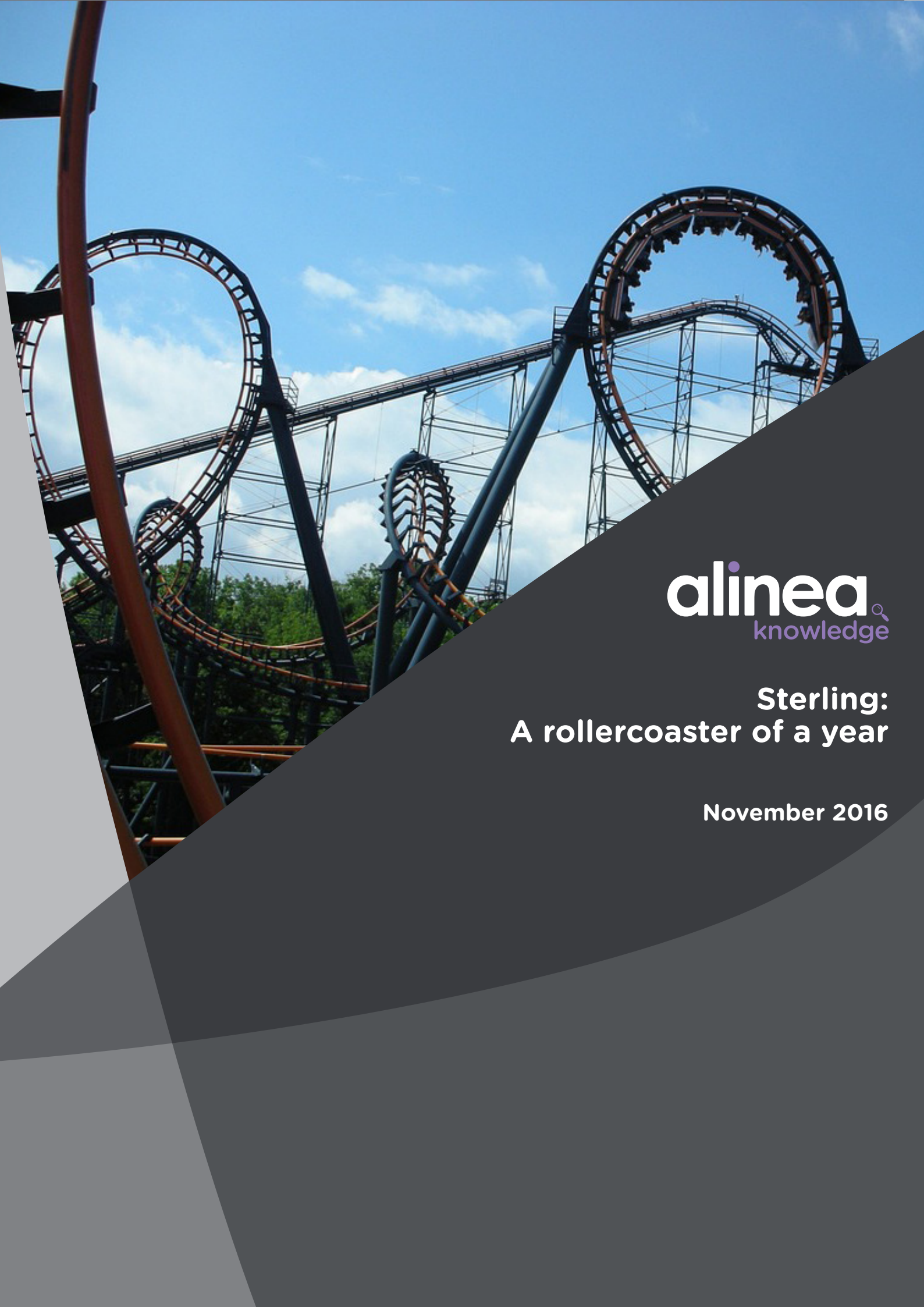


alinea knowledge

Sterling: A rollercoaster of a year

November 2016

One Angel Court - a European sourced envelope

Executive summary

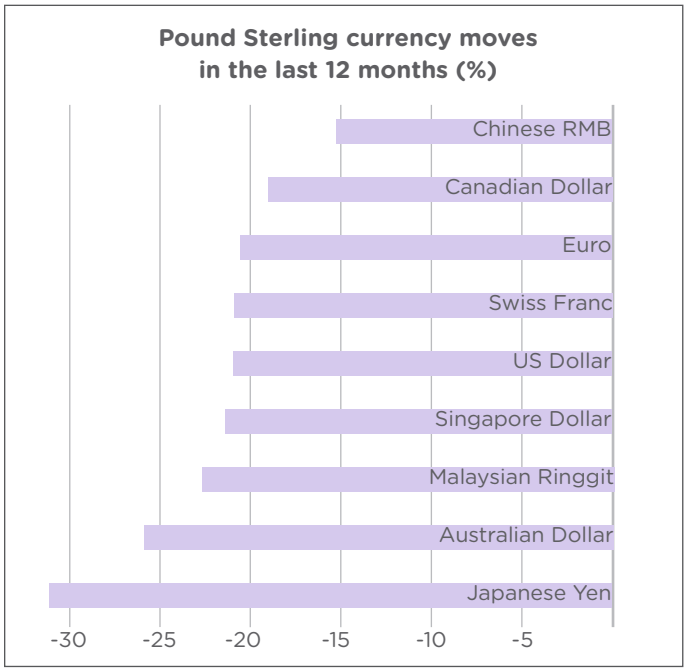
Sterling has endured a turbulent year. Its performance against a basket of key currencies has not only been volatile but has left it severely weakened. In fact, it has fallen to its lowest point ever, or at least since reliable data has been available. In the last four months alone it has plunged from a high of $1.50 to a low of $1.20 against the US dollar. It has also lost over 20% of its value against the euro, from a recent high of 1.45 last year.

Where it goes from here nobody can predict with any certainty, and views vary wildly. Some commentators believe that sterling has finally found its true worth, having been over-valued for years. Others point to purchasing power parity data, which suggest that the pound should be worth around $1.45.

There are various factors that affect such valuations, such as inflation, interest rates and trade tariffs — not to mention shocks such as the result of the UK's EU referendum and the US presidential election. There is room for more surprises to upset even the most considered currency forecast, which makes it essential for buyers of construction to understand the potential implications, and consider their options to lessen the effects.

