BTG Financial Consulting

INDUSTRY UPDATE

Construction Issue 4: November 2016

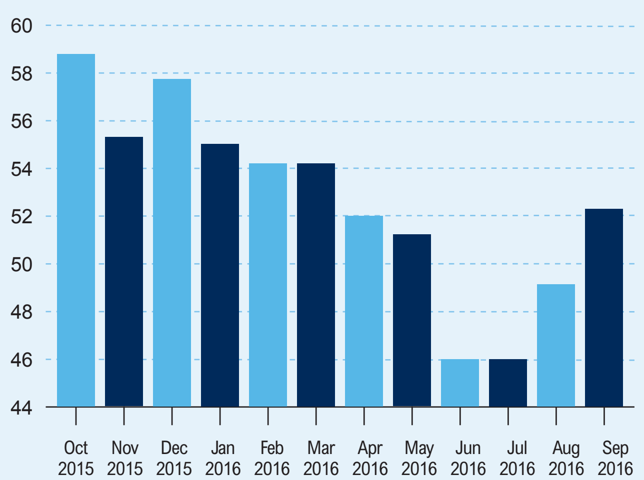
A case for cautious optimism

In the fourth in a series of construction updates, BTG Financial Consulting considers the outlook for the construction industry which, despite ongoing uncertainty, appears more optimistic as the Bank of England slashes interest rates, offering a strong boost to negate post-Brexit Referendum nerves.

At 46.0 in June 2016, the Markit/CIPS UK Construction PMI dropped below the neutral 50.0 threshold for the first time since April 2013. However, it was a slower rate of contraction than during the 2008/09 downturn, with better than expected performance in July when the PMI dropped to 45.9, barely changing from the previous month and much higher than some expectations of 43.8. It was soon to recover, though, jumping to 49.2 in August and reaching 52.3 in September. New order volumes continued to fall, but at a slower pace than the three-and-a-half year low seen in June, suggesting that the initial Referendum shock quickly gave way to a more sanguine approach.

Share prices in property and civil companies have leapt again since the Bank of England cut interest rates to 0.25% from 0.5%.

Markit/CIPS UK Construction PMI Market Data



Source: Markit/CIPS

Resurgence of Optimism in Housing

According to Markit/CIPS data, in July, residential construction was the worst performing subcategory, with activity falling at the fastest pace since December 2012. However, this should not disguise the fact that 41,222 new homes were built in the UK in the second quarter of 2016 – the highest number of houses built in any three-month period since Q4 2007.

The residential research arm of Savills reports that major housebuilders are well capitalised and transaction levels remain strong, with housebuilders likely to continue to benefit from continued government commitment to tackling the housing crisis.

Persimmon, the UK's leading housebuilder by volume, shares this optimism. It reported a 29% jump in pre-tax profits during the first half of 2016 and reports that customer interest remains 'robust', claiming that its private sale reservation rate since 1 July was 17% higher than at the same time last year.

"The group is now trading through the traditionally slower summer weeks but customer demand remains encouraging and we anticipate a good autumn sales season," said Group Chief Executive Jeff Fairburn.

Persimmon, Barratt Homes, Bellway and Taylor Wimpey have all registered significant gains since interest rates were slashed. Equity analysts at Shore Capital reported that market sentiment was moving to the view that Brexit could have a very limited impact on the housing market.

There may be other good news on the horizon. According to an August report in *Property Week*, the government is preparing to launch a new multibillion-pound fund to back property developers. The fund, which will be administered through the Homes and Communities Agency (HCA), will offer loans to developers across the residential sector, including the PRS, and will be aimed primarily at SMEs and developers using modular construction.

Short-term Impact on House Prices

Consensus among agents indicates a short-term limited drop in house prices nationally. Halifax, which maintains the longest-running house price index, recorded a decline of 1% in July, but the rate of decline has since slowed.

