

Cover story

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Germany is the fifth largest economy and the second largest exporter in the world. It is the largest economy in Europe and is expected to be at the forefront of any European recovery..

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Global Construction Costs

Recovery brings risk of cost inflation

Construction costs have dropped drastically as many contractors have cut margins to survive. For contractors any recovery is welcome relief, but for buyers the signs of inflationary pressures on costs are already evident. The UK, for example, has seen its Consumer Price Index jump from 3.0% in February 2010 to 3.4% in March 2010, whilst the US has seen an increase from 2.14% to 2.31% in the same period.

For the global construction market, the rapid rise in commodity prices is the clearest warning of inflationary danger. Copper prices (right) almost doubled over the past 12 months, touching a 20 month high in April 2010 of over USD 8,000, despite the fact that supply is at its highest level on record. This has nothing to do with normal principles of supply and demand, but is due to institutional investors holding on to stocks for longer-term gain.

Steel prices are also set to rise significantly. Iron ore is the core ingredient in steelmaking, and Japan's Sumitomo Steel has confirmed that the world's biggest ore producer, Brazil's Vale, is increasing their supply price of iron ore by 90%. The global iron ore market is dominated by just three suppliers. The others will almost certainly follow Vale, which will impact significantly on construction prices worldwide.

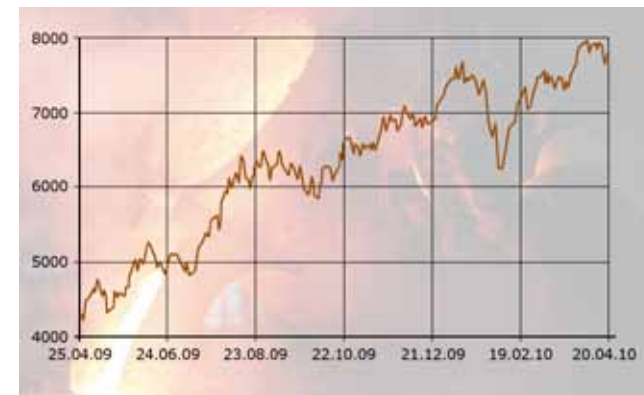
Managing the risk

Steep commodity price increases present a major risk to construction procurement, which buyers should manage in one of three main ways:

- 1. Procurement Strategy:** Agree fixed price contracts of varying lengths with suppliers. However, this transfer of risk onto the supplier may push costs even higher and reduce flexibility.
- 2. Margin Management:** Pass on the additional cost of the raw material to the customer – if this can be done without jeopardising market share or service level agreement.
- 3. Hedging:** Mitigate price fluctuations by using the derivatives market.

Continuing fluctuations, and probably increases, are inevitable in these essential construction commodity prices, fuelled further by national debt uncertainty and speculative commodity trading. If not doing so already any organisation with significant construction procurement programmes should be considering these risk mitigation strategies as a matter of urgency.

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US

US markets generally are beginning to stabilise as evidenced by the rise in the US stockmarkets, the return to profitability of many US corporations and a nominal increase in retail sales. The construction industry appears to have bottomed out. Outputs and general prices are likely to remain at current levels for the next six months, certainly until both developer confidence and an increase in reasonably priced and available credit returns to the real estate market. For organisations investing in construction in the US, supplier capacity and margins are very appealing. General contractors' fees are between 2% and 3%, and in some instances as low as 1%.

UK

The UK construction industry has seen a continued decline in tender price indices as competition for work has become fiercer. This has been exacerbated by suppliers and manufacturers trying to fill holes in order books, and by main contractors trimming overheads through reductions in staff. This has been reflected in tender prices falling 5% since Q2 2009. Material prices have stayed fairly stagnant in this period, with a 0.7% increase. The market has seen preliminaries drop by 3.5% and overheads by 2% since Q2 2009.

Western Europe

Germany has seen construction costs increase by 0.9% in the last 12 months, with an expectation this will touch 1% in 2010. Costs across Austria have remained stagnant since Q2 2009. Compared to the UK, costs have increased by approximately 8% due to the weakening of Sterling against the Euro since Q2 2009.

Ireland's construction industry continues to be badly affected by the country's poor economic circumstances, and tender prices are still falling. Tender levels have dropped by approximately 20% during the past year alone.

