



FALLING PRICES – A CLIENTS' GUIDE TO WORKING IN A RECESSION

November 2008

Executive Summary

Davis Langdon forecasts falling construction prices until at least 2011. Following November's Pre-Budget Report, we can also now anticipate that any recovery in 2012 will be wholly dependent on activity generated by the private sector.

The health of the construction industry is closely related to the general economy and the depth of recession forecast for 2009 points to a continuing deterioration in the outlook for contractors and consultants.

Clients' risk exposure is increased in downturns. Clients and their project teams will need to be vigilant and well organised to secure low exit prices on projects tendered during the downturn. We outline steps that can be taken to increase chances of success.

Clients who act responsibly by proceeding to contract with a well designed scheme and a carefully selected, robust contractor have a good opportunity to secure value in the current market place, but will need to work hard to protect their interests.

The 2008 downturn – How we got here

The change in the prospects for the UK economy and construction during the 2nd and 3rd quarters could not be more marked. Table One summarises data from HM Treasury, Construction Products Association and Davis Langdon, showing how the consensus view moved from expectations of a 'soft landing' to full-scale crash within 5 months.

		2007 %	2008 %	2009 %	2010 %
GDP	Jun 08	3.1	2.0	2.0	3.0
	Oct 08	3.1	1.1	-2.0	2.0
New Build Output	Jun 08	4.2	-1.8	-0.7	1.7
	Oct 08	4.2	-3.6	-5.6	0.2
Tender Prices	Jun 08	6.9	5.9	5.0	5.0
	Oct 08	6.9	3.0	-5.2	-7.2

Table 1 – Changing Market Indicators – June to October 2008.

INTRODUCTION

Clients have an important role in creating conditions for success, and fully designed schemes that have been de-risked from the perspective of both the client and contractor will give all parties the best chance of a successful outcome

This briefing has been prepared as a commentary on Davis Langdon's 3rd Quarter Market Forecast, which predicts significant falls in tender prices over the next two years.

The pace of change in the economy has been breathtaking, and between the publication of our July and October forecasts, our prognosis has shifted from a slowing rate of price growth to a price crash.

Whilst price reductions will reduce the affordability problems that many projects are facing, such a rapid reversal in fortunes brings its own challenges. A low price of entry does not automatically equate to a low cost of exit, and, well advised clients may choose to review their project risk allowances at the same time as they reduce their inflation budgets. Clients have an important role in creating conditions for success, and fully designed schemes that have been de-risked from the perspective of both the client and contractor will give all parties the best chance of a successful outcome. Now is not the time to attempt to deliver high risk projects on the back of rock-bottom tenders, based on an incomplete design.

The downturn in headlines

The key features of current market conditions and Davis Langdon's forecast for 2009 – 10 are as follows:

- Recently published forecasts of construction activity suggest that new work will have fallen by 9% by the end of 2009, despite continuing growth in work in infrastructure and the public sector. This is a faster rate of slowdown than occurred after the 1989 boom
- Tender prices are forecast to fall by 5 to 7% in 2009. This will be the first sustained fall in prices since 1992
- Deflation is expected to continue in 2010 – at around 6 to 8% per annum and a return to positive price growth is not anticipated before 2012

Not all clients will be in a position to benefit from the greater competitive pressure that a decrease in workload will bring. Contractors in sectors which continue to enjoy growth such as infrastructure will not be offering fire-sale prices

In sectors which are contracting, securing a low entry price will be relatively easy. However, converting that into a low exit price will require hard work by the client and project team...

