

# Building Costs Update

Quarter 1 2009



# Market Overview

## GVA Grimley view

Between 2004 and 2007 a healthy economy, low interest rates and plentiful credit created an investment and development boom. In the three years to the peak of the market in June 2007, the capital value of all commercial property rose by 36% (IPD), and over the same time period there was a 50% increase in commercial construction orders. Like most strong property upturns, investment and development activity became overheated.

Since the Summer 2007 peak, IPD All-property commercial capital values have fallen 37.5% (June 2007 to January 2009), and Nationwide have recorded a 18% fall in house prices since October 2007. New office, retail and industrial construction orders have fallen 35% since their peak in Q2 2007 and in the private residential sector they have fallen by 47%. Resulting from this is a fall in tender prices, which past performance indicates follows a steep downturn in development activity.

UK economic growth is now declining at an accelerating rate. The Bank of England view, in common with many UK economists, is that the recession will be severe in the first half of 2009, to give an overall decline in output of over 3% in 2009 as a whole. A weak upturn is expected in 2010, with close to zero economic growth. This would make the current recession weaker than the early 1990's recession and more similar to the early 1980's recession in magnitude.

The recession is affecting occupier demand and rental growth, which is now negative. We expect the overall rental value decline to accelerate to 20% over the next three years, with the greatest falls in the central London office market. Capital values are falling more strongly and our latest forecast for 2009 shows a further fall in capital values of 15% and our expected peak to trough decline is 45%.

This cycle will therefore see a larger decline in commercial and residential capital values than in the last recession. There will continue to be a severe effect on development viability and a continuing drop in development activity over the next two years. The severity of the decline in development activity will also depend on the decline in tender prices, which in turn will be affected by the amount of total public and private sector construction activity.

Over recent months the worldwide economic downturn has caused a sharp fall in commodity prices and many raw material prices are significantly lower than they were last year, but the depreciation in sterling has partially offset this. More significantly, construction companies are now lowering their tender prices and squeezing their profit margins as they compete for fewer contracts in a declining market. In the early 1990's recession tender prices fell about 23% over the four years, 1990 – 1993, and an even greater fall seems possible in this recession.



Front Cover Image: 10 Crown Place, London  
Above Image: Spirella House, Oxford Circus, London

# Input Costs

Overall input costs have risen sharply in 2008 but the severe world economic downturn has dampened both construction material and labour inflation and we forecast more subdued growth over the next two years.

## Materials

- While tender prices have recorded a significant decline in 2008, underlying building costs rose strongly by 8% during the year. This is as a result of the sharp rise in commodity prices in the first half of the year. Subsequently there has been a sharp decline since the summer, particularly in oil, fuel and steel, which fed through to material prices at the end of the year and with the continuing deterioration in the economy, we are likely to see continued downward pressure in prices over the next two years. The BCIS forecast materials inflation at around 2% pa for 2009 and 2010, which is similar to general inflation.
- Due to the spike in prices experienced during the middle of the year for some construction materials, 12 month and 3 month figures are shown separately. This clearly shows the wide variation in price changes between different materials and how price changes altered during 2008. The difference between the change over the final 3 months of the year and over the year as a whole is marked.

Various Materials Price Growth to December 2008	Source: BERR	
	Dec 07-Dec 08	Sept 08 – Dec 08
Imported Plywood	29%	20%
Concrete reinforcing bars	20%	-19%
Asphalt products	18%	2%
Cement	13%	0%
Sand and Gravel	10%	1%
All bricks	-4%	-1%
Fabricated structural steel	10%	-17%
Imported softwood	-16%	-2%
Sawn Wood	-6%	-4%

## Labour

- According to the BCIS, wage settlements are expected to remain above inflation for the next two years as they have been for the last two years. The National Agreed Wage Awards show wage increases of 4-5% pa between 2006 and 2010. While site rates and labour cost inflation will remain subdued as a result of the industry's recession, labour with union support is more likely to maintain wages at slightly higher rates. Recent agreements in January include 5% for plumbers, 4.5% for electricians and 6.6% for steelworkers.

