Construction Prospects for 2015

Special Report

November 2014

Prepared by Glenigan

A 4C Service

Glenigan
Constructing Insight
A 4C Service

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Construction Prospects for 2015

Rising private sector confidence and investment are driving growth in construction activity. Output volumes rose 0.8% during the third quarter of 2014 to stand 2.9% up on a year earlier, the sixth consecutive period of annual quarter on quarter growth. Current output growth largely reflects the strengthening in project starts recorded by Glenigan during 2013 and the opening months of this year, with rising private sector and infrastructure investment lifting industry workloads.

The industry's forward pipeline points to sustained output growth next year. Glenigan has recorded an 8% rise in the value of projects starting on site during 2014, primarily driven by increases in private housing and non-residential building projects.

Furthermore the pre-construction pipeline remains firm. During the first ten months of 2014 detailed planning approvals have consolidated on the 19% rise seen over the previous two years, with strong growth in private housing approvals, in particular, offsetting weakness in public sector areas.

Renewed consumer confidence and the accompanying revival in the general housing market have emerged as key growth drivers for both construction activity and the wider economy. While average household earnings growth remains modest, increased employment levels and the brighter economic outlook have bolstered consumers' confidence and spending. Revised Office for National Statistics (ONS) data recorded a 1.6% rise in household spending in 2013, with the pace of growth quickening to 1.9% during the first half of this year.

Mortgage finance has become more accessible, in part due to the government's Help to Buy scheme. Although mortgage lending activity has stabilised in recent months, in part due to the Bank of England implementing tighter regulations and lending criteria, the housing market will remain an important engine for construction growth. Activity is rippling out from London and the South East as faster average earnings growth further strengthens consumer spending and confidence.

Table 1: Value of underlying project starts by sector

Change on previous year	2013	2014e	2015f
Private Housing	7.2%	13.5%	12.0%
Social Housing	16.1%	-5.5%	-11.9%
Industrial	-6.5%	48.2%	18.1%
Offices	11.7%	8.0%	22.7%
Retail	-0.8%	-8.0%	12.1%
Hotel & Leisure	0.7%	14.5%	10.4%
Education	21.3%	1.6%	7.9%
Health	-8.7%	9.0%	-12.0%
Community & Amenity	8.0%	-0.7%	-2.1%
Civil Engineering	6.7%	8.4%	9.0%
Total	**7.6%**	**8.0%**	**7.3%**

