BTG Advisory

INDUSTRY UPDATE

Construction September 2017

Uncharted waters

BTG Advisory provides comment on the implications of political and economic uncertainty for the UK construction market.

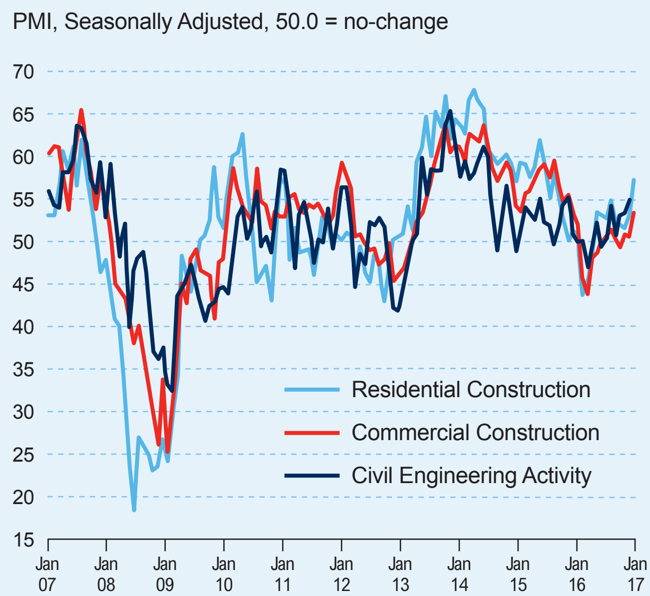
Activity in the industry remains high, but the mood of post-Brexit optimism has been tempered by the political challenge of a hung parliament, uncertainty in the macroeconomic environment, and the outcome of Brexit negotiations.

At 54.8 in June, down from 56.0 in May, which indicated the strongest expansion in business activity for 17 months, the seasonally adjusted IHS Markit/CIPS UK Construction Purchasing Managers' Index (PMI) registered above the 50.0 no-change mark for the tenth consecutive month. However, the Index also indicated a weakening in momentum across all activity categories.

Tim Moore, Senior Economist at IHS Markit, commented: "The construction sector experienced a growth slowdown in June, largely reflecting weaker rises in commercial building and civil engineering activity. But residential construction work continued to increase at one of the fastest rates since the end of 2015."

In a similar vein, the Construction Products Association (CPA) State of Trade Survey for 2017 Q2 reveals that UK construction product manufacturers experienced growth in sales and activity for the 17th consecutive quarter, but manufacturers' optimism for the near term future is more subdued. *(See chart opposite)*

UK Construction PMI® by Category of Activity



Source: IHS Markit/CIPS

Housing Continues To Lead

The rise in residential work has been a key factor supporting overall construction activity with a strong rebound following the triggering of Article 51 and the seven-month low seen in March.

According to IHS Markit, May registered the fastest increase in residential building activity since December 2015 and June displayed the second fastest rise over the same period.

Barratt Developments, the UK's largest housebuilder, announced in July that its order book was 12% higher than the previous year. The company has also seen its average selling price rise by 5.9% to £275,000. Pre-tax profit for this year is forecast to rise 12% to approximately £765m. Persimmon, the UK's second-largest housebuilder also reports that its revenues grew 12% during the first six months of 2017.

David Madden, analyst at CMC Markets, commented: "The low interest rate environment is still fuelling buying."

Bank of England sources indicate that mortgage approvals have remained in a narrow range between 65,200 and 68,600 per month over the past eight months, indicating that homes sales are likely to remain steady.

