ARCADIS
Design & Consultancy
for natural and
built assets

2017 AND THE NEW ERA OF VOLATILITY

2017 at a glance

- **Economic recovery still some way off despite positive early indications**
- **Falling demand for commercial property to see tender prices drop in buildings sectors**
- **Infrastructure tender prices to remain buoyant**

In a volatile, uncertain and complex environment, success will rely on the willingness and ability to take greater risks. Clients will need to take risks on programme and project decisions, whilst suppliers will need to take risks on pricing.

A key question is whether the adversarial tactics of previous downturns will make a comeback. With volatility all around, the winners will be those who manage to create the greatest certainty.

> “ON THE FACE OF IT THE UK ECONOMY HAS WEATHERED THE BREXIT STORM BETTER THAN EXPECTED. THAT SAID, THINGS COULD BE ABOUT TO CHANGE.”

HOW CONSTRUCTION CAN MITIGATE THE ISSUES AHEAD

Key Issues	Mitigations
MAINTAINING PROJECT DECISION MAKING	• Build in exit strategy at key break points • Take a long term view to 2020 and beyond • Ring fence contingency money ‘below the line’ to deal with high levels of uncertainty .
CHANGING BUSINESS CASES	• Revaluate business case components including costs, end user demand and benefits • Increase level of due diligence to better manage risk and spot opportunities.
INCREASED COMMERCIALITY	• Be prepared for increased levels of contractual behaviour • Up the game on record keeping • Increase collaboration with all tiers of the supply chain • Understand the supply chain’s position.
FINANCIAL FRAGILITY	• Take steps to help ensure payment is made in accordance with the contract conditions • Maintain neutral cashflow • Take steps to help ensure that risk transfer to the supply chain is proportional • Maintain transparent and open relationships with all suppliers.
RISING LABOUR COSTS	• Redouble efforts to make best use of existing resources • Explore increased use of technology to improve productivity or output • Continue to make specific commitments to apprenticeships.
RISING MATERIALS COSTS	• Quantify the true impact on your projects – it may not be as much as the headlines suggest • Eliminate currency risk through local sourcing • Review specifications to ensure they can be sourced from the UK as far as possible • Revisit buying strategies. Can they be bettered?

Economic outlook

On the face of it, the UK economy has weathered the Brexit storm better than expected, surpassing expectations in the short term. Economic growth forecasts have gradually risen over the past quarter and the Treasury's consensus forecast in December predicts GDP growth at 2.1 percent and 1.3 percent for 2016 and 2017.

That said, things may be about to change. 2017 looks set to be a slow year with a number of indicators signalling concerning issues over the longer term:

- The UK can borrow money at almost record low cost. This provides some respite on public finances but also reflects the market's expectation that further interest rate cuts lay in store, in response to future slowing in the economy. For SMEs, a lack of access to credit is still, anecdotally, acute.

- The Bank of England's Agents' Scores show that business investment sentiment is still generally falling. Investor demand for commercial real estate has fallen, particularly in London, with projects being challenged more rigorously and some scaling back or deferrals. However, many clients continue to build and there have been some positive recent examples including Google's new headquarters and 22 Bishopsgate reflecting the faith held in London's status as a global city.

- Consumer spending, which accounts for over 60 percent of GDP, is likely to take a hit in the longer term. Most large retailers have hedged their exposure to the dramatic fall of sterling which means prices will not rise significantly until mid-2017, triggering a slowdown in consumer spending.

- UK exporters should be celebrating the weakening of sterling, making their prices more competitive abroad. However, a boost to exports does not necessarily follow over the longer term, particularly considering a highly uncertain global trading environment. Demand for raw materials is raising costs and the threat of protectionism could drag down trade.

- The recovery of the FTSE100 and 250 can be interpreted as a sign that investors are putting their money into equities, perceived to be 'safe haven' assets. Revealingly, stocks related to the commercial building markets have generally bucked the trend of the wider indices and have not recovered to pre-referendum levels – reflecting sentiment towards the sector.

- The stability and health of the USA's economy is central to that of the world economy and the stability of global markets. Any negative impact on stability and positive growth in the USA will inevitably have a negative impact on the UK. However, the OECD recently endorsed Trump's ambitious infrastructure spending plans as a positive driver for economic growth.

What lies ahead for construction prices?