- Prices have risen by 3% during 2008, peaking in the 2nd quarter. Price levels have since fallen by 1% during the third quarter. A steeper and earlier decline in prices has been more evident in regional markets. Few of the reductions seen to date are at the level of deflation which we anticipate will occur from the 4th quarter of 2008 onwards
- A number of projects, notably those let on the basis of two stage tenders, are continuing to reflect the high overall pricing levels experienced during early 2008
- Building cost inflation remains in the system, albeit that the rate of increase has begun to slow as energy costs and some commodity prices have fallen. Devaluation of Sterling continues to affect input prices and the costs of performance bonds and warranties are also on the rise. This means that contractors will continue to face upward input cost pressure as they price aggressively to secure turnover and market share

After enduring years of rising prices, which have tested the viability or affordability of schemes across the private and public sectors, this change must feel welcome to many clients. Not all clients will be in a position to benefit from the greater competitive pressure that a decrease in workload will bring. Contractors in sectors which continue to enjoy growth such as infrastructure will not be offering fire-sale prices. Furthermore, contractor selection strategies such as two-stage tendering, which rely less on head to head competition may also be taken by contractors as opportunities to maintain more healthy margins in some elements of their portfolio.

In sectors which are contracting, securing a low entry price will be relatively easy. However, converting that into a low exit price will require hard work by the client and project team, focused on the following key issues:

- Elimination of sources of uncertainty – incomplete design, poor coordination and so on increase the risk of disruption, overrun and claims. Clients, project managers and design teams must give a higher priority to eliminating these risks than has recently been the case
- De-risking the project. Optimum prices for lump sum contracts and overall cost certainty could be enhanced by isolating major sources of risk such as demolitions and groundworks from the main contract
- Ensuring that accepted bids and programmes are realistic and deliverable, and that selected principal and trades contractors are financially secure

The relationship between the health of the wider economy and demand for construction is well established, unfortunately when the economy sneezes, construction catches pneumonia. The certainty that the UK is shortly to enter recession is bad news indeed

- Including adequate contingencies in budgets to account for the likelihood of claims and other risk events, together with the security of adequately backed warranties and performance guarantees

What can we learn from the past?

Boom and bust has long been a characteristic of the construction industry and in retrospect, it may be the length of the 1993 to 2008 bull run that is viewed to be unprecedented rather than the downturn that we are now moving into. One aspect of many downturns is the speed at which prospects for a modest inflation turn into a full-scale crash – in this case driven not only by the withdrawal of investors from the property market, but also by the wider impact of the turmoil in financial markets.

Without wishing to suggest a false sense of optimism, it is helpful to identify some pointers to how recovery in the current cycle might emerge:

- Some sectors are currently showing robust growth, with infrastructure and public sector spending set to grow by 30%, exceeding £20bn in 2008 alone
- The Middle East still provides opportunities to consultants and contractors with an international business model – albeit that some Emirates such as Dubai are looking far less certain as a long-term source of sustainable workload
- The labour market in the UK is more flexible as a result of the UK's access to a pool of migrant labour

The prospects for renewed growth in both the commercial and public sectors could however be dampened by the long term impact of Government re-capitalisation of the financial sector and the planned tightening of fiscal policy in 2010/2011, threatening employment growth and the ability to support public sector investment.

The relationship between the health of the wider economy and demand for construction is well established and unfortunately when the economy sneezes, construction catches pneumonia. The certainty that the UK is shortly to enter recession is bad news indeed. Figure 1 plots annual percentage change in construction output and GDP. Where either line is below the x-axis, output is falling. The graph shows that there is a close relationship between recession in the wider economy and falling construction activity and furthermore, that construction downturns tend to be deeper and longer than the accompanying general slowdown.

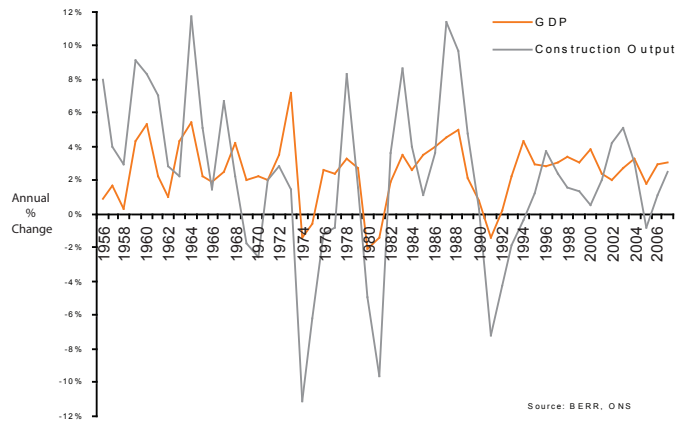


Figure 1. GDP and construction output. (annual % change 1955 to 2008)

By contrast, the recovery of output is typically much sharper in construction than for GDP overall which points to potential problems when the industry does recover, with constrained capacity and reduced competition driving rapid reflation, which could potentially stifle recovery at source.