Source: Glenigan

N.B. Underlying project starts exclude individual projects of £100m or more

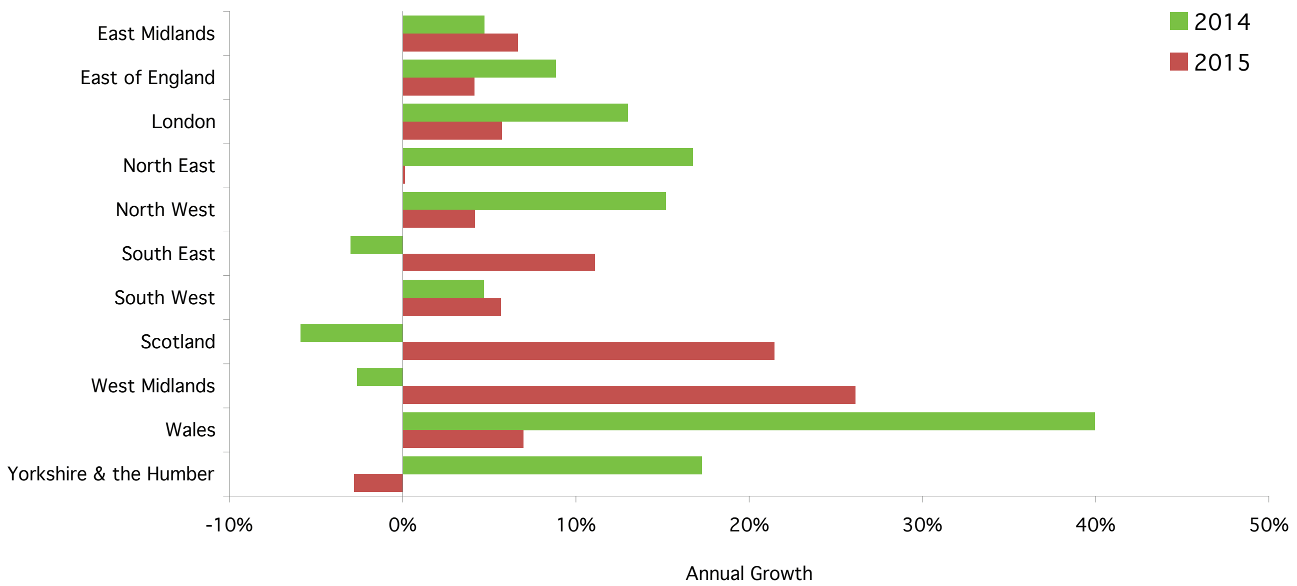
However consumer spending is not the only driver behind construction growth. Business investment picked up sharply during the first half of 2014, being 9% up on a year ago, and is forecast by the Office for Budget Responsibility (OBR) to grow by 8% per annum in each of the next five years. This resurgence in investment should provide sustained support for the industrial and commercial sectors. Following a strong rise in detailed planning approvals last year, industrial starts are on track to rise by around 50% during 2014, with further substantial growth anticipated for next year. The value of underlying office starts has grown more modestly this year, rising by an estimated 8% and consolidating the strong recovery seen over the last two years. Firmer growth is now anticipated for the next two years, with sector activity picking up in key regional centres across the UK. In addition, the upswing in hotel and leisure sector activity during 2014 is forecast to continue next year, with the value of underlying starts forecast to rise 10% as higher consumer discretionary spending prompts developers to bring forward new projects.

In contrast, government-funded investment generally remains constrained. Social housing starts are a particular weak spot, with the value of project starts falling by 4% this year and further decline forecast for 2015.

However, education is a relative bright spot. The sector is benefiting from increased investment as local authorities adapt and extend their primary school estate to accommodate rising pupil numbers. In addition the government's free schools, Priority School Building Programme and university investment schemes are all fuelling sector activity.

There has been rising political concern that the economic recovery is regionally unbalanced, with London soaking up all the growth and job creation. Certainly the capital led the initial recovery, with the value of underlying project starts jumping 21% in 2013. However Glenigan data now points to a broader recovery in construction activity across the UK. London remains an important growth area, but the north of England and Wales have seen the fastest pace of growth in 2014. Strong regional growth is forecast for the West Midlands in 2015, while Scotland is expected to bounce back as projects deferred in the run up to the independence referendum vote get underway.

Chart 1: Value of underlying project starts by country and English region



Source: Glenigan

Looking ahead, we expect rising private sector investment and improved consumer confidence to underpin further growth in both detailed planning approvals and project starts during 2015. Underlying project starts are forecast to grow by 7.3% next year, building upon an estimated 8% increase during 2014.

Office project starts are expected to pick-up in major metropolitan areas as the demand for more quality office space spreads beyond the capital. Retail and leisure project growth is expected to be spread widely across the UK as consumer spending picks up across the country. The focus of government capital expenditure on transport will broaden from rail towards road projects, and this will lead to a more even spread of infrastructure work across England.

Private housing

Rising consumer confidence, improved mortgage availability and the government's Help to Buy scheme have combined to lift housing market activity and new house sales over the last year. While the Bank of England has recently implemented tighter regulations and lending criteria amid concerns of too rapid a recovery in housing demand, new homes are seen by both government and the opposition as the longer term solution to an overheated and restricted housing market.