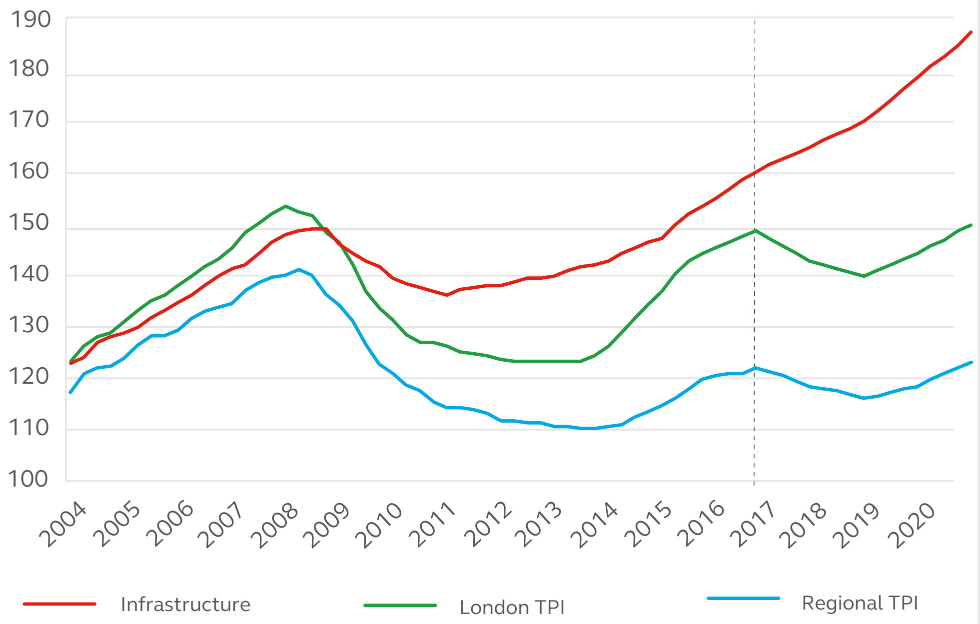
We do not currently see anything other than a two-year slowdown in demand in some sectors. Greater clarity through reduced uncertainty will be the catalyst for a return to buoyancy in these markets.

KEY QUESTIONS OF UNCERTAINTY

- Will the economic cycle support investment? The cyclical switch away from bonds is evidence that there is less demand and that yields will continue to rise. Furthermore, built asset value growth is slowing. Both residential and commercial rents have softened and sales prices are forecast to grow at a reduced pace or fall, such as prime residential, where sales values have fallen by as much as 10 percent.
- Who will keep building? How many clients keep building in the face of such uncertainty is the most critical factor. With increasing volatility, how many will have the confidence in end user demand and asset values to continue building?
- Will we see a race to the bottom? Suppliers have learnt from the last downturn and will aim to avoid no-margin bidding. According to a survey recently published by Leading Edge and Construction News, 74 percent of firms named aggressive pricing from their competitors as the top barrier to winning work over the next 12 months.
- How fragile is the supply chain? Despite improved conditions of the past few years, dysfunctional balance sheets still haunt the supply chain. Rising input costs, tighter lending conditions and any fall in new orders will increase the challenges associated with cash flow management.
- Can better management truly reduce costs? The current environment may present an opportunity to re-evaluate the efficiency and productivity of your projects.

“REDUCED UNCERTAINTY WILL BE THE CATALYST FOR A RETURN TO BUOYANCY.”

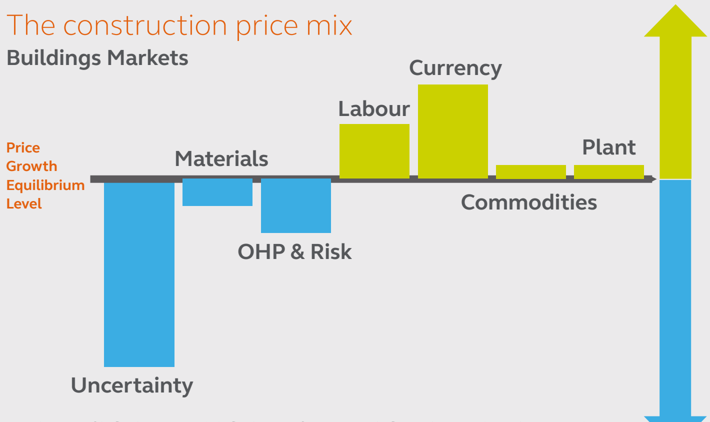
Year	Regional	London	Infrastructure
Q4 2016	+2.0%	+3.0%	+4.5%
Q4 2017	-3.0%	-4.0%	+3.0%
Q4 2018	-2.0%	-2.0%	+3.0%
Q4 2019	+2.0%	+3.0%	+5.0%
Q4 2020	+4.0%	+4.0%	+5.0%



