exigere

Q2 2024 Market Update

Development viability remains challenging but better news on inflation in 2024, so far, creates a more supportive environment for interest rates to fall sooner, and more rapidly, than previously anticipated.

Weakness in household consumption and signs of wider economic malaise add to the case for monetary policy easing.

Reductions in financing costs and greater pricing stability both support the viability equation. A weak but steady outlook for the UK economy, and gradual improvement in occupier and investor demand, also contribute to a more stable decision-making framework.

As the threat of exceptional volatility has reduced, a greater proportion of development risk can be effectively managed and mitigated by intelligent design, robust value-based decision-making, and collegiate and innovative procurement strategies.

But it's still far from easy. There has been a step-change in baseline construction costs, external threats from geopolitical tensions remain high and the policy backdrop is difficult – with further change to come. Plus, main and trade contractor insolvencies, along with the aging profile of the domestic construction workforce and forthcoming changes to skilled overseas worker visas, mean shortages of skilled labour are likely over the medium term.

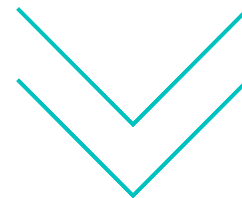
Changing landscape

Inflationary pressures are generally easing and consumer price inflation has fallen to 4%. Monthly volatility is likely, but inflation is following a downwards trajectory and the consensus among economic forecasters suggests CPI will average 2.2% during 2024 and broadly stabilise in 2025. This paves the way for interest rates to fall earlier, and possibly faster, than previously anticipated, and market expectations have adjusted. City forecasters now expect the base rate to hit 4.25% in Q4, a 100-basis point reduction compared with early 2024.

Investment volumes in central London's core office markets reduced sharply in 2023 as financing costs soared, but there are tentative signs of improvement. Yields have now stabilised and agents report renewed investor appetite in early 2024. As near-term interest rate reductions look increasingly likely, expectations that yields will harden later this year have strengthened, and history tells us that competitive pressure can quickly build in this market so transitions can be swift.

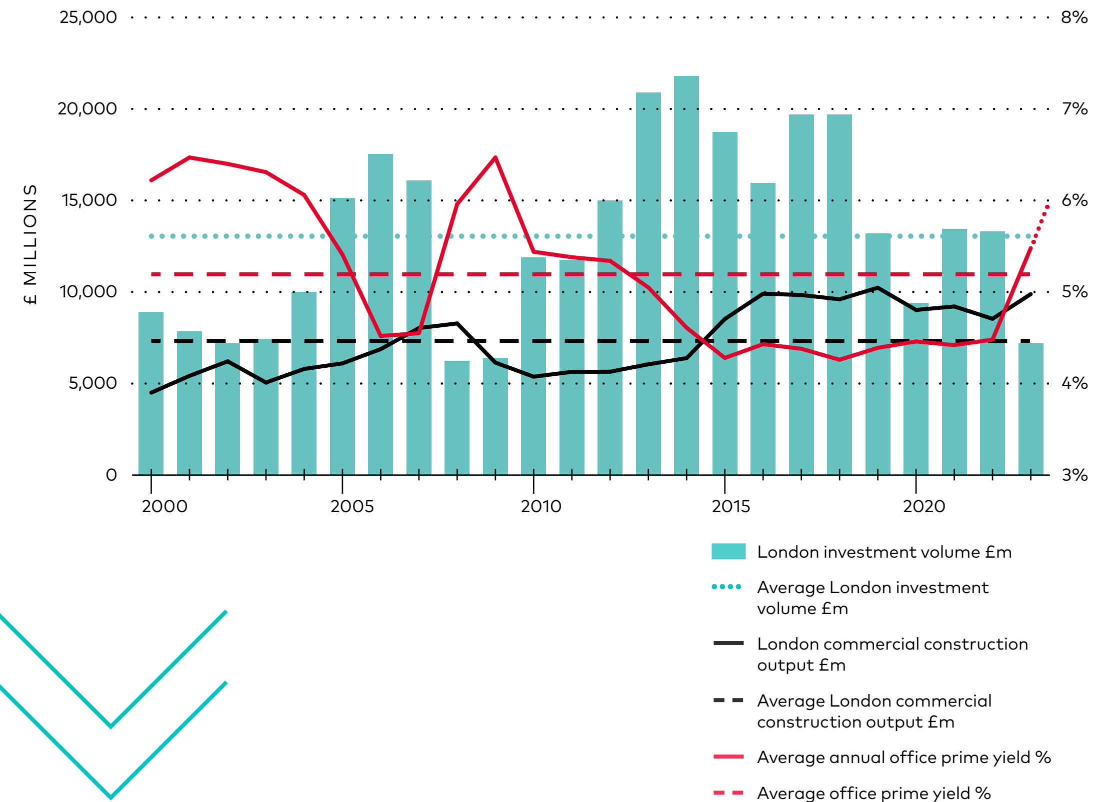
Overall occupier activity remains muted but, again, signs that appetite is generally strengthening have emerged and high-quality space remains desirable. Savills reports that active space requirements in the West End and City markets are up by 21% on the five-year average and 30% higher than the 10-year average respectively. Grade A rents are appreciating in both markets and developers are responding.