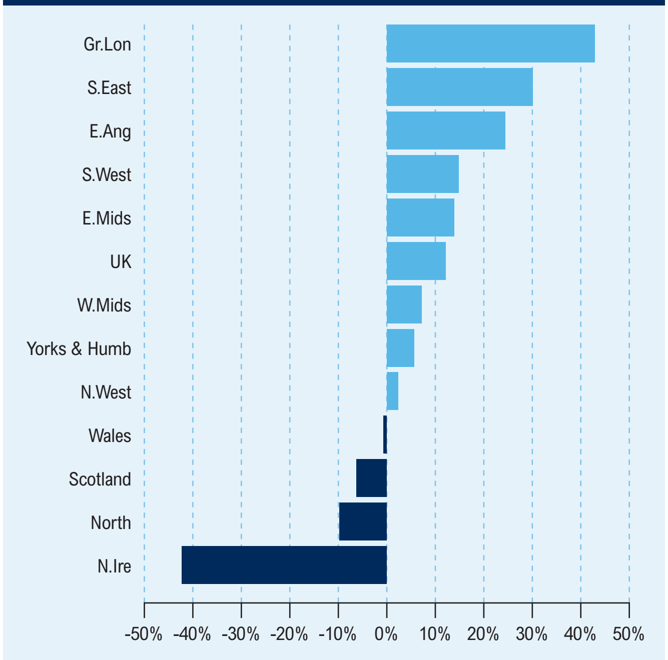
Moreover, the pressure on housing supply shows no signs of abating. Average stock levels on estate agents' books are now at an all-time low, according to the Royal Institution of Chartered Surveyors.

Glenigan's Economics Director Allan Wilen said: "With red tape on planning being cut back by the government, restrictions on social housing provision loosened and government subsidy for both developments and enabling infrastructure available, housebuilders are clearly in an optimistic mood with regard to developing new homes through the planning system."

Housebuilders have quickly recovered from the dip that followed the June election results. Ten of the twelve companies that make up the FTSE All Share's Home Construction sub-sector saw double-digit share price returns in the first half of 2017, led by Persimmon and MJ Gleeson.

One branch of the private housing sector which is gaining very rapid momentum is Build to Rent. Last year, project starts in the sector were worth £750m, involving more than 5,500 units – three times the level of 2015 – and further growth is expected this year.

UK House Prices vs. Q2 2007



Source: Markit

London 'Drag Effect' On Property Prices

London has witnessed a particularly marked price slowdown, with annual price growth of just 1.2% – the second slowest pace of the 13 UK regions and the weakest pace of growth in the capital since 2012 according to Nationwide. The Q2 Halifax House Price Index, administered by IHS Markit, also draws attention to this with London ranking among the weakest performing areas for house price growth with annualised growth at just 0.8% in Q2. Only Scotland and the West Midlands showed worse performance.

However, Robert Gardner, Nationwide's Chief Economist, points to figures that indicate UK house prices rebounded in June, with prices rising by 1.1%, erasing the decline recorded over the previous three months. "The annual rate of house price growth, which gives a better sense of the underlying trend, continues to point to modest price gains," he states. "Annual house price growth edged up to 3.1% from 2.1% in May. In effect, after two sluggish months, annual price growth has returned to the 3–6% range that had been prevailing since early 2015."

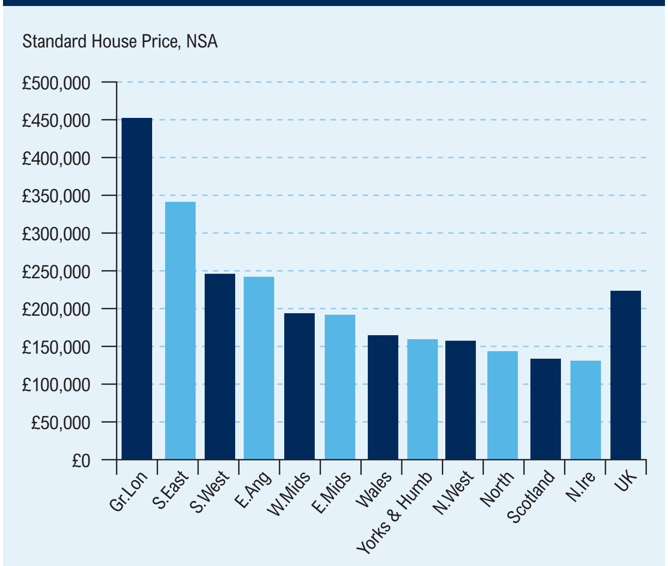
According to the Halifax House Price Index, national house prices in the three months to June were 2.6% higher than in the same period of 2016. However, it is indicative of a general easing that Halifax notes prices in the three months to June were 0.1% lower than in the preceding quarter. Research by Nationwide also indicates the annual rate of growth slowing to the lowest level in four years. Martin Ellis, Halifax economist said: "Although employment levels continue to rise, household finances face increasing pressure as consumer prices grow faster than wages. This, combined with the new stamp duty on buy-to-let and second homes in 2016, appears to have weakened housing demand in recent months."

