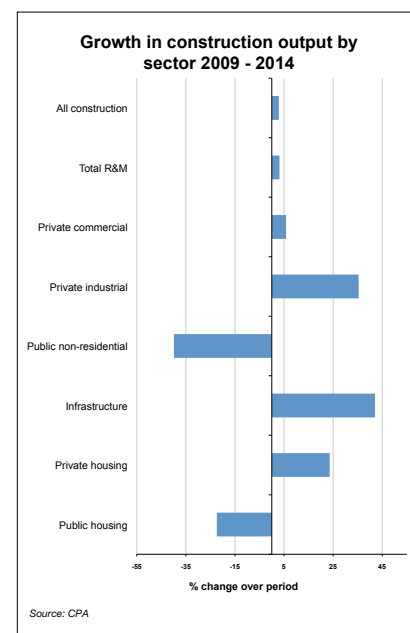
UK economic indicators might be strengthening but conditions for the construction industry remain extremely challenging. Industry output fell to £97.2bn in 2009, 11.5%, or £12.7bn, less than in 2008 and the steepest contraction in a single year since 1974. An overall fall of 11.5%, however,

conceals the extreme weakness of privately financed work, which declined by an unprecedented 20%. The government's decision to advance future public sector spend proved to be pivotal in preventing what could have been the worse year for the industry since records began.

Housing market indicators in 2010 so far, raise serious questions about the stability of the modest surge demand witnessed in the final months in 2009. A return to house price deflation in early 2010 implies that rising prices in 2009 were driven more by the limited number of properties on the market rather than a strengthening in underlying demand and following the withdrawal of the 2009 stamp duty holiday at the end of the year, mortgage approvals have contracted sharply. The house building was one of the few parts of the construction industry to gain concession in the recent budget but, while obviously welcome, the extension to the stamp duty holiday for first time buyers has only an indirect impact and references to programmes offering direct financial support to the industry, rather than peripheral stimulus, such as Kick-start and HomeBuy, were ominously absent.

The rapid deterioration in sentiment in both the consumer and corporate sectors drove a 27% contraction in commercial construction output in 2009, the sharpest annual contraction at least since the early 1950s.

Occupier activity in the central London offices market rebounded robustly in the second half of 2009, after a weak first half. New offices development generally lags a revival in market activity

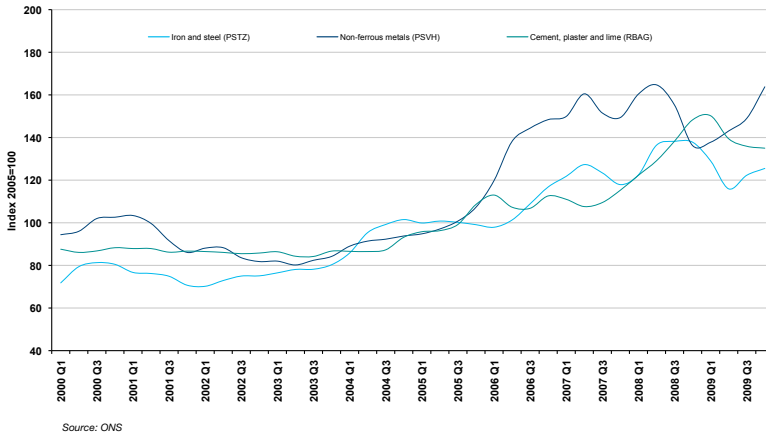


by between 12 and 18 months but compared to past booms, the overhang of speculative development is limited. Newly completed space coming to market in 2010 is predicted to fall to an historic low, and in recent months there has been a realisation among occupiers that availability will be limited post-2010. Rents have started to increase and are forecast to rise by around 15% in 2010, partly regaining the significant 35% fall in rents during the downturn.

Offices orders contracted significantly in 2009 as a whole, by 59% compared to 2008 and some 75% less than the 2007 peak. Knight Frank report that their speculative funding has been particularly badly affected with currently only 4 million square feet under construction compared to 10 million square feet just 24 months earlier, with previous demand constraints exacerbated by difficulties in obtaining finance. Yet, with increasing demand increasing and current spare

# Economic background and industry overview continued

## Selected input prices



forecast for 2011, 2012 and 2013 before the rate of growth slows marginally in 2014 by which time output will be roughly back on a par with 2006.

The risks to these industry forecasts are weighted to the downside. A double-dip economic recession cannot be ruled out when the unprecedented fiscal stimulus is withdrawn and the robust resurgence in commodities price inflation is a further threat. The timing and scale of pending public sector cuts, however, will be pivotal.

office space starting to be utilised, demand for new build is expected to return in 2011.