Eastern Europe

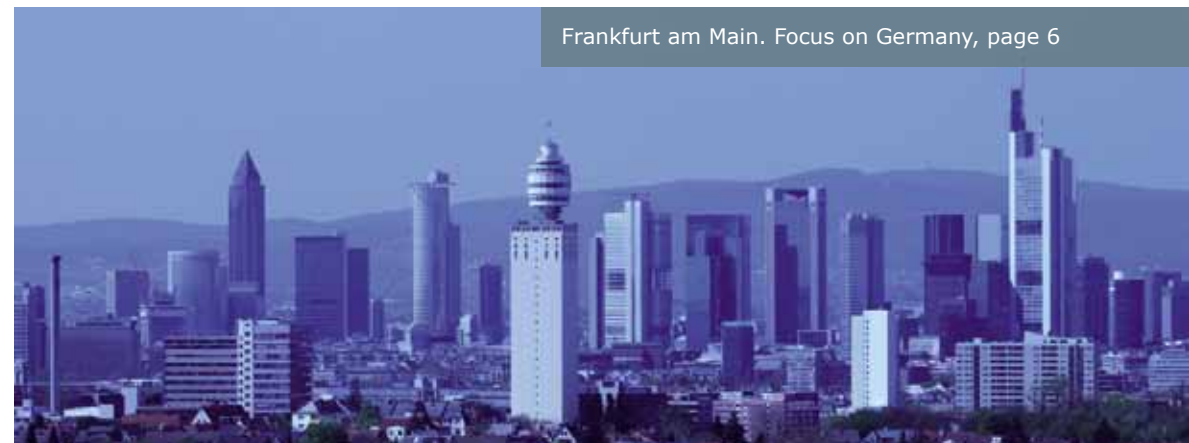
Construction confidence has stabilised in Eastern Europe over the past few months, mostly as a result of an improvement in expectations for employment levels. The mood in Romania and Poland is more optimistic than in its neighbours due to increased enquiries and relatively higher employment.

UAE

The oil rich emirate of Abu Dhabi accounts for 60% of the UAE economy and looks set to continue on a major capital expenditure programme as it progresses towards the Abu Dhabi Vision 2030 masterplan. The emirate is under less financial pressure than its neighbour Dubai, although more recently tendered works have been priced 10% to 12% lower than 12 months ago. In Dubai the construction industry has been severely affected by the financial crisis. Where projects are going ahead, pricing is generally 15% to 18% lower than a year ago.

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Abu Dhabi looks set to continue on a major capital expenditure programme. But tender prices are still 10% to 12% lower than 12 months ago.



Frankfurt am Main. Focus on Germany, page 6

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Global Construction Costs News

Regional Forecasts (cont)

South Africa

The labour market does not reflect the recessionary times experienced in the economic cycle. The economy is fairly flat with GDP at 3.2% and the Consumer Price Index remains within the Reserve Bank target of 3% to 6%. The prime interest rate is at 10%, which is low for South Africa. Contractors experienced the largest drop in confidence in 20 years between 2007 and 2009. The non-residential sector has now begun to recover, while the commercial sector is expected to follow towards the last quarter of 2010.

India

India's construction industry has been growing at 15% to 20% year on year, mainly on the strength of increased manufacturing activities, industrial growth, and heightened investments – especially

by the Government – in infrastructure and real estate. The Indian Government's decision to allow 100% foreign direct investment in the real estate business has helped stimulate construction activities throughout the country. Although the recent economic downturn had slowed the real estate business, this sector is already showing signs of recovery. Currently the size of the real estate construction industry is approximately USD 44 billion, with expected growth levels averaging 26% until 2014.

China

China's CNY 4 trillion fiscal stimulus plan continues to boost local construction demands. With a strong economic recovery of 8.9% GDP growth in Q3 2009 and a loose monetary policy, residential and commercial real estate markets are scaling new peaks. Construction costs in Q4 2009 were expected to rise by approximately 5% when compared to Q1 2009, due to a rebound in construction materials prices and an increase in private sector investment.

Singapore

Singapore is showing signs of emerging from recession with growth of 0.8% in Q3 2009 compared with a year earlier – the biggest expansion in more than a year. The construction industry has increased 12.4% as real estate developers build homes, hotels and office blocks. Basic materials groups comprising cement, steel bar and granite are still showing erratic price trends, with no signs of stabilisation.

Australia

The Australian economy has shrugged off the downturn with minimal impact. Unemployment has been better than expected at 5.3%, and GDP growth forecasts have been revised upwards to 2.8% for 2010. Construction costs turned upwards in most states in Q1 2010 and widespread trade skill shortages are again being reported. Further announcements of major projects in LNG, coal and iron ore foreshadow a sharp upturn in construction costs by 2011 to 2012, as the skills shortage worsens. The Australian dollar has strengthened to around 60 pence, well above its long-term average, which is keeping imported building materials cheap. Finance is gradually easing and a number of high profile construction projects shelved during 2009 look likely to proceed.