To date the strongest growth in housing market activity and house prices has been in London and the South East, to the extent that the Bank of England has been looking for targeted measures to temper the London market. However, recent months have seen a shift. High prices and the 'mansion tax' proposals have dampened London market activity, especially for prime residential properties. In contrast, although mortgage lending has stabilised in recent months, confidence remains firm in the wider market with activity rippling out from London and the South East.

House builders have secured permission on sites across the country in anticipation of a broader based upturn in demand, with the number of dwellings approved on private sector projects climbing 22% last year. Furthermore, the sharpest rise in unit approvals were in the Midlands, the north of England and Wales. Unit approvals rose by only 7% in the capital last year and while the first half of 2014 has seen a jump in approvals this is largely due to the approval of a few major long term projects, such as the redevelopment of Earls Court that will be built out over several years.

Social housing

Over the last few years the social housing sector has had to adjust to a radical change in its funding model. Social housing providers are now expected to rely upon private funding to meet a greater proportion of their projects' development costs. While landlords can now charge affordable rents of up to 80% of market levels on new lettings, providers have also been developing schemes with a higher element of shared ownership and open market properties to defray scheme costs.

Social new housing starts picked up in 2013, with an 18% rise in starts to 30,000 units largely offsetting the decline seen during the previous year. The potential development pipeline also improved with the value of projects securing detailed planning approval rising by 24% in 2013. The increase in activity reflects the successful adaptation by social landlords of their development plans to accommodate the government's new funding regime.

Nevertheless, the reduction in government capital funding remains a constraint on sector activity. The value of project starts has slipped back an estimated 5% this year. In addition, there has been a sharp drop in the value of detailed planning approvals which is forecast to feed through to a 12% drop in starts during 2015.

Industrial

Industrial construction has been a bright spot for growth in 2014. Structural change in the retail sector with the continued growth of on-line retailing, click and collect and home deliveries is fuelling demand for warehousing and distribution premises, with a near 50% increase in the value of industrial starts this year.

The relatively short construction periods associated with warehousing construction has supported a rapid growth in industrial sector output, which the ONS estimates was 11% up during the first nine months of 2014.

UK manufacturing output has grown for six successive quarters, although the pace of the recovery has slowed from the rapid growth seen at the turn of the year. The ONS estimates manufacturing output grew by 1.5% in the first quarter of 2014. The pace of quarter on quarter growth moderated to just 0.4% during the third quarter, but output was still 3.4% up on the corresponding period of 2013.

The latest CBI *Industrial Trends Survey* in October recorded a similar slowing in output growth and reported a weakening in export order books. Manufacturers are looking to strengthening domestic demand as the main engine for growth over coming months. However while firms remain positive about their prospects, the slower pace of growth appears to have tempered capital expenditure plans, especially for investment in buildings where a balance of 14% of firms plan to reduce their spending.