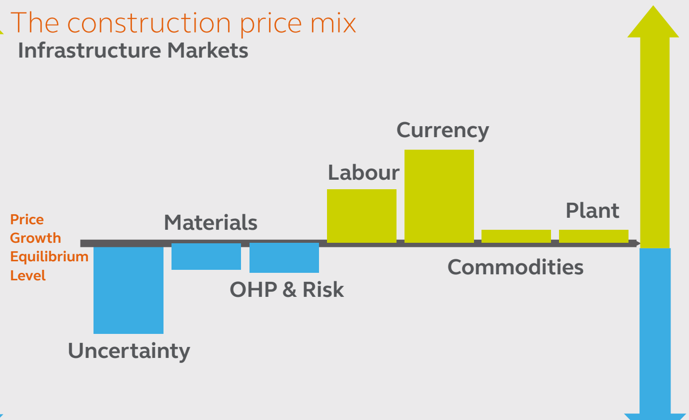
Q1 2000 = 100

Key assumptions behind this forecast include:

- Article 50 triggered H1 2017
- A Brexit-related economic slowdown taking hold in H2 2017 into 2018, driven by deep and continued uncertainty surrounding negotiations with the EU and resulting adverse impacts on demand levels in commercial buildings sectors
- Continued growth in infrastructure output as a result of government stimulus and its status as an attractive inflation-busting asset class for long term investors
- A return to growth in the regional and London indices from 2019 represents costs feeding through rather than price recovery, consistent with a stabilising market, as negotiations conclude, uncertainty lifts and the UK’s future economic performance becomes clearer.



A mixture of inflationary and deflationary factors are influencing tender price growth rates.



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Some factors have an inflationary effect on tender prices whilst others have a deflationary effect. For example, we expect infrastructure sectors to see continued tender price inflation and commercial buildings sectors to see falls in tender prices. Other influencing factors are explored in more detail in this tender price forecast section.

Other key factors that have been considered in our forecast include:

DEMAND-SIDE FACTORS

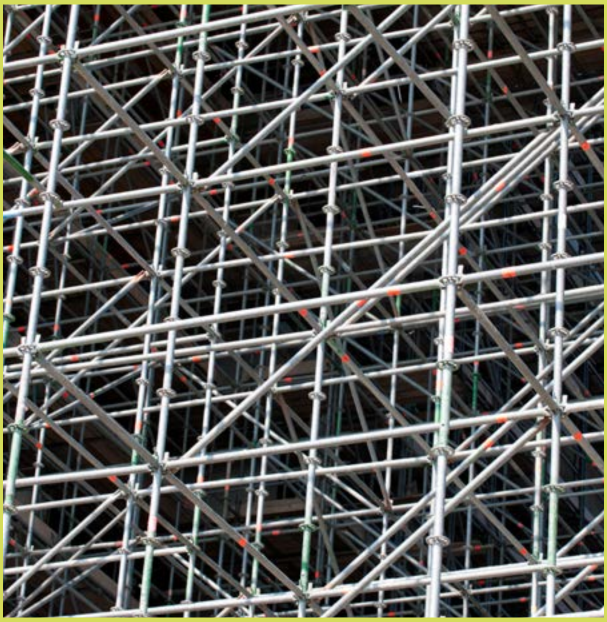
The Construction Products Association and Experian forecast that construction demand will be flat to 2019 overall. Different sectors will experience differing levels of demand fluctuations, with infrastructure set to see growth, whilst commercial buildings sectors carry a more bearish outlook currently.

- **Continued uncertainty.** Short-term positive indicators have overwhelmed a longer-term negative outlook. However, we expect ongoing uncertainty and volatility to potentially intensify in the first six months of 2017, coinciding with the trigger of Article 50. This is impacting decision making on construction investment and procurement. In some ways the uncertainty has not reached constructors yet but this may change in 2017.

- **Negative long-term economic indicators.** There are a range of long term indicators, such as investor sentiment and future consumer spending prospects, which give reason for a cautious view of future economic performance in the UK.

