

3RD 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

In this issue

**IS BREEAM
SUSTAINABLE?**

IS BREEAM SUSTAINABLE?



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Traditionally, measures of sustainability on building projects – for example BREEAM and LEED have been based on a very specific and prescriptive set of “environmental” criteria – energy use, water consumption and even proximity to public transport.

Recent years have seen a growth in other types of certification – more focussed on occupiers and human health and wellbeing rather than just environmental performance, for example the WELL and Fitwel standards in relation to wellbeing and WiredScore for IT connectivity and resilience.

However, the effectiveness and value of these forms of certification is under question. Why?

PERFORMANCE GAP

A building may achieve a BREEAM “Excellent” rating which can be – in some cases – more than five years out of date before the building is delivered to the market.

There is an increasing body of research that suggests that actually there is little difference between the energy consumption of some “environmentally” certified buildings and buildings without certification. The argument that certification makes buildings more sustainable is not necessarily supported by the data (although it is helpful to have some common building standards for measuring sustainability). However, whether they drive higher environmental performance in buildings is questionable.

This “design for compliance” approach has led to a performance gap between how a building is designed and how it operates in practice. As a response, some third party

certification organisations are gathering more data on operational buildings and are looking to potentially recertify older buildings (how much better is a BREEAM 2018 “Excellent” building than an “Excellent” BREEAM 2011 building?)

In the UK, the Better Buildings Partnership is promoting the Design for Performance initiative to try to bridge the performance gap between how buildings are designed and how they perform in practice and we are now beginning to see this introduced on new development schemes in central London.

WHAT NEXT?

Although we are unlikely to see the demise of building certification just yet, there is certainly a move in the market from designing for compliance to a better assessment of actual building performance. At the same time, a more holistic view of sustainability – rather than purely environmental performance – but the wider social and community impact of buildings is becoming more important at a corporate level, not just in relation to reporting but how the value of real estate assets are measured.

This, coupled with technological disruption from outside of the construction and property industry in terms of real time information, which can be shared with other building users, about the actual performance of a building – air quality etc. may mean that in the near future the environmental performance will be judged not by the design team but by the building occupants.

This is an extract from a longer article.
Visit: [marketintel.gardiner.com](https://www.marketintel.gardiner.com) to read in full.

INTRODUCTION

UK construction output has been on a general downward trajectory since February. July's construction output data may have bucked this trend, but it followed a particularly weak month when bad weather delayed work on-site. Output in the three months to July (compared to the previous three-month period) contracted by 0.8% and corresponded with a slowdown in the economy.

Further evidence that the sector is contracting came from the Purchasing Managers Index (PMI). Although activity regained some momentum in August, the reading pointed to the fourth consecutive month of contraction. The August survey results revealed a further moderation in new orders, marking the slowest pace of new business growth in four and a half years.

Whilst Q2 2019 new order data doesn't paint a particularly rosy picture for UK construction, certain sectors such as infrastructure and private new housing remain fairly resilient. In central London, investment in offices fell by more than a third (37%) in the first half of 2019 compared to the first six months of the previous year. Further proof that, despite strong demand for space, capital continues to sit on the sidelines awaiting further clarification on Brexit.

TENDER PRICE FORECAST

Our latest tender price forecasts show some regional variation from our previous report. Whilst tender price inflation in East Anglia and Northern Ireland has been revised down from our previous forecast, the Midlands, Yorkshire & Humber, North West and North East have all been upwardly revised. We've seen stronger activity in these regions in this past quarter and most of these regions have also experienced construction output growth. These upward revisions, however, do not affect our weighted UK average forecast for 2019, which remains at 1%.

Our 2020 UK average forecast also remains at 1% but this could change (in either direction) quite quickly. Demand for projects and input costs are very dependent on the current political environment. A smooth and positive Brexit outcome that provides much needed certainty for the UK's economy could usher in an anticipated 'post-Brexit bounce'. In this scenario we would likely see more projects moving forward that were previously put on ice, improved demand and a stronger pound helping to reduce import-led material price inflation. We would also expect a less competitive market leading to higher tender prices.

Conversely, if the UK falls off the 'cliff-edge' with

a no-deal Brexit, we could see an even more competitive market with tender prices coming under downwards pressure due to lower demand. Higher input cost inflation compounded by weaker Sterling would likely mean that contractors would consider reducing margins to secure workload. The prospect of a general election and further changes to the global political climate only add to the unpredictability the industry is facing.