Offices

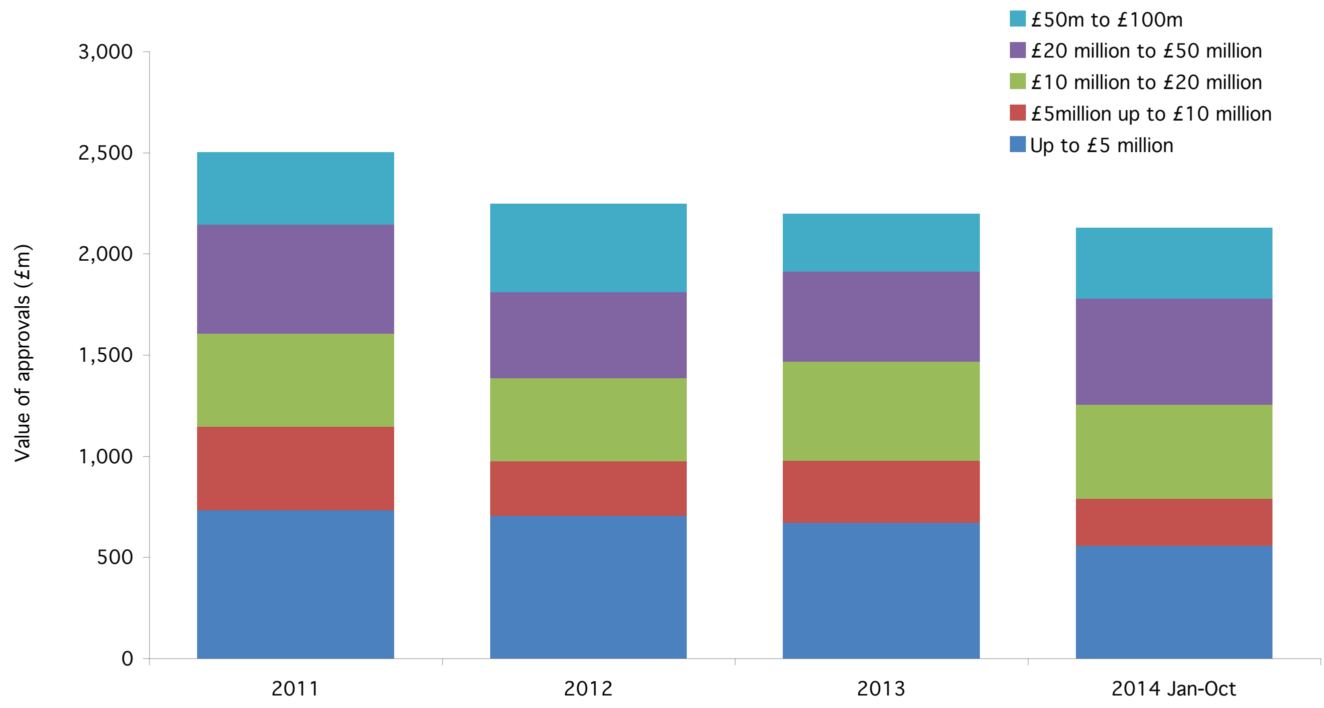
The value of office construction output during the first half of 2014 was 24% up on a year earlier, boosted by the strong growth in the value of underlying project starts tracked by Glenigan in 2012 and 2013.

While project starts have grown more slowly in 2014, rising by an estimated 8%, sector prospects remain bright and a sharp rise in starts is forecast for 2015. This strengthening pipeline will underpin output growth over medium term.

Office project starts are expected to pick up in major metropolitan areas as the demand for more quality office space spreads beyond London. A 56% rise in the value of underlying detailed planning approvals in the capital during the first ten months of 2014 points to a strengthening in project starts in the region during 2015.

However, rising demand for office accommodation and a lack of development activity has tightened the supply of available office space in other major office markets. Investors and developers are now responding to changing market conditions. Detailed planning approvals have increased sharply in the North West and West Midlands, rising by 23% and 68% respectively during the first ten months of 2014. This is set to feed through as increases in project starts in Greater Manchester and Birmingham during 2015.

Chart 2: Value of office projects securing detailed planning approval by value band



Source: Glenigan

Retail

While consumer confidence and spending are on the rise, retail construction activity is being driven as much by structural changes in the sector as by investment to capture rising sales. Indeed retail project starts slipped back 8% this year despite the brightening economic outlook.

Refurbishment and fit-out projects are accounting for an increasing amount of work in the sector as retailers rationalise their estate and remodel stores in part to accommodate click and collect services. Investment by the major supermarket chains has been a major source of sector activity in recent years. Intensified price competition between the majors and loss of market share to the discount chains has hit the profitability of the top four hard. The market leaders, Tesco and Sainsbury's, have already scaled back their investment programmes to focus on their convenience store network. Looking ahead, however, the sector should see new opportunities during 2015 as Aldi and Lidl step up the expansion of their supermarket network.