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Singapore. Building homes, hotels and offices



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One of the key factors incorporated into this model is that the starting point is the tenant's fitout – the condition handed over by the developer varies around the world. For example, in India a tenant will typically be given a shell and core, whereas in the UK developers typically deliver the space to a Category A standard (with raised access floor, ceiling etc).

Some substitutions of items have been made to reflect local practices (e.g. metal stud partition v plastered blockwork wall) and the accuracy of the model may be affected by varying local design codes and regulations.

VAT and Sales Tax

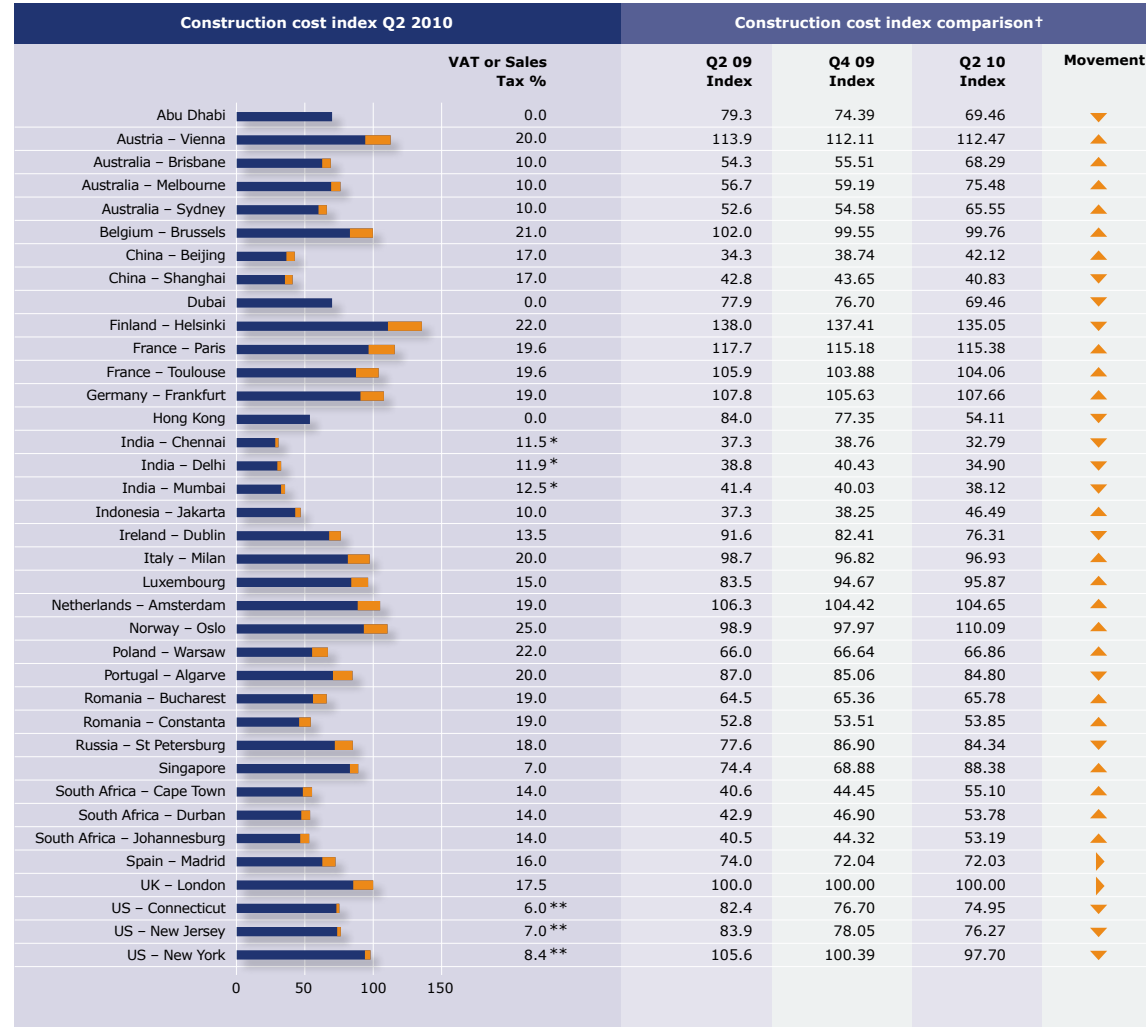
It should be noted that VAT/Sales Tax can vary at both country and city level.