A typical sizable commercial construction project could have a third of its cost subject to international currency movements. Some trade packages will be more explicitly linked to exchange rates: 15-20% of the total trade cost might be Euro-derived across the façades and vertical transportation elements alone. In the absence of any mitigation measures, these two packages could have driven up a project's construction cost by 3-5% over the last year.

A cost consultant must help the client consider its options well before the cost impacts of exchange rate movements become a fait accompli.



Key considerations

- ! Be clear on the basis of trade prices: their underpinning exchange rate; any tolerance in this rate; the proportion of the price that is non-sterling related.
- ! Obtain a cash flow of sterling and non-sterling payments.
- ! If and when the currency is to be fixed, agree the rate measure to be used and any hedging costs.
- ! Consider paying the relevant amounts directly in the alternative currency.
- ! Consider leaving the currency rate unfixed (if none of the above yields a satisfactory answer), valuing each progress payment at the prevailing rate – and possibly allowing the rate to be fixed at some future point.
- ! Assess options to source materials / components from the UK.

A roller-coaster of a year

Following the UK's vote to leave the European Union, one of the most talked about topics has been sterling's weakness. The pound has fallen to an all-time low when measured against a basket of currencies of its major trading partners (Germany, Russia, Japan and Italy).

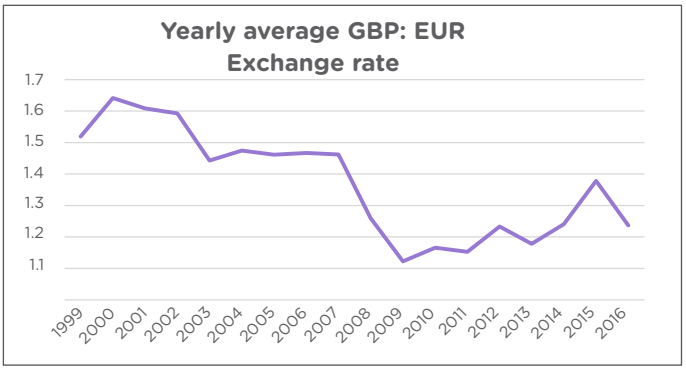
It has also been the worst performing currency of 2016, when compared to the global marker of the US dollar.

