MARKET SECTOR INSIGHTS - MAY 2020

Construction Industry

> *In real value terms, global construction output is forecast to rise to $12.9 trillion in 2022, up from $10.9 trillion in 2017.*

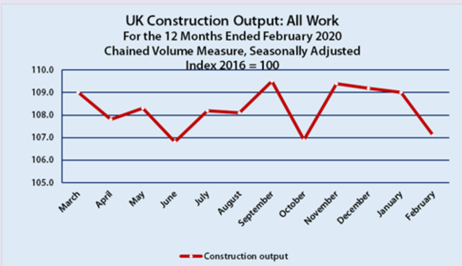

Fig 1: UK Construction Output

Global Overview

A March 2019 report from Orbis Research predicts annual average growth of 3.4% for the global construction market during the forecast period of 2018 to 2022. In real value terms, global construction output is forecast to rise to $12.9 trillion in 2022, up from $10.9 trillion in 2017.

Although construction output growth in China is set to slow, to average 4% in 2018-2022, this will be offset by an acceleration in construction growth in India. Construction activity in Western Europe is forecast to expand by 2.4% per year on average in 2018-2022, improving on the sluggish growth of 1.3% in 2013-2017. The expansion in advanced economies will remain stable at 2% in 2019-2020 before easing back over the remainder of the forecast period.

UK Construction Industry

According to figures from the Office for National Statistics ("ONS"), construction output fell by 0.2% in the three months to February 2020, compared with the previous three-month period; this was driven by a 1.7% fall in repair and maintenance but partially offset by 0.6% growth in new work. The rise in new work in the three months to February 2020 was driven by growth in infrastructure and public other new work, which grew by 2.8% and 4.5% respectively; no other new work sectors saw growth.

In repair and maintenance, the fall in the three months to February 2020 was driven by a 5.6% fall in private housing repair and maintenance – the largest fall in this series since October 2012 when it fell 5.7%; in contrast, public housing and non-housing repair and maintenance increased by 2.2% and 0.1% respectively.

Over the longer term, UK construction industry has seen subdued growth in output over the last 12 months. However, since the 2.3% month-on-month growth in November 2019, which was a bounce-back from the weather-impacted October 2019, the industry has experienced three consecutive monthly falls. This is the first time we have seen this in total construction output since March 2018.

In the monthly series, construction output decreased by 1.7% in February 2020 to £13,522 million. This is the largest fall in monthly growth since October 2019 when it fell 2.4%. Similar to October 2019, the decline in construction output in February 2020 may have been affected by adverse weather.

Brexit

Now that the UK has left the EU, it has entered into a transition period, which runs until 31 December 2020. As things stand, the UK government maintains this will not be extended, following the enactment of the European Union (Withdrawal Agreement) Act 2020. Brexit's impact on construction, as for the country as a whole, will be shaped by negotiations between Member States and the UK, with the political declaration featuring as the starting point for discussions.

A large proportion of the UK's construction workforce and building materials are sourced from the EU, which could leave yawning gaps in contractors' capacity to deliver projects – at a time when demand for residential property in particular shows no sign of slowing down. Although there are early indications that sentiment in the real estate market has responded positively to policies put forward by the new government.

This is in contrast to the quarter running up to the election, when it was clear

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"According to a Savills research report, 2018 saw the third highest percentage rise (46.2%) in UK timber prices recorded during the last 35 years…"

that many lenders were refraining from deploying capital in the real estate market and that transactional activity had largely been put on hold. But this improved political certainty does not assuage practical concerns about Brexit that remain high on the agenda for many in the construction sector, the answers to which will ultimately depend on what arrangements the UK agrees in terms of work visas and trade tariffs.

According to Property Reporter, the construction industry has been struggling to increase its total output, which has been in decline for over 12 months. June 2019 also marked the construction industry's worst-performing month since 2009 with output in sharp decline. However, figures from Markit/CIPS UK Construction Index for January 2020 revealed that the rate of output decline is slowing down. This is being partly attributed to a recovering pound and greater political certainty.