Figure 1 also suggests that the growth in output during the recent cycle has been steady rather than spectacular – as it was in the 1980s. However, 14 years of near uninterrupted growth has left new build output 40% higher in real terms, which leaves plenty of headroom for a reduction in activity. Latest data from the Chartered Institute of Purchasing and Supply, set out in Figure 2 shows that the rate of decline in activity has been deeper and more rapid for construction than in either the manufacturing or services sector.

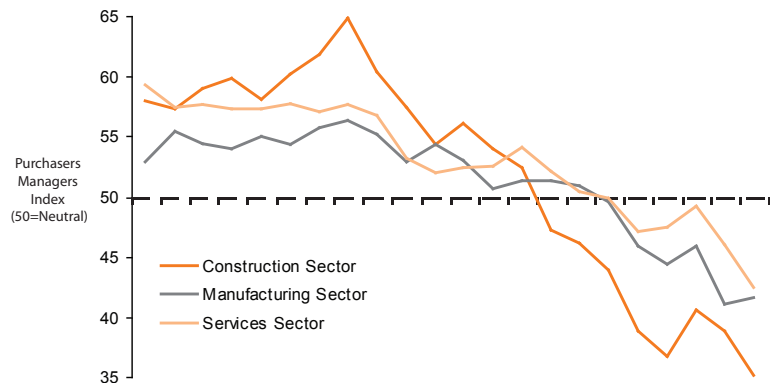


Figure 2. Prospects for Sector Activity

Looking at prospects for construction in more detail, the Construction Products Association's October 2008 forecast makes grim reading, with new work output in 2008 and 2009 forecast to fall by 9%. Some of this decline has already manifested itself in housebuilding, but the real effects for contracting will emerge during 2009 when non-housing new work is anticipated to fall by 4%. Figure 3 shows how sector fortunes will diverge over the next few years, with significant growth in the public sector and infrastructure being more than offset by a collapse in commercial and industrial workload.

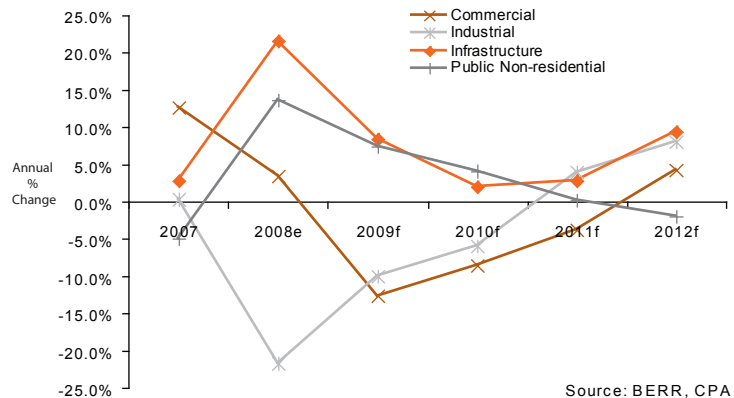


Figure 3. New Build Construction output (2007 – 2012)

Despite the depth of the collapse in output, particularly in the commercial and industrial sectors, it is important to also maintain some perspective with regard to the potential for prices to fall. In the aftermath of the 1990 crash, prices fell by 34% over a three year period. Whilst we are forecasting a severe downturn, we do not expect this to have as dramatic an impact on prices over the next 2-3 years. This is for the following reasons:

- Prices have not risen as fast in the current market as they did in the 1980s. Figure 4 compares the rate of growth in Davis Langdon's tender price index in the boom periods up to the peaks of 1989 and 2008. Inflation has been indexed back for a period of 10 years so that the rate of growth and the absolute level of inflation can be compared. The graph shows that inflation in the current cycle was steady and, as measured, never reached the peaks that we identified using the same methodology during the 1980s. Furthermore, the dip is currently forecast to be shallower.