By 2021, we expect UK tender price inflation to rise to 1.5% - higher than previously forecast due to anticipated stronger growth in the North East and Yorkshire & Humber where the pipeline has improved in certain sectors. Our 2022 forecast remains unchanged at 1.5%

All forecasts take account of all sectors and project sizes as a statistical average, indicating an overall trend in pricing levels. Individual projects may experience tender pricing above or below the published average rate, reflecting the project specific components and conditions.

All forecasts continue to assume an orderly Brexit with open market trading conditions being retained.

MACRO ECONOMICS

After a contraction in UK GDP of 0.2% in Q2 2019, GDP recovered in July, rising by 0.3% and beating City forecasts of 0.1% growth. This meant rolling GDP growth was flat in the three months to July. Economists now expect that the UK will avoid a technical recession and grow in Q3, speculating that further stockpiling prior to the October Brexit deadline will boost growth.

Whilst manufacturing, services and construction industries all expanded in July, the three-month data series tells a slightly different story. In the three months to July, services was the only positive contributor to GDP growth, growing by 0.2%. Output in manufacturing and construction both acted as a drag on GDP growth over the period, contracting by 1.1% and 0.8% respectively.

August's PMI survey data found that new orders contracted for the fifth consecutive month, with commercial construction leading the decline. The PMI survey also found that input cost inflation fell to its lowest level since March 2016 due to softer demand for construction products and materials. As a consequence, respondents noted that this has helped to alleviate some of the pressure on the supply chain and has helped to lower delivery times.

The Consumer Price Index (CPI) 12-month inflation rate was 1.7% in August 2019, down from 2.1% in July. Inflation is now at its lowest level in almost three years. Economists believe that fears over Brexit and a slowdown in the economy may have discouraged

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



**M&E
COMPONENTS**

◀ 2.3% ▶



**FABRICATED
STRUCTURAL STEEL**

▲ 3.9% ▲



**CONCRETE REINFORCEMENT
BARS (STEEL)**

▼ -2.8% ▼



**READY MIXED
CONCRETE**

▲ 1.0% ▲

MACRO ECONOMICS



**UK GDP ANNUAL
GROWTH RATE
(Q2 2018-Q2 2019)**

▼ 1.2% ▼



**CPI
AUGUST 2019
(12-month rate)**

▼ 1.7% ▼



**UK
UNEMPLOYMENT RATE
May-July 2019**

◀ 3.8% ▶



**UK BASE
INTEREST RATE**

◀ 0.75% ▶

businesses from raising prices. Firms may be waiting to see beyond 31st October before making price adjustments. A no-deal Brexit and a weaker Pound would drive up the inflation rate in Q4. Concerns over oil supply are also likely to lead to increased input costs, raising prices across the supply chain.

Average weekly earnings (total pay) rose at an annual pace of 4% in the three months to July, in a sign that the labour market is surpassing expectations. Once adjusted for inflation UK wages rose above 2% for the first time in nearly four years. However, there are early signs that the labour market is cooling with lower than anticipated job creation and vacancies falling to their lowest level since November 2017. The unemployment rate fell to 3.8% in the three months to July 2019 - back to its joint lowest since the three months to January 1975.

Despite inflation being reasonably close to its 2% target, strong wage growth and low unemployment, the Bank of England (BoE) is expected to keep

REGIONAL BREAKDOWN OF CONSTRUCTION OUTPUT (ANNUAL GROWTH Q2 2018 - Q2 2019)

| REGION | CONSTRUCTION OUTPUT GROWTH % (Q2 2018 - Q2 2019) |
|----------------------------------|---|
| Greater London | 2.23 |
| South East | -2.93 |
| South West | -5.09 |
| East | 0.47 |
| East and West Midlands (Average) | 8.30 |
| Wales | 2.54 |
| Yorks & Humber | 7.16 |
| North West | 2.74 |
| North East | 14.07 |
| Scotland | 9.01 |
| Northern Ireland | 10.78* |

*NI output growth is between Q1 2018 - Q1 2019

interest rates on hold at 0.75% until the outcome of Brexit is known. With a deal in place the BoE has said that it plans to resume a gradual and limited series of interest rates hikes. Without a deal, the bank is likely to cut interest rates to support the economy.

CONSTRUCTION OUTPUT

In the three months to the end of July 2019, construction output fell by 0.8% compared to the previous three-month period. The fall meant that most of the output growth seen in the previous three-month period to April 2019 was given up in the three months to the end of July.

Construction output growth has been relatively flat since January 2017. Before Brexit-related uncertainty began to take its toll, construction output enjoyed a steady period of growth from early 2013. However, since the referendum, real output has expanded at approximately half the pace of the previous three years, with the monthly 'All Work' construction output figure hovering around £13bn - a clear sign that spending decisions continue to be put on hold.