*Rates of VAT vary across India. Additional taxes such as Octroi tax are applied to material costs and Service Tax is applied to both labour and material costs.

**Represents State Sales Tax in the US – applies to materials costs only.

†Net of VAT or Sales Tax

■ Construction Costs
■ VAT or Sales Tax



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Global Construction Costs News

Construction Costs Fluctuations (cont)

The sovereign debt problems in Greece and the fear of this crisis spreading to other European countries has seen the Euro weaken whilst the USD has remained stagnant with growing certainty of an upturn in the US economy.

In the past quarter UK costs have increased following the reversion to 17.5% sales tax from 15%. Further increases are likely when the planned rise to 20% comes into force in 2011.

Over 30% of the cities indexed have seen a decrease in costs due to currency fluctuations and falling demand, the worst casualty being Dubai following a virtual collapse of the construction industry.

On the whole, Asia and the Pacific regions have weathered the recession – in particular, mainland China and India which are still showing signs of strength, bolstered by growing middle class demand.

Australia has also been resilient to the downturn, which helped the AUS\$ gain strength, and this is likely to continue into 2011 with the IMF predicting positive growth in GDP in the region of 3.4%.

Key Assumptions

- This model is based on a gross area of 914m² in a low storey building.
- All materials are procured locally and meet local specification.
- 70% of the gross area is utilised as open plan office, 20% meeting space and the remaining 10% is miscellaneous support space.
- The cost model has been priced based on current market rates for Q1 2010.
- Currency conversion is based on exchange rates of June 2010.
- Contractors' preliminaries, overheads and profits are included within the cost model at local rates.
- Sales Tax/VAT is included at local rate.
- It is assumed that the tenant fitout will be undertaken in a developer's new build therefore no strip out works will be required.
- Acoustic requirements are taken at NR38 in general office space and NR35 in meeting rooms.
- There are sufficient incoming gas and electrical supplies, therefore no upgrades are required.
- UPS/Standby generator is provided by the developer for emergency life systems only. No allowance has been included for n+1 for any communications rooms.
- No works are required to any lift installations.

Key Exclusions

- Inflation
- Design and Price Risk
- Consultant Fees
- Data Cabling
- Furniture
- Landlord Contributions

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Global Construction Costs News

Focus on Germany

Germany is the fifth largest economy and the second largest exporter in the world. It is the largest economy in Europe and is expected to be at the forefront of any European recovery. It is also the biggest European construction market by far and a leading global exporter of construction expertise, so the prospects for this industry are important not only for the country but also for Europe as a whole.

After a turbulent 2009, with declining prices and inadequate demand, figures for the first quarter of 2010 indicated an upturn for the German construction industry. This is encouraging as 52% of all investments in Germany were in construction projects.

The main beneficiaries of the upturn have been office buildings and retail premises. Good prospects for future development are also expected in the logistics and residential property areas.

Forecasts by market observers underline the prediction that in the coming years the German commercial property market will perform well compared with many other large, mature markets, with a growing emphasis on environmental and sustainable impact.

What the industry really worries about is what will happen in 2011. That is when the construction sector will first experience the full force of the recession.

Analysts anticipate a clear imbalance between the investment and leasing markets in 2010. Although the capital market for property investments is already showing distinct signs of revival, leasing is lagging behind the still-fragile economic recovery. This leads to higher procurement prices combined with higher vacancy levels and declining net operating results. There is a threat of record vacancy levels in office markets.

The German property market is presently shaped by low interest rates. Only Frankfurt am Main as an office centre has proved to have better long-term structural stability than most of its European competitors. This is shown by an analysis of large Western European office centres based on various risk indicators. Even with the standard measurement methods, which ignore strong deviations from the average, Frankfurt occupies a solid third place in the value stability ranking, after Amsterdam and Brussels.

Public sector stimulus

In the view of the Institut für Wirtschaftsforschung, public sector construction will become a problem for the construction industry.

The Government's economic stimulation packages have partially offset declines in the construction of commercial and residential properties and thus reduced the impact of the economic crisis on the construction industry compared with other industries, but the price for this must be paid in the coming years.

The volume of public sector construction rose by 4.5% in 2009, and is expected to increase by as much as 10% this year because the economic stimulation measures are only now exerting their full effect. This increase is reflected in the increased construction procurement costs shown in our Cost Index on pages 4-5.



Trends

Whole life value

Turner & Townsend is seeing a significant rise in requests to provide Life Cycle Cost Models along with capital cost advice. Clients in Germany are increasingly looking for expertise to drive value on the whole life of the building and not just on capital investment.

Contract changes?