The currency has had a tumultuous 10 months after peaking against the Euro in November 2015 at a rate of 1.45. In the latter part of 2015, analysts voiced concerns that the pound was overvalued (a claim that the International Monetary Fund has repeated since 2014) and expected its value to fall in 2016 as the UK government increased cuts to public spending and the UK's referendum on its membership of the European Union loomed large.

Confusingly, others see sterling as now being undervalued, referencing metrics such as price parity as evidence - not to mention the 'Big Mac Index', though the validity of that measure could warrant a report in itself.

It all adds to an underlying uncertainty about the UK's currency, and where it will head from here.

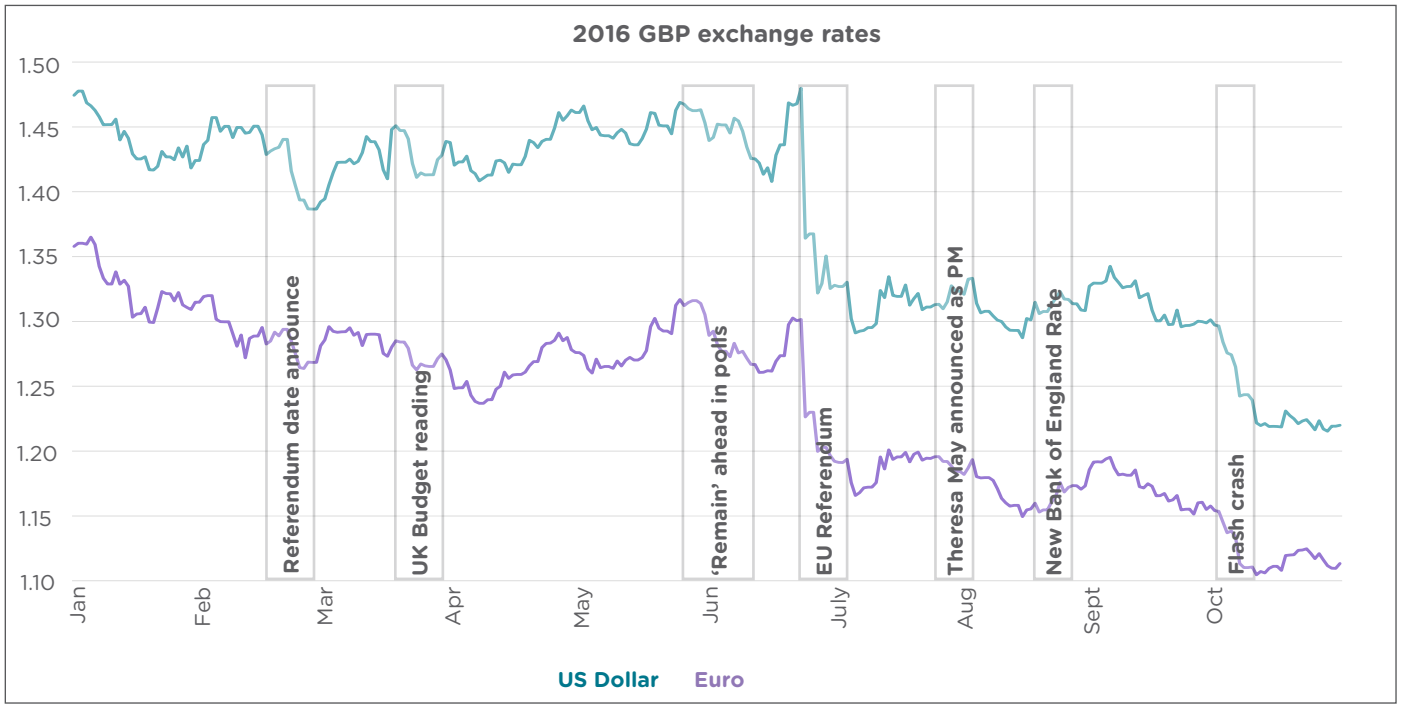
It is also volatile, and sensitive to not only political events, but press coverage too. Pre-referendum, during the renegotiation of the UK's EU membership in February, sterling fell to a seven-year low against the dollar because of the perceived poor deal achieved by Cameron.