Are we nearing the bottom?



Central London investment volumes vs average annual prime yields vs London commercial construction output

Source: Savills, Q4 2023 and ONS



Arding & Hobbs - an extensive transformation from a Grade II listed department store to a contemporary mix of retail, leisure and workspace for W.RE

Better prospects for demand, along with the increasingly pressing need to upgrade lower specification space to meet evolving occupier expectations and satisfy pending changes to minimum energy efficiency standards, drove a 25% increase in planning applications and approvals in the City in 2023, according to the latest data from the City of London Corporation. Agile, strategic investment in response to the demand-side shift is also a driver. As the need for expansive floorplates lessens, for example,

© Richard Chivers

'Occupancy rates are steadily increasing globally and research by Savills suggests London is performing well relative to its European and US counterparts.'

Canary Wharf will focus firmly on responding to the opportunity urban population growth presents by building its existing platform as a destination to live, work and play. Adaptation and resilience means the outlook for both the City and Canary Wharf is far more positive than feared in the immediate wake of the pandemic.

Occupancy rates are steadily increasing globally and research by Savills suggests London is performing well relative to its European and US counterparts. At 62%, occupancy in the West End is significantly higher than the European average of 57% and less than 40% in New York, Los Angeles and San Francisco.

Upwards pressure on construction costs eased in the second half of last year and we anticipate this will continue unless an escalation in simmering geopolitical tensions further disrupts the current supply outlook. Wholesale energy costs have fallen markedly and, as we enter spring, upside threats from exceptional winter weather have diminished. Inflationary pressure impacting manufacturers has eased and factory-gate inflation is falling overall.

A marked slowdown in the pace of economic growth in China, and the depressed state of its real estate markets, may exert some export deflation into the UK market. Policy interventions in the Chinese manufacturing sector distort the relationship between supply and demand, and significant stocks of some manufactured products are building. Attempts to dump surplus product on global markets will almost certainly be met with protectionist policy by western governments to level the playing field for domestic manufacturers but, if China's strategy proves to be less aggressive, it may offer some positive buying opportunities.