However, considering that a number of large schemes were postponed prior to construction in

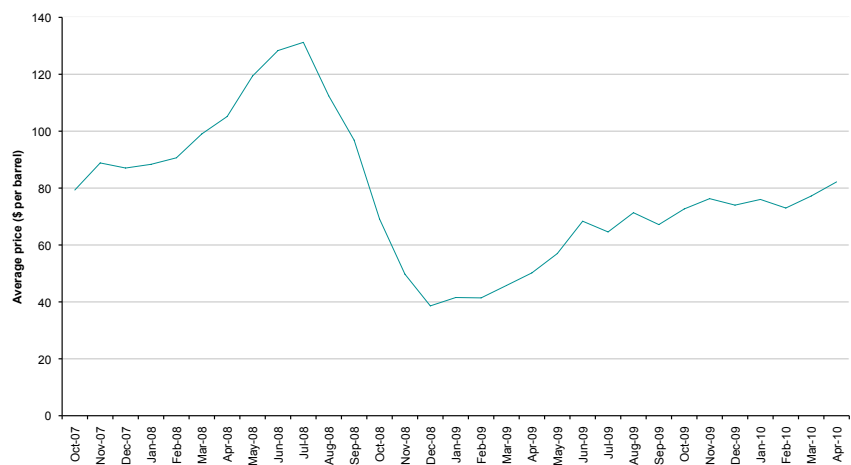
2008, there is a core of designed and approved projects ready to start on site when demand conditions permit. A further sharp contraction in 2010 is forecast to precede a bullish return to growth. Double-digit annual increases are

## Materials

Production volumes of raw materials and building components, in general, declined sharply for a second consecutive year in 2009. For metals, where export markets are firmly established and global demand is strengthening, production has rebounded strongly. Elsewhere, however, production levels have started to recover in 2010 Q1 from what were extremely depressed levels.

Sales of sand and gravel were down 3% and 6% year-on-year in 2010 Q1, according to the Minerals Products Association (MPA). In 2009, 55 million tonnes of sand and gravel and 86 million tonnes of crushed rock were produced,

## OPEC Reference Basket (monthly average price)



# Materials continued

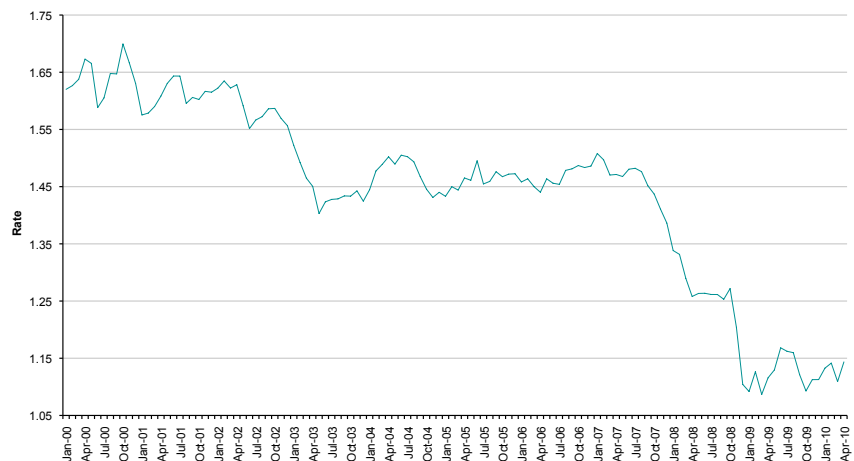
23% and 25%, respectively, lower than in 2008. Sand and gravel production peaked at 86 million tonnes in 2004 and crushed rock at 130 million tonnes in 2007.

Even during periods of industry growth, levels of cement production can be prone to fluctuations from quarter to quarter. However, since the start of 2007 production has contracted in eight out of the 11 quarters. From a peak of 3.2m tonnes in 2007 Q2, production levels fell to 2m tonnes by 2009 Q3, a contraction of 37%. 2009 Q1 was particularly weak at 1.8m tonnes but quarter-on-quarter production rose by 14% in 2009 Q2 and in the third quarter stabilised, possibly suggesting that production has bottomed out.

The rate of decline in brick production accelerated to 37% in 2009, compounding the 22% fall recorded in 2008 but production recovered in 2010 Q1. 285 million bricks were produced in the first three months of 2010. Brick production, however, had been in gradual decline in the decade leading up to the recession, not least because of the significant shift towards the construction of high density flats as opposed to more traditional houses.



Monthly average euro/sterling exchange rate



Source: Bank of England

Global steel production increased sharply in March, rising by 30.6%, compared to a year ago, to 120 million metric tonnes. In the first quarter of 2010, steel production in the EU area rose by 37% compared to the same quarter of 2009 but by far the strongest increase was seen in North America where volumes were up by nearly 55% during the quarter. As the traditional annual benchmark pricing system for iron ore is replaced by quarterly negotiations based on spot prices, analysts fear greater price volatility is inevitable and iron ore prices are forecast to rise by between 80% and 100% over the next 12 months. The World Steel Association warns that steel producers are unlikely to be able to absorb increases on this scale and the price of crude steel could rise by up to 15%. Even before the introduction of the new pricing system, pressure on raw materials prices has been mounting. Corus, one of the world's top ten steel producers, announced that transaction prices for structural sections will increase by £80 per tonne from 30 May.

