

ECONOMIC BULLETIN



A quarterly update from Franklin + Andrews

Volume 6.2 | September 2002

UK economy – somewhat of a dilemma

The annual growth rate of the UK economy, whilst still positive, has now slowed to its lowest level since the dark days of 1992 despite the house price boom, high consumer spending and stable employment. At their last meeting the Bank of England's Monetary Policy Committee rejected making any changes to interest rates, which are at their lowest level for 38 years. Recent speculation has been divided as to the next move on interest rates and this could prove to be a decisive moment for the UK economy.

The dilemma facing the policy makers at the Bank of England is whether to risk a boom and bust scenario, as seen in the late-1980s, by retaining or cutting the present rate thereby encouraging more borrowing and expenditure from consumers. The alternative, an interest rate rise, would reduce this risk but could well act as a millstone around the neck of the economy slowing growth further by encouraging consumers to save. The UK economy is inextricably linked to the behaviour of that in the US, often mirroring gains and declines. If the US economy mounts a sustained recovery the Bank of England will surely be on the verge of announcing a rise in interest rates.

A rise in interest rates would inevitably impact on the construction industry most noticeably in the housing sector. Demand for new housing could fall as potential buyers reconsider their earnings to borrowing ratio and mortgages become less attractive. This could see a return to the situation of the late 1990s where large numbers of home owners were caught out by negative equity after overstretching themselves. There is, however, a housing deficit in the UK, especially in the south east social housing sector, and therefore it is unlikely house builders will see their order books diminishing for sometime to come.

An interest rate cut aimed at sustaining/instigating an economic recovery may act to encourage consumer expenditure through a more favourable borrowing climate and normally would help to fuel the housing market. However, with house prices in the UK at the inflated level they are now it is unlikely this will happen. Our view is that an interest rate cut will sustain house prices and serve to protect against a crash.

Although a decline in the manufacturing sector remains evident the future is beginning to appear brighter. Both input prices and manufacturing output levels

are improving and are likely to reach positive inflation rates as the strength of the pound finally begins to reduce and UK export levels once again gain a competitive edge in the international market.

Construction materials which witnessed only modest growth last year are expected to fare better for the remainder of 2002 due to a more stabilised global trading environment increasing raw material input costs. Costs have been affected by the aggregate tax levies introduced on April 1st this year as any burden felt by the contractors is passed down the supply chain to the client.

Labour cost increases are also now beginning to percolate through to the client as manufacturers who absorbed price rises initially in the year are now passing the cost on.

Construction output and workbooks remain healthy despite the flagging manufacturing sector. As suspected with such high consumer spending and house price inflation, both the commercial and the residential construction sectors are looking strong. Government expenditure plans for health, education and social housing have boosted the private sector and ongoing road

and rail maintenance levels have left the infrastructure sector also with a very positive outlook. Detailed analysis and forecasts of sector performance can be found later in the bulletin.

Finding the right balance between protection from the boom and bust cycle through interest rate raises and the maintenance of economic growth through lower rates is the challenge facing the Bank of England's Monetary Policy Committee. Timing is the key to this decision; failure to meet the specific economic requirements of the situation could prove costly.

Table 1 below plots the annual inflation forecasts for the construction industry in relation to a medium UK economy scenario. Tender prices fuelled by boosts in public spending are expected to rise at levels of up to 7% for the next 18 months when market conditions are expected to cool.

Labour costs are expected to rise around the 6% per annum mark which is significantly higher than retail price inflation. Material price inflation should remain at similar levels to retail inflation reflecting the struggling performance of the manufacturing sector.

	2000	2001	2002	2003	2004
Building sector tender prices	6.1	7.5	7.1	5.0	3.7
Building input costs	4.5	3.5	3.5	4.2	3.6
Labour	6.5	5.0	6.6	8.7	5.2
Materials	1.8	1.5	1.5	2.3	2.3
Retail prices	2.8	1.7	1.6	2.8	2.6

Table 1: Annual inflation forecasts



A view from the chair

by Guy Leonard, Managing Director

UK – for or against the Euro?

One thing that we can all expect to see in the near future is a resurrection of the debate on the European Monetary Union and the potential for Britain to adopt the Euro in favour of the £Sterling.

Based on a study which we have undertaken, we set out the arguments for and against the Euro in a clear and concise format which will allow you to form your own decision. If we left it to the politicians to manage the debate it is surely destined to collapse into emotional and recriminating sound bites that do nothing to educate the population in formulating educated views.

At the outset we should perhaps understand the purpose of why monetary union is being proposed in terms of the underlying benefits to our current economic status as a sovereign country.

The purpose

Economic union with our most significant trading partners ensures we trade for the foreseeable future without tariff restrictions in a common currency thus avoiding foreign exchange volatility. Improved stability and certainty of market conditions for trading businesses is the net objective.

Gains

- No business likes risk and whilst mechanisms exist for dealing with risk, the best strategy is to eliminate risks
- Interest rates throughout Europe have consistently been lower than in Britain – suggesting that if we join, our cost of borrowing as a nation will fall in the short term at least.