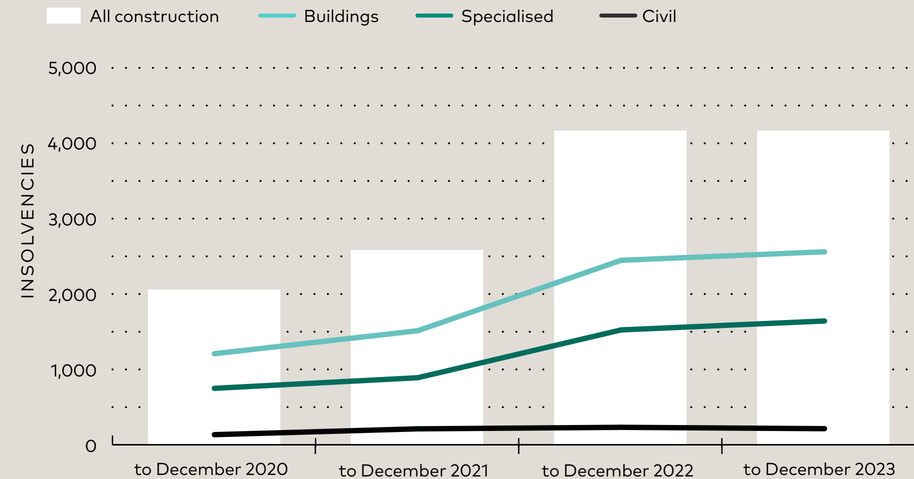
'...if China's strategy proves to be less aggressive, it may offer some positive buying opportunities.'

Supply chain evolution

Exceptional financial challenges and evolving demand requirements are reshaping the construction supply chain. Construction firm insolvencies are nearly 40% up on pre-pandemic levels. Post-financial crisis levels were exceeded at the end of 2022 and numbers are still rising. Profit warnings issued by listed firms operating throughout the construction supply chain remain elevated according to EY-Parthenon and firms with greatest exposure to the residential sector are most at risk.

Construction company insolvencies (12 months rolling)

Source: Insolvency Service (compulsory liquidations only); Companies House (all other insolvency types)



Financial challenges will persist throughout 2024 as delivery progresses on some contracts negotiated before rapid cost inflation hit. In addition there are ongoing financial impacts of legacy issues such as fire safety in the wake of the Grenfell tragedy, and fundamental concerns recently reported in the CMA Housebuilding Study which need to be fully understood. Losses and board reshuffles at major Tier 1 contractors have hit headlines in recent months as firms take stock and reevaluate.

Procurement in these turbulent conditions is challenging. On one hand, there is a need to ensure that project procurement takes a reasonable and pragmatic approach to risk, to avoid exacerbating the serious issues currently affecting supply chain partners but, on the other, the need for comprehensive due diligence to build a clear understanding of exposure to risk throughout the supply chain has never been more important. How procurement strategy should seek to balance these objectives and deliver the best outcomes is explored in our recent insight on insolvencies.

exigere insight February 2024

How stakeholders react and behave in these challenging times is critical and looking beyond traditional measures of financial strength such as the use of tools like Creditsafe is key. Access to contractors' management accounts is important. Indicators such as the supply chain's ability to obtain credit insurance and performance bonds in the insurance market are worthy of exploration and further understanding.

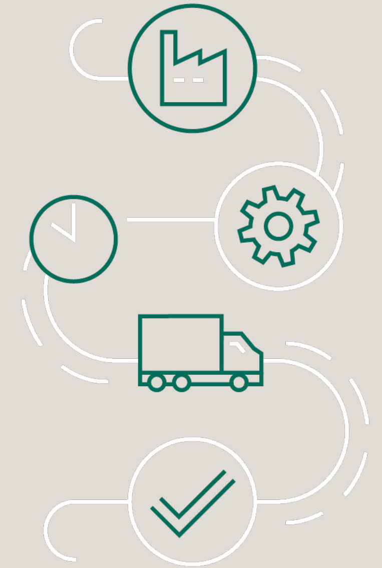
In response to several large contractor insolvencies, construction bond market capacity has reduced as insurers review, and lessen, risk exposure. Bonding to net worth ratios, which determine bonding ceilings for contractors, have fallen from around 70% of balance sheet worth down to less than 50% per bond, and some providers have exited the surety market altogether. Contractors are often now required to use cash collateral to secure bonds, and premiums have increased by up to 20% over the past 12 months.