From a low of \$39 per barrel in December 2008, oil prices have

increased robustly. In April 2010 the price of a barrel of Brent Crude averaged \$82, according to OPEC, an increase of more than 100% from December 2008. Prices, however, stabilised in April, easing marginally to average \$78 during the month. Further rises in oil prices are anticipated as the global recovery gathers pace, but a return to the pre-recession peak of \$147 per barrel, reached in July 2008, is unlikely. At its recent meeting in Vienna, OPEC voted to maintain current production levels even though a marginal increase in global demand is anticipated.

In April the sterling/euro exchange rate appreciated marginally to 1.14 from 1.11 in the previous month. Compared to the long term average, sterling was approximately one quarter lower. Prospects for sterling are subdued over the medium term as the breadth of the UK's budget deficit continues to weigh on investor sentiment. There was a similarly modest improvement in sterling's position against the dollar. In April exchange rates averaged 1.53, compared to 1.50 in March. March's level was approximately 8% lower than the long term average.

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## Labour

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More than 200,000 construction jobs were lost in the 15 months between September 2008 and December 2009. While the rate of decline in job losses slowed in the last three months of 2009, levels were nonetheless down by 9% on an annual basis, according to official statistics from the ONS. Across the whole economy workforce jobs were just 2% lower year-on-year in December 2009.

Industry wages have increased by around 1.5% over the past year according to the latest Labour Force Survey and in February, weekly earnings, excluding bonuses, averaged £554. On a monthly basis, however, average

wages fell in both January and February as annual contracts were renegotiated and, considering that recovery remains a dot on the horizon, may continue to do so as this year progresses and further jobs are shed.

Recent research from consultant Begbies Traynor suggested that construction firms continue to experience financial problems, with 30% more reporting significant or critical distress in the first quarter of 2010. In the three months to March 2010, 22,990 firms suffered financial problems resulting from difficult trading conditions compared to 17,736 in the last three months of 2009.




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## Conclusion

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Contracting demand and rising costs suggest that a tough year is in store for the construction industry over the next 12 months. Until the Comprehensive Spending Review in autumn, it will be difficult to gauge exactly what public sector cuts mean for the industry. The emergency budget in June is likely to communicate short-term decision about spending, but long term plans about capital expenditure are unlikely to be revealed until the Comprehensive Spending Review in autumn.

As we enter a more austere period, only spending in the NHS has been ring-fenced, but with no significant programme of work already committed, a budgeted fall in capital health funding of 17% is already in place this financial year. Even education is unlikely to emerge unscathed. The Building Schools for the Future programme has made good progress but commanding an outlay of between £2.5-£3bn per year, the programme is costly to the public purse and only three out of 15

schemes earmarked for funding in wave four have reached financial close making the scheme relatively easy to scale back.

The speed of the private sector recovery will therefore be crucial for the construction industry, but the latest economic indicators are mixed. Unemployment is at a 15 year high and rising, the UK's trade deficit is widening despite sterling's prolonged weakness against both the euro and the dollar and the financial markets remain

# Conclusion continued

acutely risk averse. Crucially for construction, business investment contracted by almost 25% year-on-year in 2009 Q4, a significantly sharper contraction than in any of the past three recessions and recent survey evidence suggests that investment intentions remain heavily subdued.

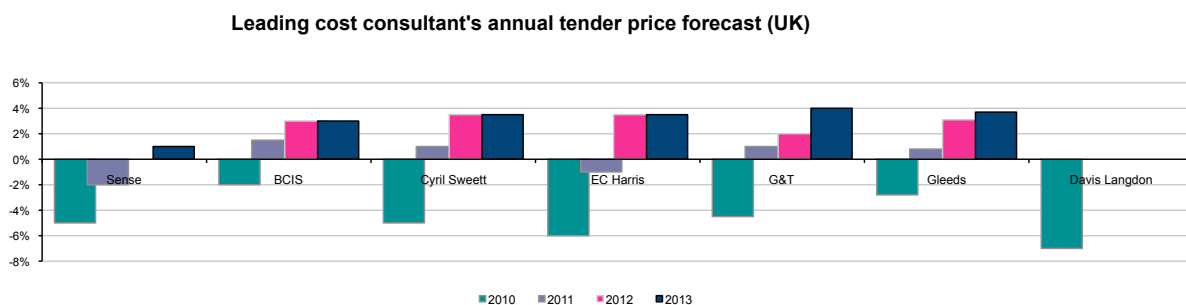
As the UK recovery fails to keep pace with other countries around the world and commodities prices continue to rise, contractors will face difficult pricing decisions.

While clients can secure exceptional value for money in the prevailing market, risks are high and procurement decisions must be made carefully.

**Analysis of the recent tender returns within Sense cost consultancy and Mace, a survey of Mace supply chain and a comprehensive review of industry and wider macroeconomic data has resulted in Sense maintaining its January forecast for tender**

**price inflation in 2010 at -5%. However, recent political developments have weakened medium term demand prospects for the industry, and prices are now expected to decline by a further -2% in 2011 before stabilising in 2012 with 0% predicted. Tender prices are not expected to return to growth until 2013 and even then only a marginal 1% increase is anticipated.**

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



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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