Bradbrook

Construction Bulletin | Spring 2015

Bradbrook

Headlines

- UK economy records strong 2014
- Consumer price inflation nears 0%
- Construction tender prices rise 7.1% over whole of 2014
- Private Commercial work output ends 2014 on a down
- Strong forecasts for the hotel sector for 2015 and 2016

Bulletin #01
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UK Economy Overview

The data for the last quarter of 2014 was largely happy reading for the current government as the May general election approaches. The economy grew by 2.6%, the highest of any G7 country, low inflation meant that real wages were finally rising and unemployment continued to fall.

However, as always, the statistics don't reveal the whole picture. The final quarter GDP figure showed a slowdown from the 3rd quarter, and the construction sector posted disappointing figures at the end of 2014, falling 1.1% on the previous quarter. Furthermore, construction output for January 2015 was the lowest in almost 2 years. We expect this to be more of a brief slowdown rather than the start of another downturn, as the fundamentals for investment are largely good. But perhaps the memories of 2008 are giving rise to caution.

Falling inflation in the second half of 2014 brought good news to consumers and business by raising real wages and reducing pressure on the Bank of England to raise interest rates, which remain at 0.5% for a record sixth year. Rates are now not expected to increase until the end of 2015 at the earliest.

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However, the welcome rise in real wages are attributed more to falling inflation as a result of plummeting oil prices rather than rising wage packets and improved productivity. This means the rise in real wages could end as abruptly as it started if oil prices snap back to the upside, although with global demand subdued that is unlikely in the short term.

Either way, the government will be hoping that inflation does not fall much further for too long. The Bank of England has already signalled we may be in for a couple of months of deflation in the spring, but if this continues, then it is questionable how much power the bank will have to stimulate spending given the already record low interest rates and huge asset purchasing programme.

Aside from inflation/deflation worries the outlook for the UK in 2015 is positive. The Treasury's survey of forecasters expects GDP to increase by 2.7% for the year, falling to 2.3% for 2016.

International Overview

There are, for a change, encouraging signs from the EU. Unemployment is falling in most of the larger economies, growth was 0.9% for 2014 (forecast 1.3% for 2015), and Greece's exit has been postponed. The ECB is also engaged in quantitative easing, which, it is hoped, will encourage business lending. However, there are serious concerns over deflation, especially as consumer confidence is already so low.

> There are encouraging signs from the Eurozone.

The big international economic stories over the next 12 months are likely to be the price of oil, which has risen from its January lows of $45 and is hovering between $50 and $60, and currency fluctuations as the EU embarks on quantitative easing and the dollar regains its fans. The Euro is likely to fall against the pound in the coming months, which is good for those importing goods and services, but could have a negative impact on tourism, exports and even foreign direct investment. Conversely, the dollar is expected to strengthen throughout the year, with Sterling already close to a 5-year low and the Euro nearing parity.

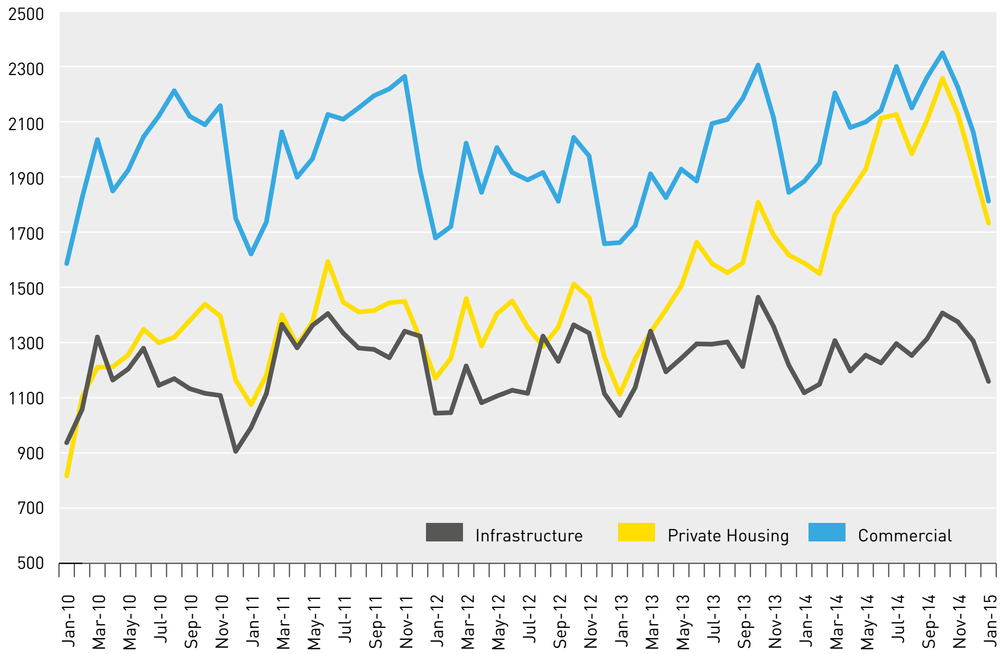
There is also some concern that global demand is flagging, especially in China which is on course to record its lowest GDP growth for almost a quarter of a century at around 7.5%. The Baltic Dry Index, which measures the physical movement and therefore demand for raw materials, has also been very low in Q1 2015, and the slump in oil prices could be seen as another indicator of weak fundamentals.