Against this backdrop, there has been a 'flight to quality' and partnering with experienced contractors with strong financial covenant is sensible. New entrants to the Tier 1 market in recent years has offered opportunity, but rapid growth in turnover and the transition to delivering larger and more complex schemes, can fundamentally shift the risk profile, which is also important to understand.

Trade contractors typically face the greatest financial risks and nearly 60% of construction firms becoming insolvent in 2023 were specialist contractors. Subcontractor securitisation, and the steps they take to protect themselves, is vital. Trades need to mitigate risks including taking out credit insurance, being transparent, and building strong partnerships with the insurance underwriting community for both trade credit and the performance bond market, is vital in a challenging market.

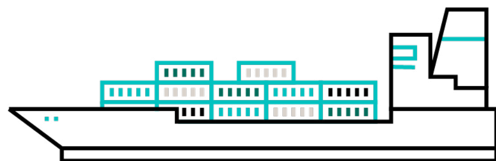
Matt Green of Trade Credit Risk states that -

"Presenting a positive financial landscape to the insurance market is critical and will greatly assist to continue to support the construction supply chain. Providing information about work in progress and pipeline, sharing accurate management accounts and delivering strong balance sheets is important. Clients can equally help the supply chain in areas such an equitable sharing of risk, flexibility around payment terms, and by releasing bonds at Practical Completion."



Challenges remain

Conflict in the Middle East continues to pose an upside threat to materials prices and supply chain stability, and forthcoming changes to UK Government policy will increase pressure on industry wages and build costs.



Global freight costs spiked in late 2023 as attacks on cargo vessels in the Red Sea prompted carriers to divert ships around the Horn of Africa – increasing transportation times between Asia and Europe by up to 20 days. Freight costs remain nearly double their level a year ago but prices have started falling and, to date, there has been no major impact on construction product prices. If disruption persists, it will undoubtably have some impact on some lead times and prices, but it is anticipated the recently agreed naval coalition between the US and EU should help to restore safe passage in due course.

Closer to home, domestic policy decisions continue to make development more challenging and complex. Recruiting skilled overseas labour in the UK is also set to get more challenging. From April, minimum salary requirements via the Skilled Worker route will increase from £26,200 to £38,700, making this labour source economically unrealistic in some instances. The shortage occupation list will be replaced and requirements under the spouse or partner visa will become more onerous, further reducing the attractiveness of working in the UK to overseas workers. Nationwide, the industry has lost 300,000 construction workers since early 2019 and the age profile of the domestic workforce is increasing.

Making it more difficult, and expensive, to recruit internationally risks increasing wage pressures, especially as demand strengthens over the medium term.

'Nationwide, the industry has lost 300,000 construction workers since early 2019 and the age profile of the domestic workforce is increasing.'

Total construction employment
Source: ONS Labour Force Survey

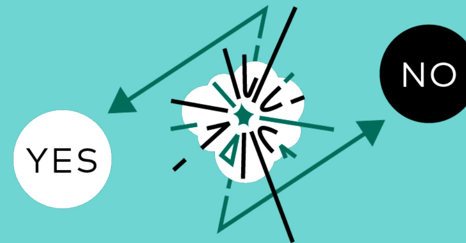
Policy changes

Our Q4 2023 market update explored the impact policy changes have had on office construction costs since 2019 and it's an evolving picture. Clarity about what policy developments to date mean in practice is still building and anticipated developments over the next two years may add to the pressure. The risk of unintended consequences from conflicting or ill-informed policy remains significant.

Complex and opaque planning policy is a major cause of development uncertainty. Protecting heritage and guiding the sustainable, and sensitive, evolution of the built environment is vital but the inconsistency and unpredictability of the flawed current framework is a significant, and costly, barrier to development.