In the risk-shedding event following the 'Brexit vote', sterling exchange rates fell dramatically against all major currencies, one of the events this year that have prompted dramatic movements, as shown in the graph below.

Whilst some ground has been recovered, rates remain subdued and the pound has become obviously responsive to political shocks. HSBC has even commented that the pound has become the de-facto opposition to political policies.

Whilst this depressed rate has provided a much needed boost for UK exporters, it has added significant costs to those who are looking abroad to source materials or products ('Marmite-gate' being a popular example!).



What impact does a volatile exchange rate have on construction costs and why?

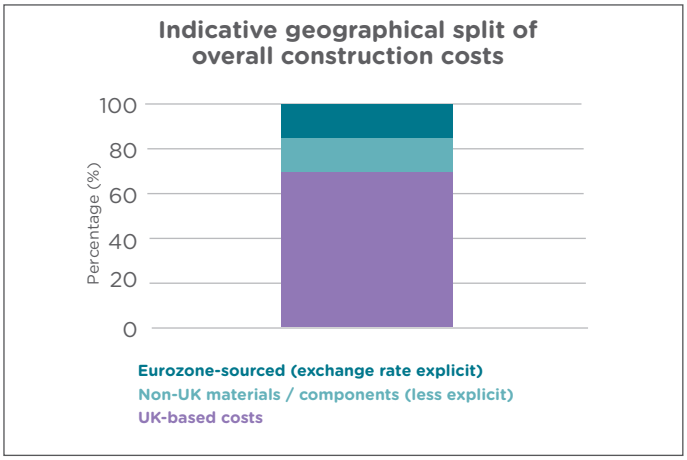
Periods of high volatility in currency markets, particularly the fluctuating Euro and US Dollar rates seen over the last 12 months, can have significant effects on construction projects.

Materials, equipment and components for construction projects are commonly sourced outside of the United Kingdom, and are therefore affected by fluctuations in currency.

The proportion of construction cost that these materials and equipment represent, varies between building types. On a commercial office project, for example, materials sourced outside of the UK could represent as much as 30% of the total build cost. Those bought from the Eurozone have perhaps the greatest impact because sterling:euro exchange rates are (increasingly) explicitly cited as a basis of pricing in tenders. 15-20% of total trade construction cost could be sensitive to sterling:euro swings.

Key elements which are imported into the UK and are therefore vulnerable to changing exchange rates are:

- Curtain walling
- Lifts / escalators
- MEP plant: generators, chillers, air handling units
- Building maintenance units
- Toilet fit-out packages
- Finishes such as stone



Buildings which have comparatively high amounts of the above elements — buildings with complex, expensive façades for example or data centres which require heavy servicing — will see a higher proportion of cost affected by fluctuating rates.

Currency movements and the associated risks are important: up until a contract is placed, all the exposure rests with the Client. It is not until the point that contracts are exchanged that contractors (and more importantly, sub-contractors) are able to place orders for materials and secure fixed exchange rates from their banks.

The effect has been felt most dramatically on many two stage or construction management projects, where there is potential for a significant period of time to lapse between the return of works package tenders and contracts being finally placed. This presents a period of uncertainty where the final contract sum will be subject to economic forces beyond the control of anyone in the construction industry.