-Timber Market-

According to a Savills research report, 2018 saw the third highest percentage rise (46.2%) in UK timber prices recorded during the last 35 years, leading to understandable nervousness over the short term direction the markets will take. But commodity price fluctuations are not new and market volatility will continue – the reality is that the price of timber will be entirely influenced by supply and demand and the efficiencies or otherwise of the production chain. The domestic market is complicated by the degree to which the UK is reliant on imports. In 2018 and 2019, this was compounded by the uncertainty around future UK trade relationships with most other exporting countries.

The report further adds that latent demand may fluctuate, but over the medium term it will not diminish. Construction demand is underpinned by house building targets in the UK, and this is replicated in China and the USA, as well as the potential from developing economies. Biomass currently offers strong demand for small diameter timber in the UK and elsewhere. This is not a sustainable use of wood fibre and, although it is clearly impacting on markets, there is the prospect of price or regulatory intervention impacting the further expansion of this sector. The key to timber prices over the longer term is likely to come from construction demand and in a buoyant economy there is no reason for prices to fall. If they do, as seen in past cycles they will recover again, and we do not believe the market has reached a ceiling price.

Furthermore, it is well reported that the UK is very reliant on timber imports, but recent inward investment in the UK wood processing industry and pricing trends highlight the buoyant and world class nature of this sector. Current conditions favour UK producers but the potential harvest is limited by availability of the resource and the practicality of harvesting more timber than what is currently being produced. Current felling rates can be considered as sustainable for the next 30 plus years, which means that, subject to external shocks disrupting demand, there is little on the horizon to suggest a change to current pricing structures.

EUROPEAN VALUATIONS

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Timber Prices

The latest national statistics on timber price indices produced by the Forestry Commission were released in May 2020 and consist of the Coniferous Standing Sales Price Index and the Softwood Sawlog Price Index.

The index was 14.8% lower in real terms (13.2% lower in nominal terms) in the year to March 2020, compared with the previous year. This follows a generally increasing trend in the index in recent years. The average price for coniferous standing sales was £28.22 per cubic metre overbark standing in nominal terms in the year to March 2020, a decrease from £31.66 in the year to March 2019.

The Softwood Sawlog Price Index was 18.6% lower in real terms (17.1% lower in nominal terms) in the 6 months to March 2020, compared with the corresponding period of the previous year. As for the Coniferous Standing Sales Price Index, this follows a recent increase in the index.

The average price for softwood sawlog sales was £54.06 per cubic metre overbark in nominal terms in the 6-month period to March 2020, a decrease from £54.54 in the 6 months to September 2019 and £65.23 in the 6 months to March 2019.

- Economic Impact of Coronavirus -

Undoubtedly, coronavirus is a black swan event – something that happens once in a century. Its spread has left businesses around the world counting costs, with many investors fearing the spread of coronavirus will pose an insurmountable challenge to the economic growth of all major countries across the globe. Almost every industry has been affected, with governments scrambling to somehow arrest the economic decline. Central banks in more than 50 countries, including the US Federal Reserve and the Bank of England have cut interest rates to try to strengthen their economies. Furthermore, most countries have announced unprecedented stimulus packages in the hopes of reviving their economy.

Manufacturing and Services Have Been Massively Hit

In China, where the coronavirus first appeared, industrial production, sales and investment all fell in the first two months of the year, compared with the same period in 2019. China makes up a third of manufacturing globally and is the world's largest exporter of goods. Like China, factories in many other economic powerhouses like the US, UK and Germany have been shut, resulting in a decline in manufacturing output at perhaps unprecedented levels.

Likewise, services sectors around the world including IT, IT enabled Services ("ITeS") and banking have also taken a hit, and perhaps the biggest hit has

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been the travel sector, with many companies in this sector now facing an existential crisis.

UK Construction Sector

According to the Financial Times, UK construction activity declined at the fastest pace since the financial crisis in March 2020 as many builders halted work and cut jobs as coronavirus hit the economy. The IHS Markit purchasing managers' index for UK construction dropped to 39.3 in March from 52.6 in February 2020, marking the lowest reading in more than 10 years.