Repair and Maintenance work has suffered the most in 2019. Its weakness has acted as a drag on All Work output. New Work output has performed slightly better but growth has still been largely flat in 2019. Over the previous 12-month period, the sector that has experienced the most growth has been public new housing (14.2%), closely followed by new infrastructure work (12.1%). Despite falling by -11.7% in July, public housing clearly benefitted in the months leading up to and after the removal of the Housing Revenue Account (HRA) borrowing cap in October 2018.

Although output growth in infrastructure has been fairly static in the first half of 2019, growth in the second half in 2018 was very strong. Many



MANUFACTURING OUTPUT

▼ -0.6% ▼



MARGINS

◀ Flat ▶



CONSTRUCTION INDUSTRY

*Average Weekly Earnings
(Annual Growth to July 2019)*

▲ 6.7% ▲



OIL PRICES (BRENT CRUDE)

(As of 24th Sep 2019)

▼ US\$63.1 bbl ▼

Figures are cumulative annual. ▼▲ denotes movement trend.



RPI
AUGUST 2019
(12-month rate)

▼ 2.6% ▼



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

▲ 4.0% ▲

will be eagerly anticipating further details on the Chancellor's promised "infrastructure spending revolution" that are due to be revealed in the National Infrastructure Strategy later this autumn.

The worst performing subsector was private housing repair and maintenance (down 12.6% in the year to July 2019). Households are reining in home improvement spending and the removal of benefits and tax advantages for private landlords has had a detrimental impact as landlords also have less money to make improvements. Public other new work has also performed badly over the past year, with output falling by 8.9% over the period. A lack of investment in public sector buildings over the past three years has impacted output growth.

NEW ORDERS

New order data in Q2 2019 was disappointing. According to the ONS, 'All New Work' new orders fell -13.3% between Q1 and Q2 2019, wiping out the 10% rise in new orders enjoyed in the first quarter of 2019. In fact, total new orders in Q2 were £10.92bn – the lowest quarterly value since Q1 2013.

New orders in all sub-sectors, other than infrastructure, experienced a contraction in Q2. Public other new work (-26%) and private commercial work (-24%) saw the largest quarter-on-quarter declines. Infrastructure grew in the quarter but only marginally (up 1%) but the ONS noted that a single project in the North West made up 46.1% of the new order value. In London infrastructure new orders actually fell by -94% compared to the previous quarter, making it the worst performing UK region for the sub-sector.

New orders have been volatile since the EU referendum, often experiencing extreme quarterly swings. However, these swings offer further evidence of latent demand as many clients are poised on the side

lines waiting until the implications of Brexit become known. Any delayed spending in the run-up to 31st October will have a negative knock-on effect on output growth in 2020, but if the UK leaves the EU with a deal we may see a surge of deferred investment towards the end of the year.

G&T continues to experience a steady stream of enquiries and opportunities in the pipeline. Government driven projects in infrastructure, healthcare and education are producing a steady flow of work. Public residential, hotel and hospitality sectors also appear to be fairly active. Whilst the political environment remains uncertain, the supply of new projects appears restrained which may lead to greater competition among contractors and keener pricing.

MARKET CONDITIONS

Our TPI survey found that market conditions are increasingly being described as 'competitive'. Work progressing to site is still buoyant and many trades are reporting that they are busy. For example, MEP contractors are reporting full or close to full order books for the remainder of the year and well into 2020.

The market has also been described as 'balanced' and 'stable', suggesting that whilst not becoming busier, opportunities are still available. However, contractors appear to be more cautious about submitting lower tender bids just to gain turnover and many main contractors appear to be choosing their clients based on potential repeat business further down the line.

Despite being the most commonly used procurement route, many clients appear reluctant to undertake a two-stage tendering process in the current market, as they desire a higher degree of cost certainty and the ability to pass on more of the risk to contractors. Single-stage is being used more regularly as the market becomes more competitive. Contractors have become more willing to contract on this basis so we may see this route becoming more prevalent over the next 12 months.

G&T has found that main contractors (particularly tier 2) are increasingly keen on identifying potential projects to fill their order book. Despite some labour

and material price inflation, tender prices are being kept in check by increased competition for work. In the short-term, however, the majority of respondents did not expect any major changes in tender pricing in the final quarter of 2019, with the most anticipating zero growth.

INPUT COSTS

MATERIAL COSTS

Corresponding with a slowing construction industry and reduced demand, construction material price inflation has softened in recent months.

The latest ONS data shows that the 'All Work' construction material price index increased by 2.2% in the year to July 2019 – the slowest annual growth rate since 2015. Since the EU referendum in June 2016, construction material prices have increased by approximately 13%, largely due to a weaker Pound raising import cost inflation.