Going forward, based on Davis Langdon's forecasts of both tender prices and building costs, prices are expected to fall faster than costs, placing further pressure on margins etc.

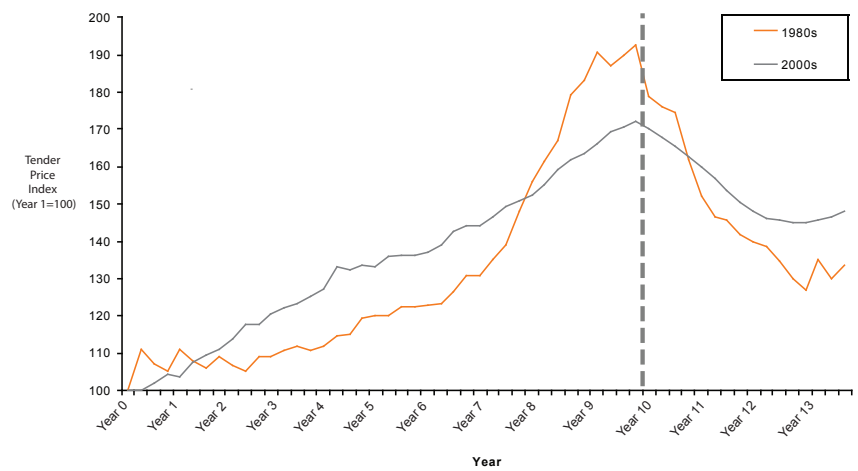


Figure 4. Comparative Boom Profiles to 1989 and 2008

- Price inflation since 2004 has been driven to a large extent by input costs such as high materials price increases rather than by 'market failure' resulting from capacity constraint. Figure 5 plots Davis Langdon's market factor which describes the balance between increases in tender prices and input costs. Where the market factor is above zero, then prices are rising faster than costs – as occurred in the late 1980s and mid 1990s. By contrast, the graph indicates that, for conventional construction at least, prices and costs have largely been in balance in recent years – meaning that inflation has been largely cost driven. Going forward, based on our forecasts of both tender prices and building costs, prices are expected to fall faster than costs, placing further pressure on margins etc.

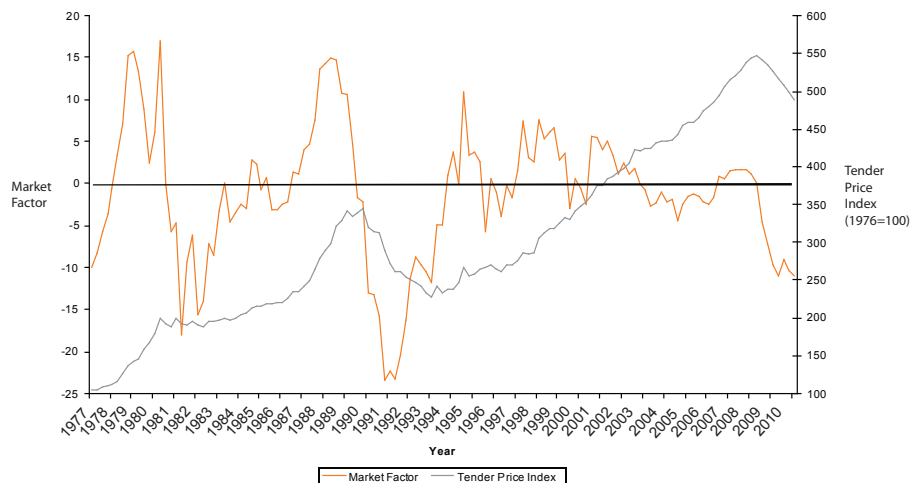


Figure 5. Market Factor 1976 to 2012

Loss of capacity caused by either contractor failure or by a more cautious attitude to securing turnover will reduce competitive pressure, which in turn could result in the resumption of tender price inflation rather faster than output forecasts might suggest