Improved Regional Balance

Analysts note that for the first time in eight years, housing price growth in northern England has exceeded that in southern England.

Nationwide identifies a clear shift towards a better regional balance, despite the overall slowdown in growth. "Price growth in the South of England has moderated, converging with the rates prevailing in the rest of the country," says Gardner. In Q2 the gap between the strongest performing region, East Anglia, and the weakest, the North, was the smallest on record. According to the Halifax Q2 Regional Breakdown, the East Midlands, with 9.7% year-on-year growth in Q2, was the best performer followed by East Anglia at 8.2%. Scotland was the worst performer, registering a 4.2% decline.

UK Standardised House Price Q2 2017, By Region



Source: IHS Markit

The trend is not only apparent in residential housing. In previous years, London dominated the list of hotspots where the value of construction contracts was highest. Barbour ABI and the CPA report that last year investment in housebuilding, infrastructure and commercial property was increasingly spread across the UK.

Scotland and the West Midlands had the highest growth by value of contracts last year. In the capital, the total value of contracts awarded was £13.1bn last year, down 14.6% on 2015. Just three areas of London appeared in the top ten places with the highest-value construction contracts.

Weakening Commercial Performance

The Q1 2017 RICS UK Commercial Property Market Survey showed both rental and capital value growth projections strengthening at the beginning of the year with demand strongest across the industrial sector, although it notes that activity across office and retail areas of the market is more subdued. But the mid-year forecast from the CPA is that office construction will decline 3% in 2017 and 10% in 2018. Retail construction, it believes, is likely to fall by 4% in 2017 and 2% in 2018, although activity in industrial logistics and the hotel and leisure sector will remain high.

Meanwhile, the latest forecast from Savills for average annual retail rental growth is less than 0.5% per annum over the next three years, with continued falling rents in secondary locations outside Greater London. Savills also reports that total shopping centre transactions in Q1 2017 equated to £358m, a 56% decrease compared to the same period in 2016 and a 58% decrease on Q1 2015.

The latest research from JLL/Glenigan shows commercial construction fell to £15bn in the year to the end of Q1 2017, down by 9.7% on the comparable figure in the previous quarter. New build activity fell fastest, down 13.7% to £8.9bn.

Key trends in all sectors include refurbishment rather than new build and offsite construction/modular build with the Modular & Portable Building Association declaring that its members continue to experience strong demand.

Infrastructure Optimism

After declining for the last two years, Glenigan now forecasts that the value of new civil engineering project starts is likely to rise by 9% this year and a further 19% in 2018. According to the CPA, infrastructure work is set to rise 7% in 2017 and 11% in 2018. Again, there is a shifting trend for major regeneration and infrastructure projects away from London to a more even spread across the country.

In previous years London was the preferred investment choice where the value of construction contracts was highest, according to research by Barbour ABI and the Construction Products Association. But analysts found that last year, investment in housebuilding, infrastructure and commercial property has become increasingly spread across the UK. They point out that Scotland and the West Midlands had the highest growth in value of contracts last year. In London, the total value of contracts awarded was £13.1bn in 2016, down 14.6% on the previous year.

The National Infrastructure and Construction Pipeline contains over £500bn in planned investment, with initial expectations that over £300bn would be invested by 2020–22. Notably, the government's Road Investment Strategy commits it to invest £15bn between 2015–18 and 2020–21.

However, it was disconcerting that the Queen's speech made reference only to rail network connectivity – the government has allocated £38bn to enhance the rail network across the country by 2019. Carillion is set to benefit, along with Balfour Beatty, from a £4bn HS2 contract that has recently been awarded.

It is too premature to gauge the impact of a hung parliament and a possible shift in emphasis in Brexit negotiations. Nevertheless, Moore at IHS Markit notes a cooling of risk averse private investors. "Fragile business sentiment led to delayed decision-making on large projects and greater concern about the outlook for workloads during the next 12 months," he stated.