The easing of material price inflation in the past few months can, in part, be attributed to a fall in commodity prices such as oil and increased global steel supplies adding downward cost pressure. Material prices may have also been affected by lower demand as some construction firms unwound their stockpiles that were built up in the run-up to the original Brexit deadline in March 2019.

Looking at the inflation of specific materials, prices for imported sawn or planed wood have continued to decline since our last TPI report. Since their high in December 2018, prices have fallen by -7%. Over the same period prices for imported plywood fell even further, declining by -13.1%. With limited domestic production, the UK relies heavily on imported wood but softer demand has, after a period of very strong inflationary price growth, put downward pressure on prices. Another material that has seen a notable drop in prices since our last TPI is concrete reinforcing bars (steel). Prices have dipped 2% since April, reflecting global declining steel prices.

Mounting Brexit and global uncertainty has reduced demand for UK construction projects. This is clear from the most recent new order figures. As a result, demand for construction materials has fallen, putting downward pressure on prices.

LABOUR

Average weekly earnings (AWE) in the construction industry increased by 6.7% in the year to July 2019 to £653 per week – a growth rate that was stronger than AWE for the whole economy, where earnings rose by 4.1% over the same period. Once again AWE growth in the construction sector was well ahead of annual consumer price inflation growth and continues to put upward pressure on costs.

Since 2000, the AWE annual growth rate in the

construction industry has been 3.2%. In only three of the last 19 years has annual AWE growth exceeded 6.7%. Despite the backdrop of falling new orders and sluggish output growth, there is a strong demand for skilled construction labour. The exacerbating skills shortage continues to put upwards price pressure on costs.

Bricklayers (masonry) and finishing trades have been particularly affected by a shortage of labour supply. According to our survey results this quarter, the proportion of respondents who anticipate a skilled labour shortage in London over the next six months remains broadly on par with our previous survey (around 63%). A lower proportion (29.3%) took a more neutral view on labour supply in the Q3 2019 compared to the previous quarter's survey (32%).

PROFITABILITY AND SUPPLY CHAIN

G&T has seen no evidence of any 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 15%.

Over the next 12 months, a growing number (25%) of survey respondents are expecting OH&P to fall from current levels, but most (63%) expect OH&P to remain unchanged. With less work around competition could tighten.

Slightly fewer respondents (16%) believe preliminaries will also fall. A greater proportion think that preliminaries will rise over the next 12 months (21%). The majority (63%), however, still expect preliminaries to remain the same, suggesting that if contractors do cut margins to secure work, they will need to at least maintain preliminaries at current levels.

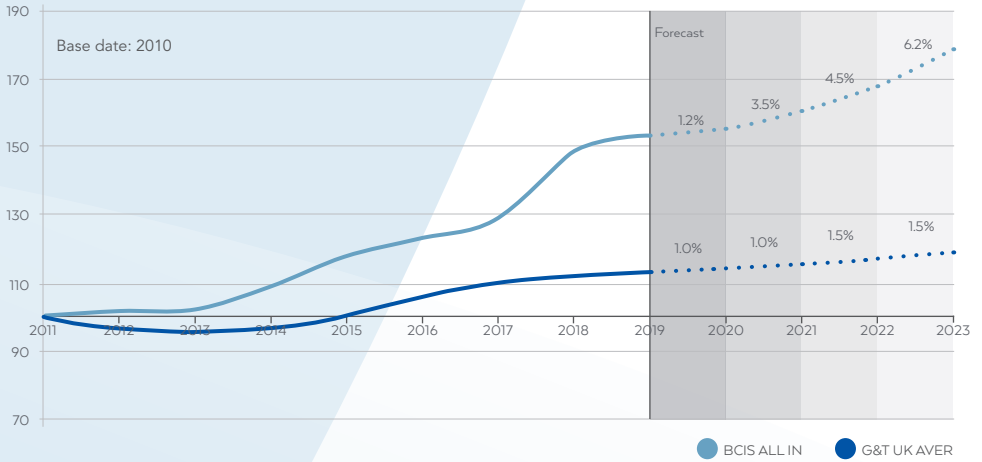
We continue to see a two-tier tendering market with smaller, low-risk schemes being competitively tendered and often coming in below our pre-tender estimates (PTE). Conversely, the larger and more complex projects are being less competitively tendered, partly because there is a smaller pool of tier 1 contractors that have the capability to take on the larger projects and also because these larger and more complex schemes are generally procured under a two-stage procurement route, resulting in higher tender returns.