BCIS Forecasts (% change)				
	Q4 06 to Q4 07	Q4 07 to Q4 08	Q4 08 to Q4 09	Q4 09 to Q4 10
Nationally agreed wage awards	4.4	4.8	4.4	3.9
Materials Prices	3.8	8.1	1.7	2.1
Retail prices	4.2	3.6	1.7*	2.1*
Construction - new work output	4.2	-0.5	-7	-3

\* the consensus view of economists in February 2009 was for RPI to be -1.9% in 2009 and +2.6% in 2010

## Currency

- Poor economic growth and interest rate cuts have led to a decline in sterling of 28% against the dollar and 23% against the euro since the middle of 2007. This decline has increased the price of imported building materials, which make up about 25% of all materials and which are mainly imported from Europe. So the UK has not seen the full benefit of the sharp fall in oil prices and the price of raw materials.

## GVA Grimley view

Although unionised labour will benefit from pre-agreed wage settlements, remaining labour rates are likely to remain static as contractor's order books decline. This, along with reduced margins will more than off-set any labour cost inflation.

Day rates for trades such as plastering and decoration are falling as sub-contractors try and secure work in a tightening market. Main contractor's are squeezing their suppliers and sub-contractors to remain competitive. As the rest of the World falls into recession, the risk of eastern European construction workers returning home and restricting the labour supply in the UK has diminished.

Pricewaterhouse Coopers have reported that eight construction companies fail every day with unemployment in the construction sector looking to double this year. There have also been substantial redundancies in the related professional disciplines. Of immediate concern to our clients is the risk of service providers and contractors folding during a project. Our Construction Support and Insolvency Team recommend some of the following basic financial checks and procedures:

- Obtain Parent Company Guarantees or Performance Bonds from main contractors
- Run financial checks, although these can be of limited value as they report on historic accounts
- Check the ability of contractors to pay salaries and amount owing to sub-contractors, suppliers etc and the use of delaying tactics to ease cash flow burdens
- Analyse general state of sector in which contractors are operating

# Building Costs and Tender Prices

Construction output increased by 1.5% in 2008, but by Q4 it was declining by 0.8% year-on-year. This decline will accelerate, with a contraction of almost 9% expected in 2009 according to the Construction Products Association, and a further contraction of 4% in 2010 – a greater contraction than at any time since the early 1980s recession. Healthy growth should return in 2012, with growth in the private sector once again exceeding growth in the public sector, where spending constraints will be inevitable due to the very high level of public borrowing.

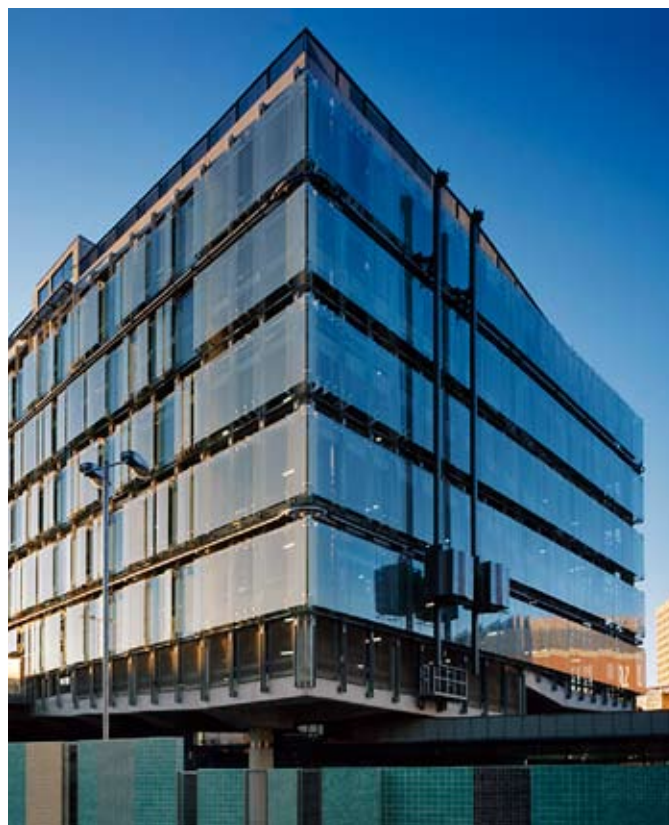
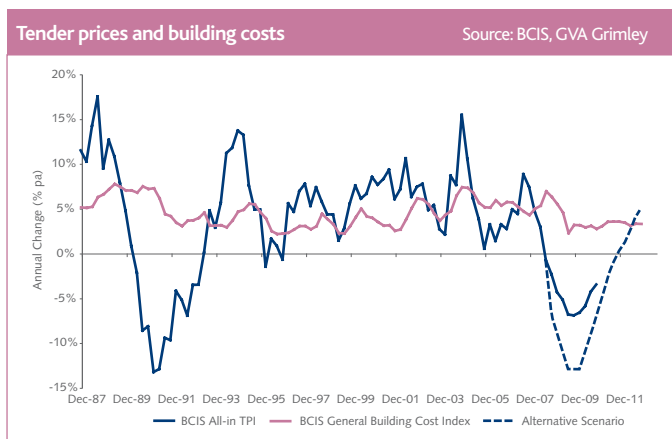
- Building costs increased by nearly 7% over the 12 months to Q3 2008, according to the BCIS, when overall (RPI) inflation was 5%. Over the next 12 months general inflation is expected to be much lower or even negative, with building costs forecast (by the BCIS) to rise by just under 3%. A similar building cost increase is forecasted over the following 12 months.
- At the end of 2007 tender prices were increasing at nearly 8% pa, almost double the general rate of inflation. With the fall in construction activity in 2008, tender price inflation weakened noticeably in the first half of the year and by Q3 tender prices were falling (1.2% fall over the previous 12 months according to the BCIS).
- BCIS forecasts have been revised downwards noticeably in recent months. At the end of 2008 the year-on-year fall was estimated to be 3.2%, with a further 7% fall expected in 2009 and 3.6% in 2010, due to the sharp fall in construction work over the next two years. The BCIS, therefore, expect an overall fall in tender prices over a three year period of about 13% due to the decline in construction activity.
- An alternative scenario is that the tender price decline will be much greater than this. As the economic recession is likely to be more severe than the early 1990s recession and as the decline in commercial and residential capital values has been greater than in the last recession, it is probable that the decline in construction activity will be greater (as expected by the Construction Products Association), even though the decline in private sector work will be partially offset by a strong public sector workload.