Managing this exposure requires an early consideration of how best to mitigate the risks. There are a number of different ways in which this can be managed and the approach taken will depend on a number of factors, including the developer's/funder's ability to use alternative currencies, their need for fixity and perceptions of likely future currency movements. Key actions and considerations are:

- ! Be clear on the basis of trade prices: their underpinning exchange rate; any tolerance in this rate; the proportion of the price that is non-sterling related.
- ! Obtain a cash flow of sterling and non-sterling payments.
- ! If and when the currency is to be fixed, agree the rate measure to be used and any hedging costs.
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Implications for façades

If we look back and track the euro:pound sterling exchange rate, there was a time when it posed a much lesser risk to façade package contract values, the rate tending to hover around the €1.40 mark. The façade contractor arranged with its bank to forward purchase the requisite amount of Euros to fix the rate, when instructed to do so.

The 'when instructed to do so' comment is the reason why a project might either benefit, or lose, from exchange rate movements, particularly in a period of volatility. Currency exchange volatility post EU referendum has also seen an increase in bank-related hedging costs.

The exchange rate can be fixed at any time; however, the façade contractor and importantly, its bank, requires a formal, unequivocal instruction, including agreement to 'unwinding costs', in the event of cancellation. This is why the majority of instructions to fix the currency rate do not take place until after a lengthy period leading to contract execution.

Whilst the majority of imported façades are from the Euro zone, it should be remembered that façades are also imported from Switzerland and other currency zones, including those further afield.

Payment in euros

Paying for the relevant amount in euros remains a good way to avoid currency fluctuation risk when employing specialist contractors from mainland Europe.

This is easier if the developer or funder possesses existing euro interests but it could be effected through a main contractor with a euro account.

Fixing the sterling : euro rate

If the façade contractor is instructed to fix the currency, it simply advises its bank of the total amount of euros to be forward ordered and provides a cash flow against programme, setting out what and when payments will be made. The bank's hedging charges are a simple function of the 'what and when' payment schedule.

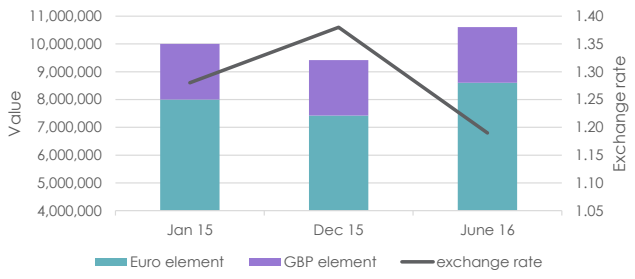
The exact exchange rate is wholly dependent upon when the button is pressed and the transaction takes place.

Other options

There are other mechanisms to reduce the currency exchange rate risk, including advance payments; however, the impact of these arrangements requires assessment on a project-specific basis.

It is known that certain façade contractors are prepared to take a view on currency risk and build a tolerance into their bid, on the basis that, if successful, they are instructed on the agreed value, irrespective of whether interim currency fluctuation has manifested a risk or benefit to the façade contractor.

A façades case study



This chart demonstrates the impact of changing exchange rates on a £10m curtain walling package. When carried out by a European Contractor the package is typically split 80% / 20% between Euro based cost and UK cost. Therefore £8 million of the package is subject to the EUR:GBP exchange rate.

For such a package, the tender period can be quite prolonged if early cost advice is gained, via a PCSA (to carry out the design development and engineering before the package is novated across to the main contractor).

In this example, the process begins in January 15 and culminates with the currency being fixed when the main contract is placed in June 16. The euro rate exchange swing during this period would have been £1.2 million (in excess of 10% of the package value). At the point of the initial cost advice the exchange rate was 1.28; by October 15 it was 1.38 reducing the package value by £600k to £9.4 million. Yet when the contract was placed in June 16 the exchange rate of 1.18 would have increased the package cost to £10.6 million. Methods of mitigating this are clearly key to determining the ultimate package value (and therefore project cost).

Author contacts

Rachel Coleman

Senior Research Analyst

rachel.coleman@alineaconsulting.com

Steve Watts

Partner

steve.watts@alineaconsulting.com

Steve Mudie

Partner, Façades Specialist

steve.mudie@alineaconsulting.com

Richard Jackson

Associate

richard.jackson@alineaconsulting.com

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alinea consulting LLP
90 Cannon Street
London, EC4N 6HA

alineacostconsulting.com