Furthermore, there is a strengthening development pipeline of shopping centre projects that are set to boost sector activity during 2015. In response to the e-commerce challenge, developers are looking to safeguard their investment by expanding established shopping centres, such as Westfield in west London. In many cases, the plans include an enhanced leisure offering in order to increase dwell time and their perception as destination shopping locations.

Hotel and leisure

The UK's hotel and leisure industries are beginning to benefit from improved consumer sentiment, even if current levels of real earnings growth suggest that discretionary incomes have yet to improve. Overseas visitor numbers have also helped to boost the sector. Spending by overseas travellers jumped 12% in 2013 and grew by a further 3% during the first eight months of 2014. Visitor numbers are also on the rise, increasing 5% in 2013 and 6% during the first nine months of 2014.

The rise in overseas visitors appears to have bolstered investment confidence. Reflecting London's popularity as a tourist destination, the fastest growth has been in the capital, with detailed approvals jumping 47%. The flow of projects entering the development pipeline has been subdued elsewhere. Nevertheless we expect sector starts to strengthen during 2015 as rising disposable incomes feed through to discretionary spending.

Education

The outlook for education work is positive in contrast to other publicly funded areas of construction. Rising pupil numbers are necessitating increased investment by local authorities to increase primary school capacity, with the major metropolitan areas seeing the greatest pressure on existing facilities. In many cases councils are looking to expand established schools through extension and refurbishment projects rather than providing increased provision through the creation of new schools.

The Priority Schools Building Programme is also expected to generate an increasing flow of work over the next year. To date only 48 schools have reached start on site, out of 261 that are scheduled to be rebuilt or improved under the programme by the end of 2017.

In addition the sector will benefit from increased investment by universities as they compete to attract students, especially lucrative overseas students, by improving their facilities. Detailed planning approvals for university projects during the first ten months of 2014 were 19% up on a year ago. Several universities have plans for entirely new campuses; while these are currently at early stages of development they signal the ambition of some universities and suggest that higher education institutions will remain an important driver of construction spend in the longer term.

Health

The value of underlying starts is estimated to have grown by 9% during 2014, reversing the decline seen last year. Unfortunately the upturn is forecast to prove short-lived with a renewed weakening in project starts anticipated for 2015.

NHS capital budgets remain under pressure, squeezed by rising costs elsewhere in the service. There had been hopes that the PF2 contract arrangement, the result of the government's review of the Private Finance Initiative, would allow private investment to fill the void left by declining NHS capital funding. However progress with the piloting of PF2 on the Priority Schools Building Programme has been slow. Comments from government and the Treasury point to an openness to private investment into energy infrastructure, but much less so for social infrastructure projects.