For now the outlook is cautiously positive, albeit with a number of potentially severe downside risks.

Construction Overview

The performance of the construction sector in 2014 was strong overall with total new work output increasing by 13%. However, the end of the year brought some disappointing figures, with all sectors showing declining output from October to January.

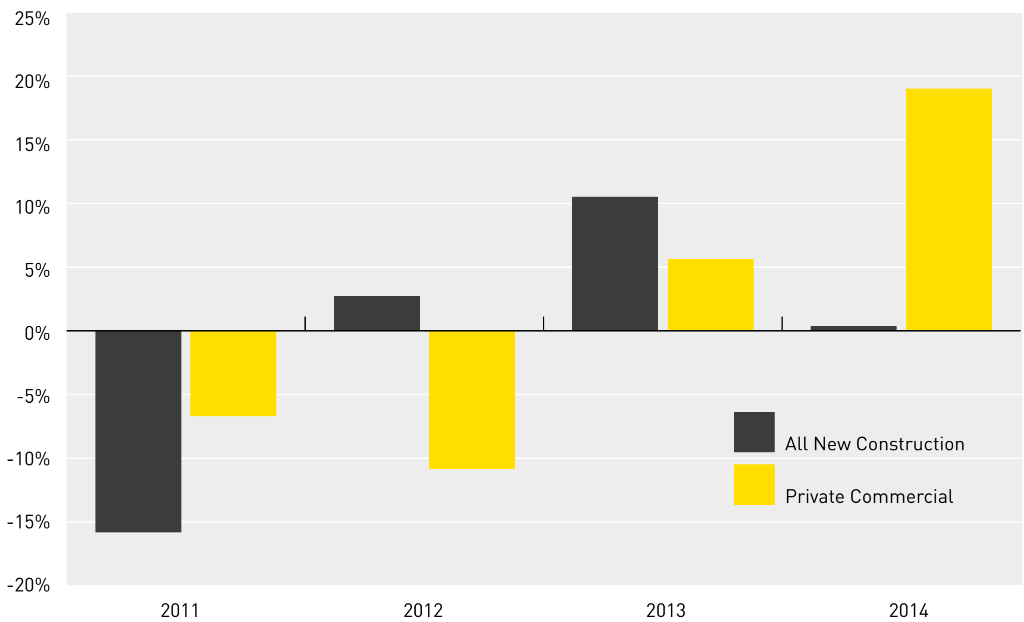
New Work Output Value By Quarter



Source: ONS

It is important to look at the larger picture and not get too caught up in short term snapshots. We take some encouragement in the broadly good figures for new work orders in 2014, which were especially strong for private commercial work.

Annual Change In New Work Orders



Source: ONS

The dip in output at the end of 2014 is most likely a temporary respite rather than the start of a protracted slowdown, possibly as clients wait until the outcome of the general election before committing to investments.

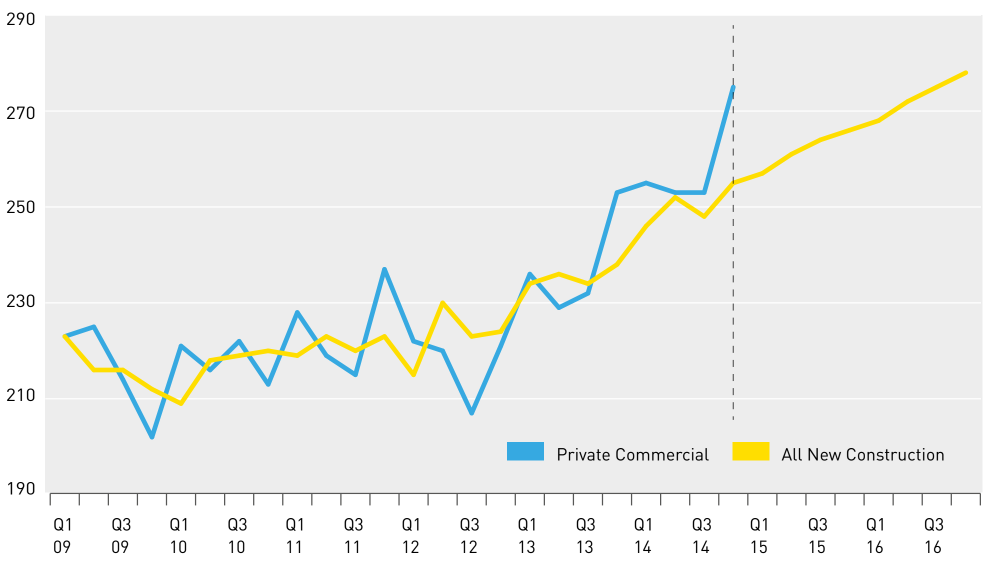
The consensus is still that 2015 will see the construction industry grow, with forecasts for new work output in 2015 in the 6% to 8% range, decreasing to around 5% for 2016.

