

Tender Price Forecast (Q2 2009)

Economic background

The UK remains mired in recession. Whilst there has been talk of an economic upturn, the evidence says otherwise. In fact, in the first quarter real-term GDP contracted by -2.4% quarter-on-quarter – the worst quarterly decline since 1958. Similarly, the associated year-on-year rate declined by -4.9% which was the worst since records began in 1948. This is now the fourth rather than the third successive quarterly decline after downward revisions to preceding quarters, making the recession not just deeper but longer too.

Delving into the detail of first quarter GDP, almost all sectors saw a further decline in activity with construction one of the worst afflicted sectors. Only the government sector saw any growth due to an expansion in health and social services, although this followed a decline in the previous quarter.

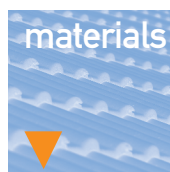
With the recession worsening, we continue to expect inflation pressures to abate with annual Consumer Price Inflation (CPI) dropping to an annual rate of 1.8% in June and likely to remain below the Bank of England's 2.0% target during 2009 and 2010. Retail Price Inflation (RPI) should be weaker still and we now expect it to be modestly negative during most of this year at about -0.7% for 2009. That said, with the evidential risk that the recession deepens as unemployment continues to rise, inflation could turn out to be weaker still during 2009.

Construction activity

The construction market has seen activity levels decline but with steeper falls in real-term output than the general economy. This was highlighted by the first quarter GDP data which showed construction output falling by -6.9% quarter-on-quarter, following a -5.0% decline in the final quarter of 2008. Whilst the construction PMI survey has shown signs of picking up since the start of 2009, it remains below the 50 level (marking constant activity) which is consistent with falling activity. Other market indicators and surveys such as Experian predict output will fall by 12% this year to £96.5bn, whilst the Construction Product Association (CPA) expects output to fall by 16% in 2009.

In terms of market sectors, residential activity remains in decline. In the first quarter private new build fell by a real-term -9.5% quarter-on-quarter, continuing the decline which started at the end of 2007. Public new build has again contracted with a -7.9% quarter-on-quarter fall, following -5.9% in the fourth quarter of 2008. Infrastructure recovered modestly after a contraction in the fourth quarter. Private commercial saw a -15.5% quarter-on-quarter contraction, but by far the weakest sector was industrial with a -20.5% real-term decline in the first quarter.

Input costs



The Building Cost Information Service (BCIS) estimates that materials cost inflation peaked at 7.6% in the fourth quarter and eased to 4.1% in the first quarter. A further easing is likely over the coming quarters and BICS predicts that materials inflation will average -2.6% over the second half of 2009.



Rising construction layoffs are keeping labour cost inflation in check. In the first quarter alone there were 49,000 redundancies, compared to 109,000 for the whole of 2008. Construction earnings (including bonuses) increased by just 1.5% in first quarter, following a contraction of -2.3% in the final quarter of last year.



Steel products have continued to fall in price, prompting further cuts in production and the mothballing of some plants. Iron ore prices continue to fall, suggesting it is too early to expect a recovery in steel prices despite tentative signs of a re-build in steel inventories.



Oil prices have risen modestly during the second quarter, but remain well below their summer 2008 peak of \$147. Crude oil is around \$60 per barrel, up from about \$40 at the turn of the year. UK gas prices have continued to fall and are about 25p per therm, compared to around 70p per therm at the start of January 2009.



Annual CPI eased to 1.8% in June from its peak of 5.2% in September. CPI inflation should continue to moderate and fall below the Bank of England's 2.0% target during both this year and next. We expect CPI to fall from 3.6% in 2008 to 1.2% in 2009, before recovering modestly to 1.8% in 2010 and running a little above target thereafter.



After six successive monthly interest rate cuts, interest rates have been held since March at an historic low of 0.5%. The Bank of England has instead shifted its focus to its £125bn financial asset purchase programme, to try to bring down market interest rates on a range of financial products.