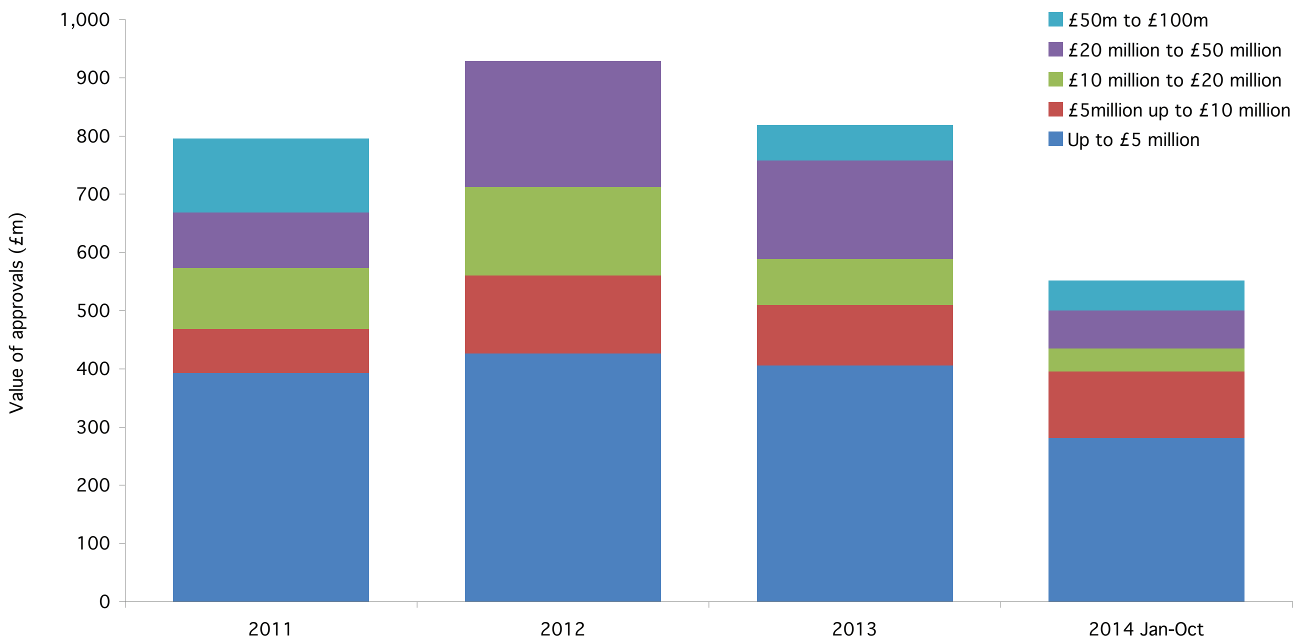
Community and Amenity

This sector continues to struggle from the after-effects of the recession and the austerity budget cuts placed on the key clients for community and amenity work, which are typically local authorities. Analysis by the Local Government Association shows that councils in England alone face a funding gap of £5.8 billion between March 2014 and the end of 2015/16.

Despite these funding pressures, construction in this sector has been largely stable over the last two years. The underlying value of starts is expected to slip by a modest 1% over 2014. However further forward looking indicators of upcoming activity, such as value of projects receiving detailed planning approval or being awarded to main contractors, have slid further during 2014.

More encouragingly another key client in the sector, the Ministry of Defence, appears to be maintaining construction spend, with a number of frameworks awarded during 2013 and 2014 to facilitate redevelopments of military bases and improvements and maintenance to the military housing estate. Despite this, we expect community and amenity starts to fall back once more in 2015, by 2%.

Chart 3: Value of community and amenity projects securing detailed planning approval by value band



Source: Glenigan

Civil engineering

Civil engineering is expected to end 2014 having seen two years of consistently rising fortunes, with the 7% rise in 2013 followed by an 8% increase in 2014. The positive expansion in civil engineering starts has been underpinned by growth in both the infrastructure and utilities sectors. Both these sectors are expected to continue to strengthen in 2015, driving a 9% increase in underlying project starts.

Having paused last year while the industry awaited the results of energy market reform, renewable energy development has picked up once more during 2014. Biomass and energy from waste facilities have been the brightest area of development, buoyed by the relative maturity and cost-effectiveness of the technology, alongside government support for combined heat and power (CHP) facilities. Analysis of the forward pipeline suggests this will remain the strongest driver of underlying energy construction starts.

Excluded from this underlying trend are major projects valued at over £100 million, and in this area the outlook is also for expansion in 2015. The twin-reactor nuclear power station at Hinkley Point C, now with estimated construction costs of £14 bilion, is expected to finally begin construction mid-2015, having cleared the European Commission's state aid investigation.

Transport investment is also expected to continue to boost new activity. The final Crossrail contract was recently awarded, though construction activity is expected to remain positive as work moves away from the main tunnelling effort to the stations and passenger infrastructure. Construction is set to begin in spring on the Northern Line extension to Battersea, while outside the capital electrification work in areas around Bristol and Manchester are among the projects included in Network Rail's current Control Price Framework, moving into its second year in 2015.