Recent high-profile cases – the proposed redevelopment of M&S's flagship Oxford Street store and ITV's former recording studios on London's South Bank – highlight just how inconsistent and unpredictable the planning process can be. After receiving approval from relevant councils, the GLA and the planning inspectorate, both applications were called in for lengthy review by the Secretary of State for Levelling-up Communities and Housing. Both proposed redevelopments sit on sensitive sites with historically and architecturally important neighbours and the Secretary of State's objections largely concerned fundamentals around aesthetics and carbon impact. After significant delay, and at great additional cost, both developments have ultimately received the green light – assuming the DLUCH does not appeal the High Court's decision in the case of M&S.

Planning policy should, rightly, ensure reuse is prioritised where viable and that available options are properly explored, however, a system in which schemes can still be rejected at the eleventh hour after securing approval from a range of professional bodies, is a strong investment deterrent – especially when alternative options have been properly considered and discounted for valid reasons.



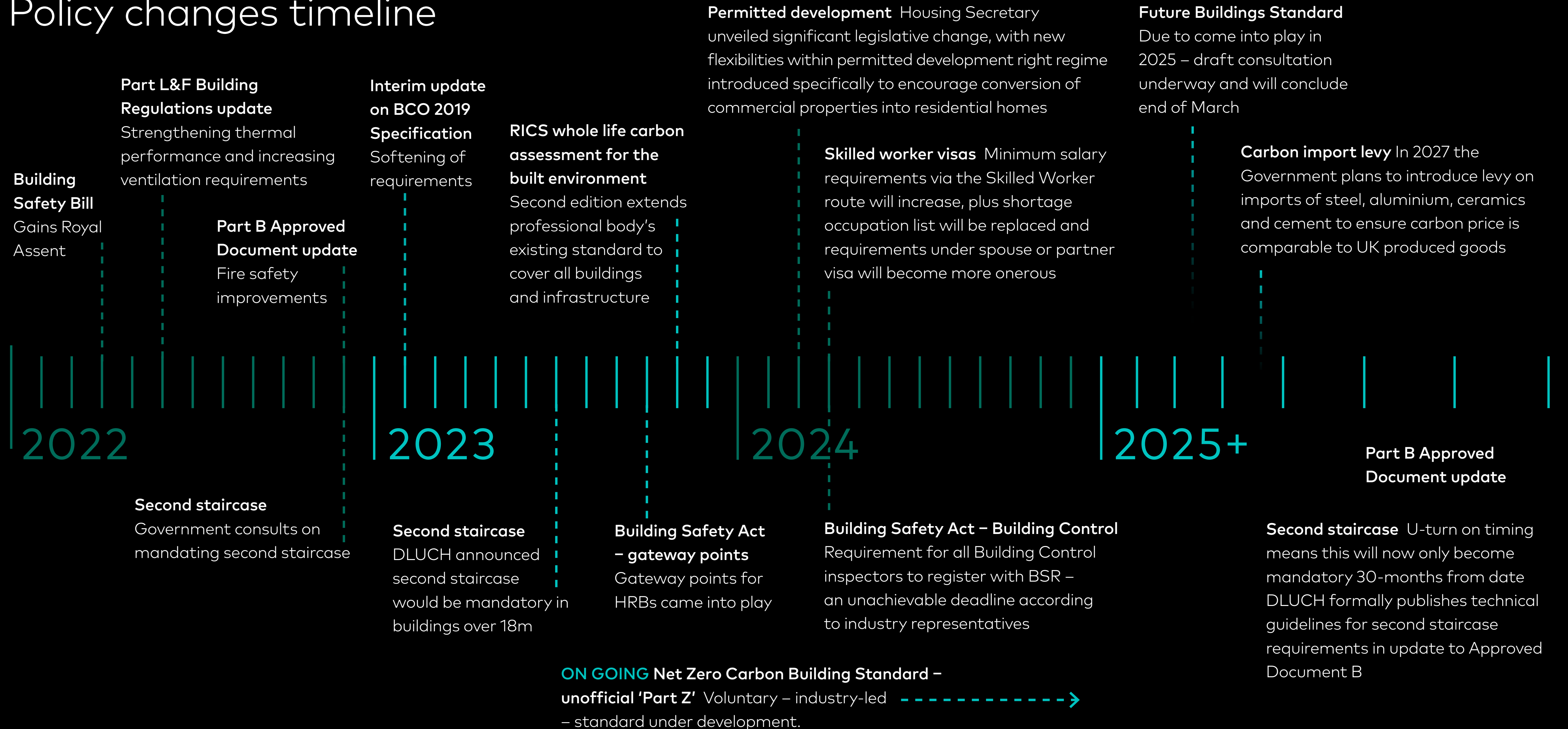
In addition, the new Building Safety Act (BSA) focusing on higher-risk buildings (HRBs) which has come into force, with a particular focus on residential construction, will likely have a significant impact on all major developments.