Sterling has recovered modestly since stabilising against the euro and US dollar at the start of 2009. It is trading at over \$1.6 compared to \$1.45 at the turn of the year. Against the euro sterling has recovered modestly to over €1.15, compared to a little over €1 at the start of the year.



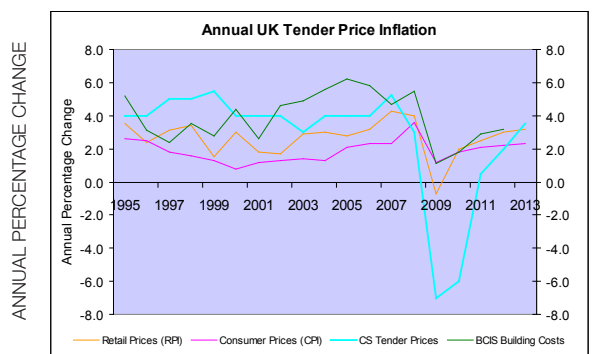
The public finance deficit hit £87bn for fiscal year 2008/09, compared to £35bn in 2007/08. HM Treasury raised its forecast deficit for the 2009/10 fiscal year to £175bn – equivalent to over 12% of GDP. The April Budget announced tax rises on fuel and deferred tax rises over the next two years, but with the high public deficit additional tax hikes look inevitable.

Tender price inflation forecast

After projected average UK tender price inflation in 2008 eased to just 3% from 5.25% in 2007, we expect a further weakening of the market in 2009 and into 2010. With the construction market recession deepening alongside the ongoing economy-wide recession and falling inflation pressures, we have downgraded our latest tender price inflation projections.

We still expect average UK tender price inflation to fall both during this year and next, but project larger declines of -7.0% during 2009 and -6.0% during 2010. However, our forecast for a modest upturn in tender prices of +0.5% in 2011 as market activity recovers in late 2011 remains unchanged with the upturn strengthening during 2012 and 2013.

UK TENDER PRICE INFLATION



Premium price effects

The tender market across regions is not however completely uniform and despite recessionary market we do still expect some regions to achieve a modest premium relative to the UK average.

The South East, Central London and Scotland continue to achieve a modest premium to the national average as a result of existing projects and the pipeline of major works. We expect this premium effect to continue over the forecast horizon but with Scotland likely to see its premium effect relative to the UK begin to fade by 2011.

In Ireland, the Republic is experiencing a continued decline in tender price inflation which began in 2008 and we expect the rate of decline to moderate during 2009. By 2010 the market could see a more modest decline than the UK and achieve a premium. In Northern Ireland, so long as the Assembly continues to release schemes onto the market and any cutbacks in public spending in 2010 are limited, there is scope for a modest premium relative to the UK average.

Regional market conditions

London and the South East are continuing to slow but the rate of decline appears to be easing. Fewer private commercial projects are being cancelled or postponed, though cancellations still remain at a high level. The market is being supported by education, health and infrastructure projects, notably Crossrail and Thameslink.

East Anglia is now contracting and expected to weaken further during 2009. Funding requirements are becoming more onerous and confidence remains fragile which is holding back development activity, especially in residential and offices. Education, health and infrastructure are the only parts of the market not in decline.

The South West is seeing a further fall in activity, though activity is expected to begin to stabilise during the second half of 2009. The public sector remains busy, with continued projects in education, health and infrastructure, though there is concern about future public sector orders.

The Midlands is experiencing a stabilisation in activity, though we do not expect this to be sustained with a renewed decline during the second half of this year. Education and health are the mainstays of the market with limited private commercial projects near-term.

Wales is still contracting activity-wise but could see some stabilisation in activity levels during the second half of 2009. Public sector projects in education, health and housing are being keenly chased by tenderers as there is limited private work.

The North West construction market remains in recession. Private commercial workload continues to fall. Education, health and infrastructure are now seeing increased activity but we do not expect this acceleration to be sustained during the second half of 2009.