- An alternative scenario, therefore, is that the decline in tender prices could be as great or greater than in the early 1990s. In that recession tender prices fell by 23%, but due to high levels of general inflation, in real terms this was a 40% decline. Over the next two years general inflation will be very weak, so if the decline in tender prices was to match the early 1990s decline in real terms, this would mean an overall fall from peak to trough of about 35%.

## GVA Grimley view

With such a volatile market it is very difficult to forecast where the decline in tender prices will end up – there is just one certainty – a continuing downward spiral. Our current experiences would indicate a fall greater than the one forecast by the BCIS of 13% over a three year period. Certain sectors will be hit harder than others, with weak demand in industrial, retail and commercial. Relative “hot spots” are repair and maintenance and large infrastructure projects.

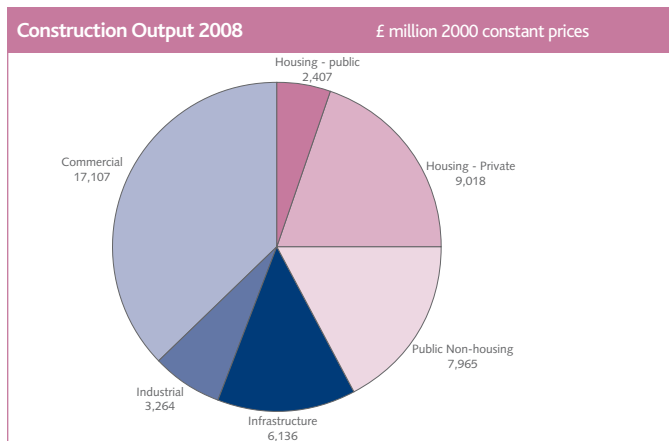
We are seeing substantial tender price reductions in the office fit-out sector of between 15-20% against budgets set in Q3 2008. Refurbishment contractors are moving in to the traditional office fit-out sector, placing further downward pressure on costs. Main contractors are complaining of fierce competition brought on by large tender lists but they themselves are obtaining prices from far more sub-contractors to remain competitive. The cost models for public sector framework agreements are being revised downwards, with around 8% being taken off budgets to account for anticipated construction price falls.