"As measures to contain the coronavirus Covid-19 pandemic were put in place across the UK, construction sites closed and builders lost their jobs on a frightening scale as overall activity fell to an extent not seen since April 2009. The closure of construction sites and lockdown measures have had a severe impact on construction activity over the past few months. As UK starts to open up now, questions still remain regarding the safety of construction workers at sites across the UK."

Impact on Timber Trade

Recently, members of the STTC Technical Committee reported that the Covid-19 pandemic has resulted in radically reduced timber trading across Europe. Many companies are temporarily closing or curtailing operations, pushing back orders and asking for longer payment terms. Impacts of the health crisis are also reported from China and African supplier countries.

The STTC Technical Committee comprises the European Timber Trade Federation, national trade associations, the FSC, PEFC and ATIBT.

The UK TTF said it was busy with member enquiries, particularly on government grants to enable companies to pay furloughed personnel during temporary shutdown. Some importers, distributors and merchants have suspended business. Others are operating at much reduced levels. Some demand continues from the UK building sector, with work on construction sites allowed within new health and safety rules. DIY sales are also holding up, which is attributed to consumers undertaking repair and refurbishment projects while off work. Importers say they have asked overseas suppliers to push back orders by 30 to 60 days but there is still concern about the build-up of landed stocks at ports, with companies unable to accept cargoes as their own storage is full.

Economic Forecast

The economic situation remains highly fluid. Uncertainty about the length and depth of the health crisis and the related economic effects are fuelling perceptions of risk and volatility in financial markets and corporate decision-making. In addition, uncertainties concerning the global pandemic and the effectiveness of public policies intended to curtail its spread are adding to market volatility.

Compounding the economic situation is a drop in the price of crude oil that reflects the global decline in economic activity and prospects for disinflation. On 29 April 2020, US Federal Reserve Chairman Jay Powell stated that the Federal Reserve would use its "full range of tools" to support economic activity

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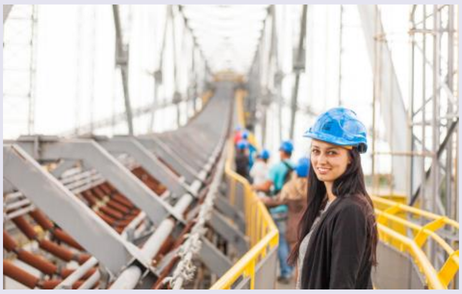

as the Commerce Department reported a 4.8% drop in US GDP in the first quarter of 2020. In assessing the state of the US economy, the Federal Open Market Committee released a statement indicating that, "The ongoing public health crisis will weigh heavily on economic activity, employment, and inflation in the near term, and poses considerable risks to the economic outlook over the medium term.

The Organization for Economic Cooperation and Development ("OECD") on 2 March 2020, lowered its forecast of global economic growth by 0.5% for 2020 from 2.9% to 2.4%, based on the assumption that the economic effects of the virus would peak in the first quarter of 2020. However, the OECD estimated that if the economic effects of the virus did not peak in the first quarter, which is now apparent that it did not, global economic growth would increase by 1.5% in 2020. That forecast now seems to have been highly optimistic.

Labelling the projected decline in global economic activity as the "Great Lockdown," the International Monetary Fund ("IMF") released an updated forecast on 14 April 2020. The IMF concluded that the global economy would experience its "worst recession since the Great Depression, surpassing that seen during the global financial crisis a decade ago."

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In addition, the IMF estimated that the global economy could decline by 3.0% in 2020, before growing by 5.8% in 2021; global trade is projected to fall in 2020 by 11.0% and oil prices are projected to fall by 42%. This forecast assumes that the pandemic fades in the second half of 2020 and that the containment measures can be reversed quickly. The IMF also stated that many countries are facing a multi-layered crisis that includes a health crisis, a domestic economic crisis, falling external demand, capital outflows and a collapse in commodity prices. In combination, these various effects are interacting in ways that make forecasting difficult.

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EUROPEAN VALUATIONS

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