UK House Prices – July 2016 (Seasonally adjusted)	
Annual Change	+8.4%
Quarterly Change	+1.6%
Monthly Change	-1.0%
Average Price	£214,678

Source: Halifax House Price Index

In its first post-Referendum forecast, Countrywide predicts that house prices will fall 1% across the country in 2017, before rising by 2% in 2018, adding that house prices would rise by just 2.5% this year as the market slows in the second half of 2016. However, the cooling market should not be attributed just to post-Brexit uncertainty. Countrywide highlighted the impact of stamp duty increases at the top end of the market, but noted that the shortage of supply of homes would act as a brake to keep prices from falling further. And overall consumer confidence remains high with a 3.6% rise in retail spending – a key indicator – in July 2016 over the same period in 2015, according to the Office for National Statistics.

Distribution Analysis, Change in Reported Retail Sales Values Between July 2015 and July 2016

Standard reporting periods, by size of business

GREAT BRITAIN

Number of Employees	Weights (%)	Growth Since July 2015 (%)
100 and over	77.9	3.6
40 to 99	3.0	17.9
10 to 39	7.1	5.3
0 to 9	12.0	2.7

Source: Monthly Business Survey – Retail Sales Inquiry, Office for National Statistics

Note: The table contains information only from businesses that reported in July 2015 and July 2016; it shows reported actual changes in their sales.

London Malaise

The London property market has long been cited as in danger of overheating, having recorded stellar price growth in recent years. Here, a more marked decline can be observed, although some analysts believe that a natural correction was due, irrespective of the Brexit vote. More than £30,000 was taken off the price of an average property in July according to agent Haart. In prime central London, the price of residential land was down by 9.4% year-on-year in June according to Knight Frank. Sales of new builds have fallen by 43% according to analysis by London Central Portfolio. Countrywide concurs that London will be hit hard by price falls, particularly in the prime boroughs of Westminster and Kensington and Chelsea, where it predicts a price fall of 6% this year.

Mixed Commercial Outlook

The Q2 2016 RICS UK Commercial Property Market Survey shows a general deterioration in market sentiment following the Brexit vote with uncertainty depressing rental and capital value projections. However, demand in the north of England remained more buoyant with Savills declaring that office transactions in Manchester increased by 8% in the first half of 2016 compared to the same period in 2015. Both sources note that it is too early to distinguish the long-term impact of the Referendum.

One response to the present uncertainty is the growing use of short-term office contracts. Regus, which is the world's largest provider of flexible office space, said enquiries had risen 10% month-on-month in July, which it attributed to companies being more cautious.

On a UK-wide basis, the RICS Survey reports that occupier demand failed to rise for the first time since 2012. Respondents in virtually all parts of the UK also noted a decline in overall investment enquiries, but the trend was most pronounced in London. Savills point to a 28% decrease in the take-up of commercial space in the capital during the first six months of 2016. However, this did not stop London recording its highest rent ever in July when Kames Capital took on an additional 11-year lease at £107.00/sq ft in The Leadenhall Building. Moreover, the weakening of sterling suggests a positive outlook for the retail and leisure property market in central London and other tourist hotspots.

Savills reports that the overall retail property market appears largely unaffected by Brexit to date and both Aldi and Lidl have unchanged and ambitious expansion plans in the UK. Industrial space is likely to be supported by the weakening of sterling as exporters gain a boost while the warehousing and logistics sector is set to continue to grow, driven by the expansion in online sales – expected to account for 17% of all retail sales by 2020.

Potential Stimulus for Infrastructure

Major projects worth collectively over £400bn are in the pipeline to update the UK's antiquated infrastructure. But it was disconcerting that Barbour ABI announced in August that infrastructure spending fell 20% in July along with postponements of a decision on a new runway for Heathrow and other major infrastructure projects; there had also been uncertainty caused by the Prime Minister's delay until the autumn to give the go-ahead for the Hinckley Point C nuclear power plant, but that has now been confirmed.

However, there is strong hope for a stimulus package following the cut in interest rates and share prices in the sector have rallied, with Balfour Beatty plc and Carillion plc posting particularly strong gains.

Carillion's Chief Executive Officer Richard Howson commented: "I think it will be good news and there will be an increase in infrastructure investment. I can see a very busy decade between 2020 and 2030 in respect of infrastructure investment and delivery in the UK."