Manchester Transport Interchange

# Construction New Work Output

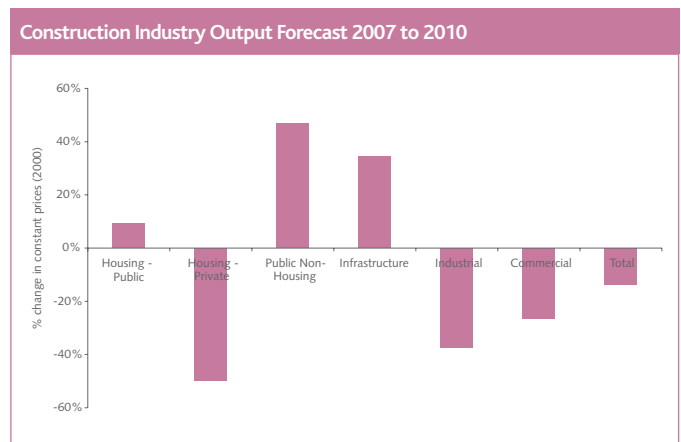
- In terms of construction output the Government has brought forward spending plans on construction projects to partially fill the gap in the rapidly shrinking private construction sector. As retail, office and industrial development plans are postponed or cancelled and housing starts fall to levels not seen since the 1920s, the Government has plans to boost spending on social housing, schools, hospitals and transport infrastructure.
- A third of construction output is currently accounted for by public construction (housing – public, public non-housing and infrastructure) and two-thirds private construction (housing-private, commercial and industrial). However, by 2010 this is forecast to be almost half and half, with an overall decline in output of 14% on 2007 levels.



- In the private sector, housing starts are forecast to have the greatest fall of 50% between 2007 and 2010, to levels not seen since the 1920s as house prices tumble and house builders struggle to obtain credit. A gradual recovery is expected from the end of 2010 / 2011.
- The private commercial sector made up 37% of the UK construction market in 2008. However, the occupational demand for office, retail and industrial space is expected to fall sharply over the next three years. Projects are being postponed and the fall in construction orders will feed through to output this year. Recovery in the commercial construction market is not expected until 2012.



The Walbrook, London



- Public non-housing will provide the most significant boost to the construction industry, increasing output by 47% between 2007 and 2010. 50% of this will be in the education sector from primary to College education, with the health sector and Olympics providing significant contributions. Spending will gradually fall after 2010 as the Government will need to reduce its borrowing after the end of the recession.
- Infrastructure will also provide a welcome boost to the construction industry, with work on rail projects such as Thameslink and Crossrail, while road improvements are being brought forward as a result of the pre-budget report.



Cookham House, Maidenhead

For advice and further information, please contact us:

**London**

Max Haycocks  
020 7911 2454  
max.haycocks@gvagrimley.co.uk

Ian Bragg  
020 7911 2749  
ian.bragg@gvagrimley.co.uk

**Birmingham**

Malcolm Smith  
0121 609 8224  
malcolm.smith@gvagrimley.co.uk

**Bristol**

Martin Hoyle  
0117 988 5310  
martin.hoyle@gvagrimley.co.uk

**Cardiff**

Mark Weare  
0292 024 8926  
mark.weare@gvagrimley.co.uk

**Edinburgh**

James Wright  
0131 469 6050  
james.wright@gvagrimley.co.uk

**Glasgow**

Danny Lafferty  
0141 305 6320  
danny.lafferty@gvagrimley.co.uk

**Leeds**

Jon Anderson  
0113 280 8054  
jon.anderson@gvagrimley.co.uk

**Manchester**

Graham Fairhurst  
0161 956 4400  
graham.fairhurst@gvagrimley.co.uk

**Newcastle**

Gordon Hewling  
0191 269 0515  
gordon.hewling@gvagrimley.co.uk

**London West End**

10 Stratton Street  
London  
W1J 8JR

**Belfast**

Rose Building  
Third Floor  
16 Howard Street  
Belfast  
BT1 6PA

**Bristol**

University Gate  
Park Row  
Bristol  
BS1 5UB

**Edinburgh**

Quayside House  
127 Fountainbridge  
Edinburgh  
EH3 9QG

**Leeds**

First Floor, City Point  
29 King Street  
Leeds  
LS1 2HL

**Newcastle**

Yorkshire Chambers  
112/118 Pilgrim Street  
Newcastle upon Tyne  
NE1 6LL

**London City**

80 Cheapside  
London  
EC2V 6EE

**Birmingham**

3 Brindleyplace  
Birmingham  
B1 2JB

**Cardiff**

One Kingsway  
Cardiff  
CF10 3AN

**Glasgow**

206 St Vincent  
Street  
Glasgow  
G2 5SG

**Liverpool**

Mercury Court  
Tithebarn Street  
Liverpool  
L2 2QP

**Manchester**

81 Fountain Street  
Manchester  
M2 2EE

[www.gvagrimley.co.uk](http://www.gvagrimley.co.uk)

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