Whilst the outcome of Brexit could have a significant impact on the construction sector in the mid to long term, for the remainder of 2019 we do not expect any major changes to construction activity. New orders and output are expected to remain subdued and tender price inflation low. Whilst input costs such as labour are still putting upward pressure on tender pricing, the recent easing of material prices has provided some respite to contractors.

TENDER PRICE TREND

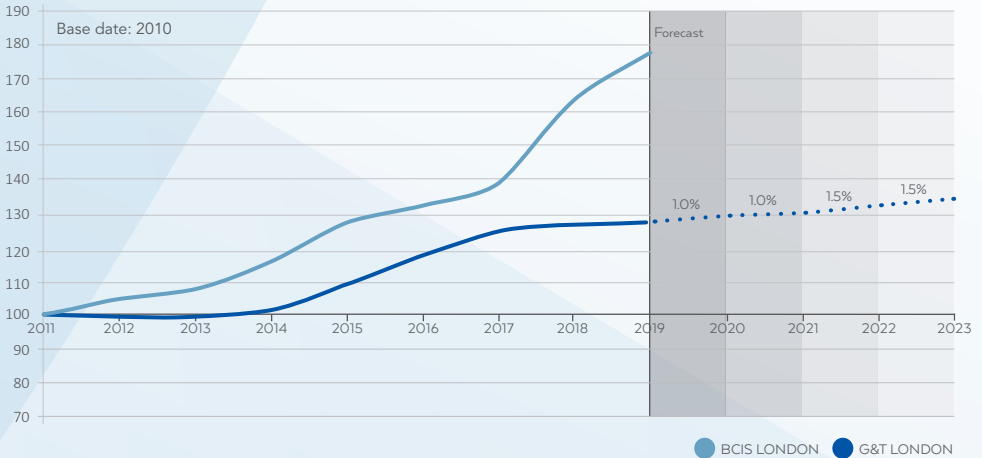
TENDER PRICE TREND "ALL UK TPI" Q3 2019

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TENDER PRICE TREND "LONDON TPI" Q3 2019

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Note: BCIS does not publish regional forecasts.

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 Q3 2019

| % | 2019 | | 2020 | | 2021 | | 2022 | |
|------------------------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|
| | Now | Last | Now | Last | Now | Last | Now | Last |
| Regional forecasts | | | | | | | | |
| Greater London | 1.00 | 1.00 | 1.00 | 1.00 | 1.50 | 1.50 | 1.50 | 1.50 |
| South East | 1.00 | 1.00 | 1.00 | 1.00 | 1.50 | 1.50 | 1.50 | 1.50 |
| South West | 1.00 | 1.00 | 1.50 | 1.50 | 1.50 | 1.50 | 1.50 | 1.50 |
| East | 1.50 | 2.00 | 2.00 | 2.00 | 2.00 | 2.00 | 2.00 | 2.00 |
| Midlands | 2.00 | 1.50 | 2.00 | 1.50 | 1.50 | 1.50 | 1.50 | 1.50 |
| Wales | 0.50 | 1.00 | 1.00 | 1.00 | 0.50 | 0.50 | 0.50 | 0.50 |
| Yorks & Humber | 1.00 | 0.00 | 1.00 | 1.00 | 1.50 | 1.00 | 2.00 | 1.50 |
| North West | 1.50 | 1.00 | 1.50 | 1.50 | 1.50 | 1.50 | 1.50 | 1.50 |
| North East | 1.00 | 0.00 | 1.00 | 1.00 | 1.50 | 1.00 | 1.50 | 1.50 |
| Scotland | 2.00 | 2.00 | 2.00 | 2.00 | 2.00 | 2.00 | 2.00 | 2.00 |
| Northern Ireland | 1.00 | 1.50 | 1.00 | 1.50 | 1.50 | 1.50 | 2.00 | 2.00 |
| UK Average (weighted) | 1.00 | 1.00 | 1.00 | 1.00 | 1.50 | 1.00 | 1.50 | 1.50 |

Note: 2022 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 |
|----------|-----------------|------------------|---------------|-----------------|-------------------|
| | Q3 2019 | SEPTEMBER 19 | Q3 2019 | Q3 - Q3 | Q3 2019 |
| % CHANGE | | | | | |
| 2019 | 1.00 | 1.18 | 1.00 | 1.80 | 2.00 |
| 2020 | 1.00 | 3.51 | 1.00 | 2.40 | 3.00 |
| 2021 | 1.50 | 4.52 | 1.50 | N/A | 3.00 |
| 2022 | 1.50 | 6.22 | 1.50 | N/A | 4.00 |

Note: All figures relate to year on year quarterly changes

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