The three-stage gateway regime for the design and construction of new and major refurbishment to all HRBs will have implications that need to be closely monitored as the system beds in. At gateway 2, it will be important to keep a close eye on any programme implications, ensuring design meets building regulations and that safety management proposals for the completed building are realistic and approvals are sought in a timely manner. Reporting major and notifiable change will be key and will likely drive the need for earlier design certainty and coordination, together with earlier contractor engagement. Making major changes that impact building regulations will be more difficult and potentially costly, both in terms of time and money, and will require a separate application to the Building Safety Regulator (BSR) for approval.

Developers in England will now be given a 30-month transitional period before compliance with the Government's 'second staircase' requirement in buildings over 18 metres becomes mandatory. The transitional period, only announced in October, will start from the date the Government formally updates Approved Document B with technical detail for second staircases. In reality, the transition period announced as it was makes little difference to development. Amendments to design are being implemented in any event with the well-publicised impacts on viability and programme.

All of the above will have implications not only in terms of construction costs, but also in administration and management costs, additional fees, preliminaries and potentially time.

Policy changes timeline



Intelligent value-driven development

Anticipated moderation in financing costs and access to capital, greater levels of competition and greater visibility of construction cost inflation will all help the viability equation, but as reported in our Q4 2023 market update, construction costs in offices in central London have risen by over 30% over the past four years through inflation, regulatory change and design enhancements to meet tenant demand. Professional teams still need to work harder than ever before to deliver effective solutions.

Cost and programme, carbon and value should drive design evolution and professional teams have a duty to present robust, transparent information to inform client decision-making. Developing a cost and carbon 'bunker' model that delivers core functionality and base specification requirements from which to measure enhancements against, can help put value at the centre of decision-making and reset the focus of project development. Proposed enhancements to this adequate baseline are only successful if the additional value delivered is deemed worthwhile after taking cost, carbon and programme implications into account. Inefficient or overengineered design is less likely to deliver an optimal solution and is unlikely to stand up to an honest, appropriately informed, appraisal.

Challenging the rule book and the accepted norms is the best way to drive better value and aid viability.

As we move into Q2 2024, our forecasts suggest cautious optimism for the London commercial market as confidence and stability returns with interest rates softening, rental growth strengthening, yields hardening, and access to capital and levels of investment returning, but there will continue to be planning and viability headwinds and a drive to high-quality and sustainable product.

Hill House - Landsec © *WAX*

Our TPI predictions remain unchanged in Q2 2024

+1.5%

Q4 2023– December: December change (%)

SENSITIVITY RANGE	2021	2022	2023	2024	2025	2026
LOW			3.75%	0.0%	1.0%	1.5%
BALANCED	5.1%	11.4%	4.0%	1.5%	2.5%	3.5%
HIGH			4.0%	2.5%	3.5%	4.5%

exigere

+making projects happen

Author

David Thornley
Partner
0203 985 1077
07834 257188
david.thornley@exigere.co.uk

exigere.co.uk