Yorkshire and Humberside is seeing a stronger decrease in activity. Private commercial activity is continuing to fall due to the economic recession and funding constraints. Public sector activity in education, health, infrastructure and residential is still steady.

The North of England is seeing a stabilisation in activity which is spreading outside of education and health. In residential, smaller projects are re-starting on site and some larger projects are set to commence.



Scotland is experiencing a faster decline in activity, driven by further weakness in private commercial. Public sector activity remains steady. Infrastructure is set for a further acceleration later this year as a result of major projects associated with the Commonwealth Games.

Northern Ireland is stabilising activity-wise after several quarters of decline. Private sector activity does still remain weak, but there are signs of stabilisation appearing in leisure and residential. Public sector activity is generally steady; health and infrastructure are seen expanding during the second half of the year.

The Republic of Ireland is continuing to contract. Private commercial activity is still decreasing with few new projects and existing projects being built out. Education and health are steady. With the public finances deficit still rising public infrastructure projects are being stopped, slowed down or in some instances re-tendered.

Market outlook

We still expect the construction markets in the UK and Republic of Ireland to see falling levels of activity during 2009 and into 2010. Both countries remain mired in economic recession, with construction remaining one of the worst hit sectors.

In the UK, the revised -6.9% quarter-on-quarter real-term decline in the first quarter has prompted a re-assessment of the severity of the downturn. The UK could now see a double-digit real-terms market contraction this year as Ireland did last year. A further modest decline remains likely for 2010 with no pick-up until the end of 2011.

Uncertainty is also created by the fact that a General Election is due by mid 2010 at the latest and this is likely to cause a hiatus in the decision-making process for Public projects and fiscal restraints are likely to lead to a reduction in public expenditure.

Explanatory notes

This report provides an estimate of annual average tender price inflation with projections over five years. Regional estimates are based on projects across all sectors of the market. The UK average is an activity weighted average of the regional estimates. The tender price inflation numbers published in this report provide a benchmark for projects which will need to be adjusted to take account of project specific commercial factors as noted below.

Commercial factors

Each individual project should be reviewed on the basis of specific project factors. This includes, but is not limited to the following factors impacting on pricing:

- attractiveness of scheme (e.g. procurement route, complexity, scale, location, risk, etc).
- keenness of tenderers (e.g. local market dynamics, workloads, hot spots, realisable margins, etc).

TENDER PRICE INFLATION FORECASTS (% rates)

	2007	2008	2009	2010	2011	2012	2013
East Anglia	5.50	3.00	-7.00	-6.00	0.50	2.00	3.50
East Midlands	4.50	2.75	-7.40	-6.30	0.50	2.00	3.50
West Midlands	4.50	2.75	-7.40	-6.30	0.50	2.00	3.50
North	5.00	2.75	-6.75	-5.75	0.50	2.00	3.25
Yorks & Humber	5.00	3.00	-7.25	-6.25	0.50	1.75	3.25
N West	5.00	3.00	-7.25	-5.50	0.50	2.25	3.50
N Ireland	5.00	2.50	-6.50	-5.50	1.00	2.25	4.00
Scotland	4.50	3.50	-6.50	-5.60	0.50	1.75	3.25
Greater London	6.50	3.50	-6.50	-5.50	0.95	2.50	4.00
South East (ex London)	5.50	3.25	-6.75	-5.60	0.75	2.25	3.75
South West	5.50	3.00	-7.00	-5.90	0.50	2.00	3.50
Wales	4.50	2.50	-7.75	-6.90	0.50	1.75	3.25
Republic of Ireland	3.00	-18.00	-7.00	-1.00	1.00	2.00	4.00
UK average (exc. ROI)	5.25	3.00	-7.00	-6.00	0.50	2.00	3.50

The Republic of Ireland's construction market remains in recession. Even the public sector, is in decline due to cut-backs needed to control the budget deficit which is set to top 10% of GDP. Market indicators point to the downturn deepening this year as the economy could see a real-terms contraction of about -9% this year compared to -2.3% last. We do not expect construction activity to begin to stabilise until the end of 2010.

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