Falling prices have the potential to unlock the viability of some projects, however, risks on projects increase in downturns, and clients and their teams need to approach the market in a realistic and vigilant manner

- Rationalisation and loss of capacity could take place relatively quickly during the downturn, with contractor's access to short-term finance being severely constrained by the ongoing credit crunch. Contractors also have a far more sophisticated approach to the management of their risk exposure, and the larger contractors with strong balance sheets may also choose to either redirect their resources into overseas markets or to stand back from the UK market whilst prices fall. Loss of capacity caused by either contractor failure or by a more cautious attitude to securing turnover will reduce competitive pressure, which in turn could result in the resumption of tender price inflation rather faster than output forecasts might suggest. Reduced investment in oil and gas mining capacity in response to the current downturn in commodity prices could also lead to an early return of materials price escalation

Risks to Clients in the downturn

Falling prices have the potential to unlock the viability of some projects, which could in turn stimulate a revival in wider activity. Procuring construction in a falling market should provide a client with an opportunity to secure an advantageous financial outcome. However, risks on projects increase in downturns, and clients and their teams need to approach the market in a realistic and vigilant manner. Key issues to look out for include:

- The timing of the downturn. Our forecast for falling prices is based on an expectation that the reduction in new project opportunities will translate directly into an aggressive pricing strategy by contractors. There is evidence of this change in strategy but our projection is based on work shortfalls emerging in 2009. Different sectors and trades will have different workload profiles and as a result, the extent of cost reductions will vary:
 - Infrastructure has been short of work for a number of years and rapid growth is likely to face capacity constraint and continuing inflation
 - Contractors with a significant public sector workload secured via frameworks will have greater confidence in their pipeline than those who have focused on commercial projects
 - Different trades have contrasting workload pipelines due to the timing of activities on project programmes. M&E specialists and their supply chain for example are not currently as hungry for work as front loaded trades such as piling or concrete works, and prices may not soften for a further 6 months
 - Continued volatility in currency and commodity markets could affect a contractor's ability to fix or reduce prices. Alternatively these risks could be packaged in such a way as to transfer risk to the client

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Negotiation or two stage tendering will continue to have a place in tendering strategy, but if clients wish to secure a lowest price of entry to ensure affordability, direct competition is likely to be necessary

- The extent of inflation built into the client's baseline estimate. Prices are anticipated to fall from a highpoint of 2nd quarter 2008 and estimates produced before this date may not reflect the full level of cost escalation which has taken place
- The stability of the contractor and their supply chain. Highly competitive pricing, reduced turnover and increasing fixed costs such as debt are all likely to put pressure on the financial stability of companies at all levels of the supply chain. An increased focus on the workload, resources and financial health of key supply chain members will help to mitigate, but will not remove the risk of company failure
- The effect of the choice of contract on project recovery scenarios. Consideration of the potential of contractor failure may also affect the selection of procurement routes – particularly where clients are dependent on short-term project finance. Design and build is very attractive to clients as a means of risk transfer, but in the event of main contractor failure, the unpicking of the contract can create a complex set of problems related to warranties or access to sub-contractors
- Maintenance of competitive pressure. In a falling market any project which offers a respite from competitive pressure will be welcome to bidders but will not secure the full benefits of competition. Negotiation or two stage tendering will continue to have a place in tendering strategy, but if clients wish to secure a lowest price of entry to ensure affordability, direct competition is likely to be necessary
- The emergence of adversarial relationships. One of the reasons for moving away from single stage competitive tendering has been as a positive response to the inefficiencies associated with sequential working and adversarial project culture. The fact that clients are willing to contemplate a return to traditional procurement suggests that more collaborative approaches have not always delivered benefits to clients. In going 'back to the future' clients should administer their project responsibly to avoid exposure to unnecessary risk. However, they should also be ready to defend their corner to secure contracted project outcomes. They should also ensure that they have set aside adequate contingencies, should these risks crystallise