The outlook for the commercial sector is also positive for the next twelve months, with consultants CBRE expecting investment in property to increase by 10% on last year's £63bn. It's also worth noting that more of this investment is coming from cash-rich, equity based sources, mainly sovereign funds and pension managers looking for steady returns.

Naturally, with demand for work increasing the cost of doing that work has also risen. 2014 saw tender prices rise by 7% due to a combination of a lack of capacity in the market and contractors looking to rebuild margins that were slashed during the recession. For the private commercial sector the increase was even greater at 8.7%.

We expect tender prices to continue to rise in 2015 and 2016, but at a more moderate 5%. Short term supply constraints on contractors and capacity should ease in 2015, making tenders more competitive. And whilst wages are likely to rise at a faster rate, around 3%-3.5%, materials prices will remain subdued, helping to keep input costs down.

BCIS Tender Price Indices + Forecast



Source: BCIS

Hotel Sector Update

The hotel construction sector looks buoyant for 2015 and 2016. London remains one of the top tourist destinations in the world and the stability and performance of the UK economy makes the country at large an attractive option for overseas investors. This appears to be borne out by the fact that London has more hotel rooms under construction (over 4,000 according to PWC) than any other European city.

When compared to other types of private commercial work, the hotel and leisure sector has posted some very encouraging figures recently. The value of hotel construction for the year to Q4 2014 was £3.1bn, up from £2.7bn in the year to Q3 2014, which is higher than the growth in offices and retail in percentage terms.

The fundamentals of the industry also appear to support the case for hotel construction. RevPAR for London is forecast to increase by around 4.5% over the next two years (2nd highest in Europe), with occupancy in the low 80% range (top 3 in Europe). Based on these figures London is likely to remain one of the very strongest markets for the hotel business for the next few years.

However, London's popularity with investors does have its downsides. Land costs, tender prices and other London specific costs have conspired to increase construction costs, making other areas of the country look like more attractive investment options. While provincial projects may lack the economic security and prestige of London projects, they make up for it in potential returns.

The hotel market figures for the regions in 2014 also suggest strong earnings can be found outside the M25:

- Occupancy in 2014 was 76% - a new record
- RevPAR grew by 5.4% in 2014 (higher than London)
- Room supply increased by only 0.7%

A shortage of supply plus increasing demand equals great potential for investors. AM:PM forecasts the supply of rooms to increase by around 2% in 2015 and 2016. By contrast the forecast for London is around 4.5%.

The greatest likely short-term threat to the performance of the hotel sector would be a significant downturn in the European economy, while the weakening Euro could reduce tourism. Over the long-term though, the disruptive nature, and potential opportunity for the savvy investor, of the peer-to-peer economy needs to be considered.

Airbnb, which allows private homeowners to rent their property to people for short stays, has boomed in the last couple of years and now has 800,000 rentals in the UK. The continued growth of services like Airbnb could start to eat into hotel revenues, and how the industry will respond to this, and in turn how it will affect hotel investment, is something we will watch very closely in the coming years.

RevPAR for London is forecast to increase by around 4.5% over the next two years

Comment – General Election 2015

The 2015 general election will take place in less than two months on May 7, with forecasters desperately shaking their crystal balls for some sort of sign of how Parliament might look on May 8. It is probably the most unpredictable election for forty years.

The Conservatives and Labour are neck and neck in the polls, both fluctuating around 34 points each. On these numbers neither will secure a governing majority, meaning the next government will either have to try and rule with a minority or form a coalition… or we'll have another election in 2015.

From a business and economic point of view, many are hoping the Conservatives remain in power. For those in construction, the level of their concerns about the next government will depend on the sector they're most closely aligned with.

Those focussed on infrastructure and house-building may not be overly concerned as both parties appear to be firmly committed to increasing output in both areas.

Labour's stance on tax and investment rules may cause some concern for those in the private commercial and industrial sector, as radical changes could discourage investment.

However, a Conservative led government does not come without risks. David Cameron has promised a referendum on the UK's membership of the EU by 2017. Whilst polls show a majority support staying in the EU, market uncertainty could cause short-term problems, while a vote to leave would cause shocks far in excess of tax rises and investment rule changes.

It will be a brave or foolish person who claims to know how the country will look on May 8. However, the bookies, traditionally the best political forecasters, have the Conservatives winning the most seats but failing to secure a ruling majority, which would make another Conservative-led coalition a distinct possibility. Plus ça change.

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