- **Construction's high sensitivity to economic performance.** Construction is highly cyclical, reacting to economic performance in an exaggerated way. Even minor bumps in economic performance will be felt harder in the construction sector than others and political and economic uncertainty will impact demand levels. In the wake of the referendum, the construction industry entered a minor recession according to the ONS.

- **Is a so-called 'hard Brexit' around the corner?** Notwithstanding a potential 'transition deal' mooted by Theresa May, rhetoric on all sides shows the prospect of an eventual so called 'hard Brexit'. A 'hard Brexit' will likely cause the greatest economic shock in the short term because of its remoteness from the status quo.



"A 'HARD' BREXIT WILL LIKELY CAUSE THE GREATEST SHOCK DUE TO ITS REMOTENESS FROM THE STATUS QUO."

Input costs

MATERIALS

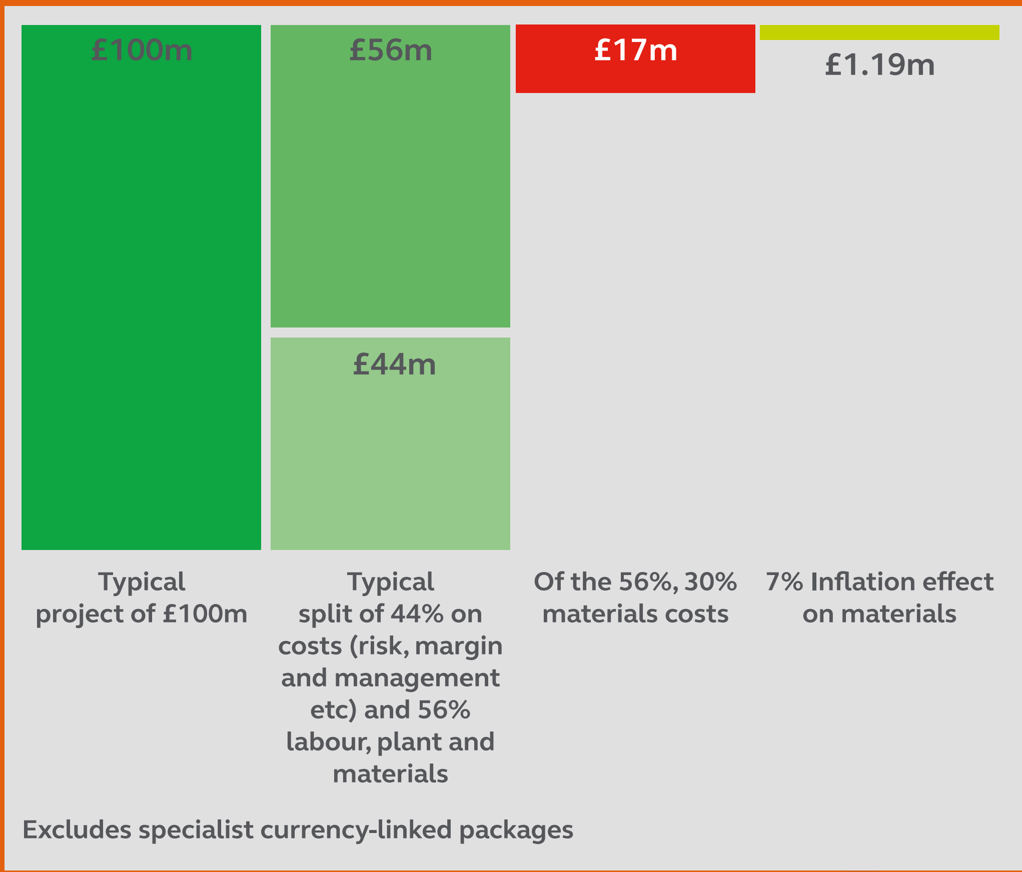
Currency-linked packages

There are some instances where the whole price of discrete and identifiable sub-contracts are directly impacted by exchange rates. These contracts tend to be associated with high-end projects such as airports, city centre offices and prime residential, where the value of these packages will typically be between 20 and 30 percent of the whole. Typical examples of affected packages include facades, switchgear and lifts. These have been directly affected by the full movement of exchange rates.

Less specialised projects

However, for many other projects, the impact of sterling's depreciation on the cost of construction materials may not be as significant as many believe. Changes in product costs as a result of exchange rate movements are not necessarily directly equivalent to the exchange rate movement itself. For instance, a 14 percent movement in the pound against the euro does not necessarily result in a 14 percent cost increase on all imported products from Europe.