Kier's construction arm recently reported the firm had secured places on three major construction frameworks with a potential spend of £5bn. The latest is a place on the £500m University of Cambridge Framework. Kier has also confirmed it has secured a place on the four-year £4bn Department of Health ProCure22 Framework which was scheduled to begin in October.

Economists Simon Wells and Liz Martins at HSBC believe the government could borrow as much as £50bn to boost infrastructure spending, adding that: "In the current environment, the case for public investment is compelling."

Late Payment – A Major Constraint

Irrespective of future stimulus packages, progress is unlikely to be plain sailing. R3, the trade body for insolvency professionals, reported in August that at least one-fifth of UK corporate insolvencies in the past year were caused by late payment or the insolvency of another company. In its most recent survey, 57% of insolvency practitioners identified construction as the sector with the worst track record for late payment, a marginal reduction from findings from a previous member survey in 2014 of 59% but way ahead of the next worst performing sector relating to government and public sector procurement.

R3 President Andrew Tate commented: "Construction is considered to have the worst late payment problem and it comes as no surprise that it is consistently the sector with the highest number of corporate insolvencies. Late payment problems and relatively high insolvency rates are not a coincidence. If the sector could diminish the extent of this issue it would see an improvement in its business survival rate."

Anecdotal evidence from construction litigation specialists also points to an increase in disputes as major contractors seek to retain their own margins by applying pressure on subcontractors in the form of delayed payments as "low-balling", or deliberately under-bidding in order to win contracts and a common practice in the immediate post-Recession years, comes to an end.

Materials and Labour Shortages

Britain's brick deficit is another major concern. In 2015, approximately 85% of imported clay and cement came from the European Union, so Brexit could have a considerable impact on supply. Overall, materials prices have increased sharply due to the weaker pound. Markit/CIPS data in July showed that average lead times from vendors were the longest since the start of 2016, with respondents citing transportation delays and lower stocks among suppliers.

There is also still a profound shortage of some skills – notably quantity surveyors and bricklayers – and real concerns over the industry's long-term reliance on foreign workers. Meanwhile, the Construction Industry Training Board is deeply concerned about the government's new apprenticeship levy, warning that could see funding for construction apprenticeships cut by nearly a third.

Smarter Use of Technology Needed

To date, the industry has been slow to embrace digital technology, which could help address some late delivery and over-budget problems and deliver significant productivity gains as well as address some labour and materials issues. The adoption of new building materials, such as self-healing concrete, aerogels, and nanomaterials, as well as innovative construction approaches like 3D printing and pre-assembled modules, can lower costs and speed up construction while improving quality, safety and supply chain agility.

Higher-definition surveying and geolocation can limit site delays, which are a common occurrence due to unforeseen geological issues. Next-generation 5D Building Information Modelling enables architects, designers, contractors and owners of a project to visualise the progress of construction activities and related costs over time, significantly reducing the risk involved in complex projects. Robotics and drones are also likely to find many new applications with the smartest players in the industry over the coming decades.

Ending Uncertainty

The best thing for UK construction would be an end to the political uncertainty surrounding the Brexit vote. When and how the government will respond to the challenge are key questions that remain unanswered. Tim Moore commented: "UK construction firms frequently cited ongoing economic uncertainty as having a material negative impact on their order books. In particular, survey respondents noted heightened risk aversion and lower investment spending among clients, notwithstanding a greater number of speculative enquiries in anticipation of lower charges."

RICS suggests a possible slowdown in the market, and that the position will become clearer in Q4.

However, some analysts believe that the Bank Rate may be cut again in November to 0.1%, supported by another round of quantitative easing which could pave the way for an acceleration in infrastructure spending to stimulate the wider economy and boost the housing sector.

Indications are that there could be a slowdown, but not the major recession that some feared. Peter Vinden, Managing Director of the Vinden Partnership, a leading consultancy on the built environment, offered his summary of sentiment in the industry. "Once it becomes clear that trade will continue with EU member states and other trade deals are struck with new territories, we will hopefully start to see the industry return to normality."

For Further Information

If you would like to discuss any of the issues raised in this update or would like to know further details about the services we provide to the sector, please contact.

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