Lord Adonis, Chairman of the National Infrastructure Commission (NIC), and three other key business organisations are calling on the government to urgently progress 12 key infrastructure projects, including a third Heathrow runway, HS3, and flood defence infrastructure. The NIC is making a strong case for Britain to maintain close ties with the EU, arguing that a host of major projects, including HS2, Crossrail 2 and HS3 rail links between northern cities, as well as universal broadband and mobile services, would be under threat in the event of a tough negotiating stance, but particularly those that rely on private funding.

Heathrow is owned by a range of foreign investors, including a Spanish consortium and Qatar's sovereign wealth fund, and the cost of a third runway has been put as high as £17.6bn. Although a decision has already been taken in principle on Heathrow, it needs to be approved by MPs voting on a national policy statement due to be published later this year.

Regarding the hung parliament, Adonis stated: "There is a real danger that no decisions come forward and we end up as a country seriously regretting yet another period of dither and delay on major infrastructure decisions."

Brakes On Growth

The industry appears to be performing well, but nevertheless has underlying problems. Total revenue for the 100 top construction companies was up by 7.3% to over £69bn – the highest since before the 2008 crash – and margins were also up to 1.6% during the last financial year. Profits increased 53.5% to £1.1bn, although it should be noted that this is still well below the 2012 total.

But it is disconcerting that 20% of top 100 players still made a loss last year and late payment continues to plague the industry. Moreover, that malaise is ongoing. Carillion boss, Richard Howson was recently forced to make a high-profile step down as shares crashed owing to a declining UK order book and falling trade overseas.

There is intense pressure on margins and lead times. The last IHS/Markit Survey indicated that supply chain pressures were among the most intense since early 2015. "June data also pointed to strong input price inflation, driven by resilient demand and upward pressure on costs from imported construction materials," said Moore.

A sharp rise in input costs was also reported in Q2 by the CPA with 93% of heavy side manufacturers and all of those on the light side reporting an increase in costs compared to the previous year.

Interest rate uncertainty is also troubling. Financial policymaker Ian McCafferty has argued it would be wise to raise borrowing costs now to depress an emergent credit bubble, but other voices on the Monetary Policy Committee want a delay, against the backdrop of an economic slow-down.

S&P's senior economist, Boris Glass, believes a delay is most likely. "Given demand weakness, the temporary nature of imported inflation, moderate domestic wage pressures, and Brexit uncertainties, we expect the Bank of England's current ultra-accommodative stance to continue over the medium term and expect a first rate hike to occur only in mid-2019," he comments.

The Financial Policy Committee has also begun to state concerns about uncontrolled lending and a possible credit bubble emerging with the implication that lenders may become more stringent in their demands, which would inevitably dampen consumer demand.

Brexit Doubts

Above all else, uncertainty over the UK's ability to negotiate a good deal with Europe is deeply worrying to investors, particularly the prospect of an extended transitional period and adapting to a new raft of complex regulatory mechanisms. The possibility of a softer approach to negotiations will be heartening to many, but the nature of the future relationship is entirely unknown.

The industry's chronic labour shortage may also benefit from the lacklustre reception given to the notion of a 'hard' Brexit in the last election. Industry leaders are strongly urging the adoption of an Immigration Bill that ensures that British business has access to sufficient levels of skilled EU workers.

Brian Berry, Chief Executive of the Federation of Master Builders, stated in June: "EU tradespeople have come to play a crucial part in plugging the industry's chronic skills gap and if the ability to employ non-UK workers is curtailed, the government's housing and infrastructure plans will be no more than a pipe dream."

Ratings agency Moody's stated in July that qualms about talks in Brussels and the minority government have increased the UK's political and financial risks, adding that it was unclear if the government could deliver a "reasonably good" Brexit deal, stating that growth prospects over the medium term could be "materially weaker" if the UK fails to sign a trade deal allowing access to the single market.

The agency also pointed to the slowing economy which they expected to weaken further during the remainder of the year. Meanwhile, inflation is at a four-year high against a backdrop of declining or stagnating earnings.

Despite the broadly optimistic outlook generated by the latest data, a moderation in growth over the near-term appears inevitable but its extent is yet unknown.

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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