- Consistent pricing of all manner of commodities, consumer goods and other products is predicted to result in a general lowering of prices to the lowest common denominator country. By the removal of tariffs and exchange controls it is probable that cross country competition will drive prices downwards. This may result in gains to Britain's businesses depending upon our ability to control costs of employment and manufacturing.
- Eradication of foreign exchange variations will enable exporting businesses in Britain to compete with other European businesses without fear of Britain's currency value rising making our goods more expensive and therefore unattractive to buyers.
- Foreign direct investment for European projects will increasingly flow into Britain if we join the Euro brigade. This is predominantly so for US-based investment as language and cultures are well understood. Transport links would put Britain ahead of Ireland in these stakes.

Losses

- The cost of change is anticipated to affect everyone in the country as a one-off expense. The cost varies [depending upon which study is consulted] from 0.5% of GDP to 4.2% of GDP.
- Everyone understands that to effect a changeover in our national currency will not only impact on every business in Britain through system changes and software modifications, but will also incur a significant implementation cost to the nation. The cost may not outweigh the benefits: recent evidence from Germany indicates that the cost of their changeover was in the order of 0.6% of GDP. This seems to suggest that the cost of change in Britain will be at the lower end of the range quoted.
- The return on investment argument suggests that we would recover this cost within two to three years.
- City traders pressing for the change see the removal of risk in exchange as an improvement in stabilising their market conditions and hence make profitable trading more predictable. In much the same way as lawyers don't mind who wins or loses a court action as they get paid regardless, so city traders have a short term allegiance and will change markets at the drop of a hat if the going gets tough. The rest of Britain however would not have such an easy opt out clause.
- Essentially those pressing for the change largely have a vested interest that suits short to medium term considerations, whilst most of us would be signing up for life. It's a little like being forced into buying a rest-of-life annuity upon retirement as the market hits a low in rates, and then watching in despair as rates rise unable to opt out and buy in at the better rates.
- The guessing game is that we do not know the full value of assets and liabilities underlying the value of the Euro. This is particularly significant in respect of hidden costs for retirement benefits payable in

the years ahead that may seriously damage the spending power of the new currency. Britain will be surrendering a known asset and liability valued currency to become a notional valued Euro Britain.

- All of Britain's gold and currency reserves would be transferred to the European Central Bank vaults.
- Interest rates would be set by the European Central Bank for the whole of Europe despite regional disparities in economic needs, and a 'one rate fits all' policy that is unlikely to suit all of the people all of the time.
- Taxation as a tool for balancing economies is potentially the next step for European central control.

Decision time

If you believe that the purpose is valid and that the gains outweigh the losses then we should seriously consider joining the Euro brigade. If however you consider the purpose too narrow or not convincing and in particular if the losses outweigh the gains then we should stay friends with Europe but keep our own currency.



International report

African economy

A report published recently by the United Nations Economic Commission for Africa (UNECA) stated that the African continent grew faster than any other developing region in 2001. The commission attributes this to better macro-economic management, strong agricultural production and the cessation of conflicts in several countries.

Forecasts made soon after the September 11th attacks on The World Trade Centre predicted that economic growth would stagnate in Africa because of lower commodity prices, reduced foreign direct investment, and diminished private capital flows. However, the global slowdown has had a much less pronounced impact on Africa than was at first thought. Output has remained strong and Africa's overall GDP growth is provisionally recorded

at 4.3% in 2001, up from 3.5% in 2000. In 2001 private capital flows to these countries rose from US\$4.9bn to US\$9.5bn, and net equity investment jumped from \$5.2bn to \$9.3bn. However, this broad view disguises the economic variability between Africa's nations.

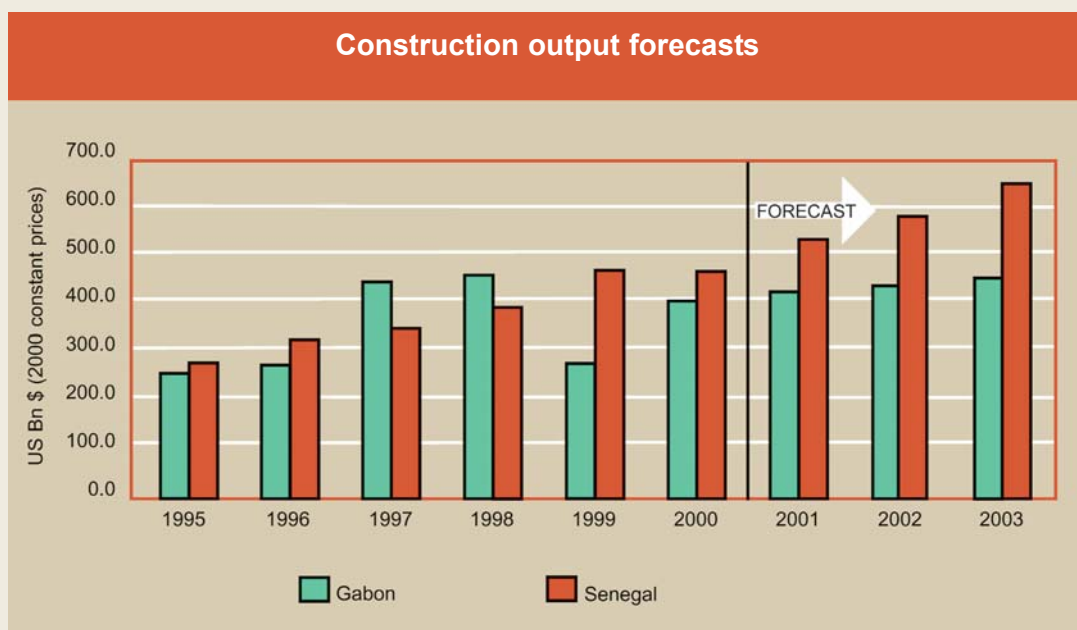
Senegal can be regarded as one of Africa's recent success stories where the Government has effectively marketed the country to foreign investors, evident by their 5.8% GDP growth in 2001. Dwelling on the political and social stability of the country they have managed to source enough foreign capital to fund two major infrastructure projects. Firstly there is a new airport to be built approximately 60Km from Dakar at an estimated cost of US\$428 million. Secondly the Senegalese Government is spending approximately US\$57 million on the expansion and modernisation