Currency-linked materials cost inflation has fed through generally at around 7 percent. When constructing a typical commercial building, such as an office or retail development, around 55 percent of the cost is tied up in labour, equipment and materials. Therefore under our scenario herein, on a £100 million development, the impact of currency-related materials cost increases amounts to £1.19m, equivalent to 1.19 percent at the midpoint of a two-year programme. Although not insignificant, it is feasible that the construction supply chain could mitigate at least some of the additional costs.



LABOUR

The skills shortage looks set to be unabated for the longer term. Although construction demand in a number of key sectors is forecast at static or falling levels, the combination of Brexit and existing labour constraints means that the issue will remain an inflationary factor.

According to the BCIS and national wage award data, labour costs have increased by 2.7 percent in the year to November 2016. For the 40 percent of construction operatives who are self-employed, their earnings are likely to have increased at a faster rate, particularly since 2013.

PLANT

According to BCIS, plant costs rose in the year to November 2016 by 5.6 percent and were up by 2.2 percent on the month before. The main inflationary pressure on plant is the devaluation of sterling.

Sectors in focus

HOUSING

Registrations for private new homes dropped 5 percent during Q3 2016, according to NHBC's latest registration figures. UK residential transactions decreased by 4.3 percent between August and September and were 11.3 percent lower in September compared with the same month in 2015. In December, Halifax reported annual house price increases of 6.5 percent and a quarterly change of 2.5 percent. Residential development land prices have fallen with prime central London land prices down by almost 10 percent in the year. St Modwen, the property company, slashed £21m (3.75%) off the value of its share of a 57-acre site in London's Nine Elms after prices for homes in the area in central London began to fall. Residential construction has been one of the engines for growth in construction demand, growing by over 68 percent since 2009, and any potential fall in activity in cities like London and Manchester could have a knock-on effect in wider construction markets.

The government will publish a Housing White Paper, expected in the spring, setting out a comprehensive package of reform to increase housing supply and halt the decline in housing affordability. To help deliver this, the Autumn Statement announced the Housing Infrastructure Fund of £2.3 billion allocated to local government on a competitive basis to provide infrastructure targeted at unlocking new private house building. This will deliver up to 100,000 new homes. The government will also examine options to ensure that other government transport funding better supports housing growth. Additional funding of £1.4bn will deliver an additional 40,000 affordable housing starts by 2020-21.

COMMERCIAL

Investor demand for UK commercial real estate has continued to recover although sentiment remains fragile and transactions remain low. UK-focused REIT share prices remain well below pre-referendum levels – indicating wider market sentiment towards the sector. According to Lambert Smith Hampton, commercial asset values could fall as much as 13 percent in the next two years. With falling asset values but still relatively high construction price levels, viability challenges still exist and may persist.

The Bank of England's Agents' Scores indicate that occupier demand, particularly in London, is in decline. According to the RICS occupier demand fell for the second consecutive quarter in London with offices seeing the most significant dip. The BoE's recent financial stability report said that previously identified risks from an adjustment in the UK commercial real estate market have in part crystallised.

Whilst there have been some positive 'go' decisions such as London's 22 Bishopsgate, this future introduction of 1.4m sq ft into the market will also has the effect of 'crowding out' other competing schemes, impacting their viability. The go-ahead for Google and Apple's London schemes is positive news and reflects their global status, less exposed to Brexit specifically, as well as the dependence on London's status as a global city.

INFRASTRUCTURE

The past quarter has seen infrastructure under the spotlight with big decisions including Heathrow Third Runway, Hinkley Point C and reiterated backing for High Speed Two. Though the National Infrastructure Commission will not be enshrined under legislation as an independent body, its existence and purpose has been validated. The Autumn Statement reinforced commitment to infrastructure with £20bn of additional funding to 2020. It also set out the power for mayoral combined authorities to borrow for their new functions, allowing them to invest in economically productive infrastructure, subject to a borrowing cap with HM Treasury, offering promise that this local flexibility could facilitate pace and scale of delivery.

The consultation reviewing the valuation of 'benefits in kind' could mean that construction workers on major projects could be subject to significant increases in tax if accommodation and food was treated as a taxable benefit in contrast with today's position. If the range of taxable benefits were to expand it could increase costs in an industry that is already challenged to deliver better value, potentially inadvertently damaging the industry that is pivotal to boosting the UK's productivity.

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