Without action, contractors' work could be disrupted, unnecessary costs could be incurred, and clients could be severely disadvantaged in their efforts to secure a low exit price on their contracts

Actions to take to obtain secure project outcomes

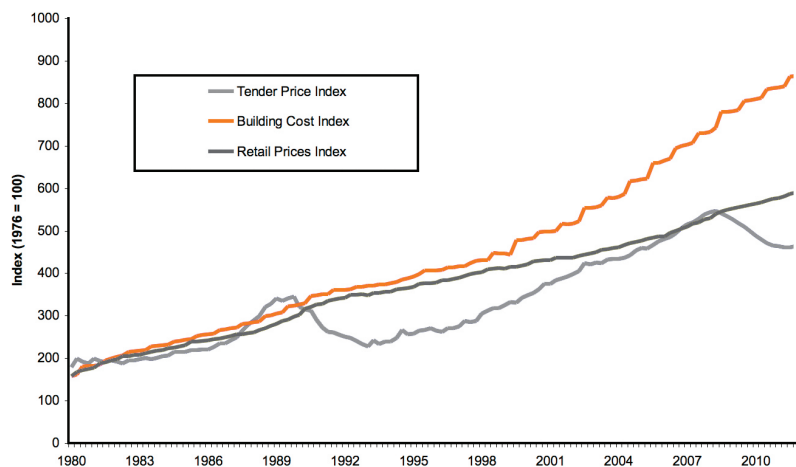
A key theme for clients in the current market turmoil is that the successful adoption of a competitive contractor selection route in order to secure lower costs will depend on active steps by the client and project team to ensure that the contractor is in a position to provide a realistic and binding bid and that contractors' bidding costs are minimised. The key steps are outlined below. Without action in these areas, contractors' work could be disrupted, unnecessary costs could be incurred, and clients could be severely disadvantaged in their efforts to secure a low exit price on their contracts.

- Keep tender lists reasonably short to keep bidding costs low and to encourage serious, competitive bidding
- Allow enough time for design work to be completed and signed off before proceeding to discussions with contractors
- Define a procurement strategy that balances the client's need to establish quality standards with the contractor's ability to drive in value and manage their risk exposure, through the allocation of design responsibility and the selection and management of the supply chain
- De-risk the project for both client and contractor through packaging strategy, design and specification, coordination and the clear definition of critical performance requirements
- Sign off design proposals and agree a change management system backed up by the authority of senior client management. For example, clients should assert control over the quality and comprehensiveness of information issued to contractors
- Evaluate the financial health of proposed contractors and their supply chain. Ensure that robust and properly funded performance bonds and guarantees are in place. Regularly monitor the health of the selected project team
- Sign the construction contract ahead of commencement of works on site. Do not rely on letters of intent
- Invest in well managed information exchange tools such as e-tendering and project extranets. Ensure that these tools are properly managed and used as the single source of project information
- Build adequate risk allowances into overall project budgets

Clients who act responsibly and proceed into contract with a well designed scheme and a carefully selected contractor team will have to work hard but should secure value

Conclusion

Falling tender prices could provide an opportunity for hard-pressed clients to bring projects to market, should the demand for their project exist. Any work opportunities will be pursued vigorously by contractors and good entry prices will no doubt be secured. Whether an equally good exit price can be obtained will rely in part on client action. The construction industry has never been 'user friendly', and the coming downturn could usher in a return to some of the adversarial behaviour which has been set aside in recent years. Clients who act responsibly and proceed into contract with a well designed scheme and a carefully selected contractor team will have to work hard but should secure value. However, for those project teams that proceed on the basis of information standards and management discipline that become the norm in an upswing, the next 2 to 3 years could provide some nasty surprises.



Tender Prices and Building Costs 1980-2011

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