One interesting development in the German construction market is evident in the practice of awarding of construction projects on the basis of prime contractor contracts. Although this form of contractual relationship has been commonly used by clients and the construction industry in recent years, there is increasing doubt about the suitability of this form of relationship due to problems with price guarantees and quality management.

During the recent spring meeting of the German Association of Project Managers, the value of this form of contract, characterised as the 'simplest solution', was questioned in a lively debate between clients and service providers, with an urgent call for a unanimous commitment to increased price transparency and direct control of the quality of execution.

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Focus on Germany (cont)

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Commercial sector dichotomy

The economic crisis in Europe and additional pressure for budgetary reforms due to current restrictions on new government debt is expected to result in a perceptible decline in public sector construction.

The second problem for the industry is commercial construction, although this area shows a distinct dichotomy. In the commercial civil engineering sector, new orders declined only slightly as a result of the crisis, in part because this sector benefits from the restructuring of the energy sector and in particular the establishment of large offshore wind parks. Necessary investments in telecommunication and railway networks also stimulate growth in this sector.



By contrast, the prospects for traditional commercial building construction are grim. New orders in this sector dropped by 20% in 2009, and the full effects of this collapse will only become apparent during the course of the current year.

Fears for 2011

The construction industry generally has a positive view of 2010, taking into account that core activities will fare worse than activities in the fitting out and services areas. What the industry really worries about is what will happen in 2011. That is when the construction sector, as a downstream industry, will first experience the full force of the recession.

The relatively good situation of the construction industry is due to the fact that quite a few projects still had to be completed in 2009 and the measures of the government's economic stimulation packages bore fruit in 2009 and will continue to do so in 2010. None of these factors will be present in 2011.

Expertise in the German speaking market (DACH) region

Turner & Townsend has been active in the German market for ten years as a provider of project management services and technical consulting services.

In addition to core project management and project control services, we provide market leading expertise in cost management, change management and mediation, sustainable building, facility management consulting and investment services.

In the German speaking area, Turner & Townsend has offices in Munich, Basel, Vienna and Berlin, and approximately 75 project managers and consultants with expertise in civil and structural engineering, architecture, process engineering and industrial engineering.

This resource is supporting clients in many economic sectors with critical future potential:

- infrastructure – main focus on transport and power;
- commercial sector – supporting national and international property owners, investors, financiers and public authorities;
- high-tech and manufacturing – management and control services, and tailored construction management solutions;
- health – focus on hospitals and research facilities.

Along with a clientele drawn from the ranks of German industrial firms and public sector organisations, we also support many international clients actively involved in the German market, as well as German firms investing internationally.

In the past ten years we have successfully completed projects for satisfied clients including Landkreis Starnberg (Kreisaltenheim Garatshausen), Hessisches Baumanagement (Behördenzentrum Heppenheim), Conergy (Fully integrated solar module plant), Masdar (Masdar MPV1), Siemens (Siemens City Wien) and many others, including public sector projects.

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Global facilities management

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More and more organisations are developing FM strategies that transcend geographical boundaries, providing the same services to the same standard for all employees whether they are based in Beijing, Birmingham or Brisbane.

The current economic climate is driving more and more organisations to look to their FM services as a way to make savings. The fact that ongoing property costs for any organisation can represent up to 30% of total running costs means that optimising FM services presents a real opportunity to improve value.

Adopting a global approach creates opportunities to reduce costs, but it also adds value in other important respects:

- Consistency of standards
- Increased value for money
- Enhanced purchasing leverage
- Sharing of knowledge and best practice
- Sharing of processes and systems

As with any other area of business improvement, the key to the success of a global FM approach is the development of the right FM solution, based on a strategy that is aligned to and fully supports the organisation's fundamental business objectives.

Turner & Townsend has a strong track record in helping clients get the right FM solution through the provision of valuable independent advice.

Turner & Townsend's FM Consultancy team provides a wide range of value added services:

FM Healthchecks / Value for Money Reviews	FM Service Monitoring / Management
Benchmarking	FM Design Reviews
Procurement	Whole Life Cost Modelling
Strategic FM Reviews	PPP FM Support
Bid Support	Mobilisation Support

As a leading international FM consultancy, Turner & Townsend is seeing an unprecedented number of clients looking for advice in relation to benchmarking their FM service costs, with a strong focus on reducing expenditure and increasing value for money.

We are helping many clients to procure comprehensive FM 'super contracts' on a regional and global basis, including major players in the manufacturing, banking and retail sectors.

If you would like to know more about our FM Consultancy services, please contact: nigel.herbert@turntown.co.uk



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