of the port at Dakar. In light of these projects and the likelihood of further similar developments, it is anticipated that construction output will increase by 9.9% in 2003.

The same cannot be said for Gabon where the dependence on the once abundant oil reserves for income has led to a much needed consultation with the IMF. Following a disappointing year in 2001, when GDP fell by 2.1%, this has left the Gabonese looking to diversify their economy and develop service sector potential. At present approximately 60% fiscal income and nearly 80% of exports come from the oil sector. A lack of new discoveries for some time has lead forecasters to predict that oil production will halve in the next five years, the implications of which would be disastrous for the Gabonese economy without some major

restructuring. The IMF underlined how necessary it was to create a fertile business climate in order to attract the external investment essential for the stimulation of the service sector. This sector, although still in its infancy, contains several elements that will require substantial infrastructure investment, leading to an estimated 5.3% growth in construction output for the country.

The chart below plots construction output figures in US billion dollars (2000 constant prices) for Senegal and Gabon between 1995 and 2003.



Industry sector analysis

Growth or decline

Private housing and commercial

Fuelled by the lowest interest rates for 38 years and a dramatic increase in the number of households in the UK, demand for private housing has grown rapidly. With inflation at record low levels and stock market uncertainty it is considered unlikely that the Bank of England's Monetary Policy Committee will increase the interest rate for fear of stifling the country's economic growth. Therefore it is not expected that this demand will wane, in the short-term, and output is forecast to grow by 7% in 2002.

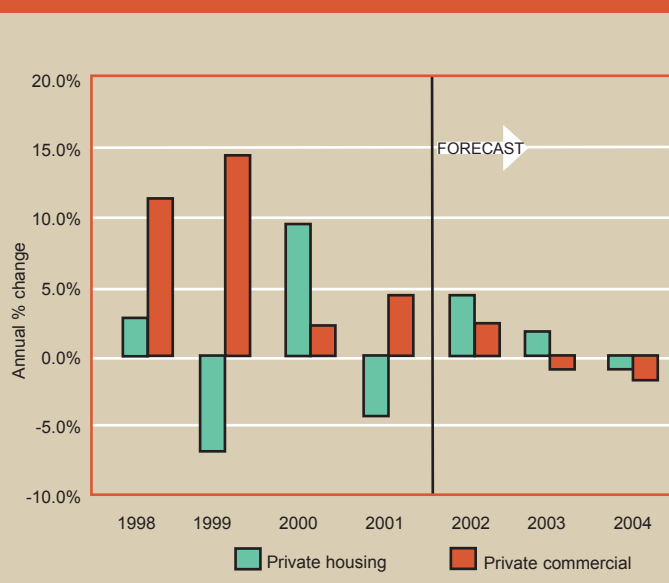
This is unlikely to continue; as more houses are built there is an increasing likelihood that greenfield sites will have to be selected. The public will demand that construction on these sites is curbed, and as a response the authorities are expected to tighten their planning policies. Coupled to that the expectation of dropping consumer confidence through possible interest rate raises in the medium term, the forecast for 2003 is not as bright, at just 1.5 % growth. Private housing repair maintenance and improvement output (RM&I) is a product of the same key factors as new works output, generally the strong housing market. However, if interest rates are raised consumer expenditure will undoubtedly drop causing RM&I output to follow suit. Our belief is that RM&I output will rise 3% in 2002 and by 2% in 2003.

New works output for the commercial sector does not appear to have a particularly encouraging short-term future. The expectation is that the global downturn will begin to bite resulting in job losses and more uncertainty over investment markets. The UK's reliance on tertiary sector industries will magnify the effects of a recession, as office construction will be amongst the hardest hit. Forecast figures for new work output in this sub-sector will see an increase of 2% in 2002 followed by -0.5% in 2003. RM&I output will also suffer from the depression as organisations tighten their purse strings. Although a decline is unlikely, growth will certainly slow over the survey period at 4% in 2002 and 3% in 2003.

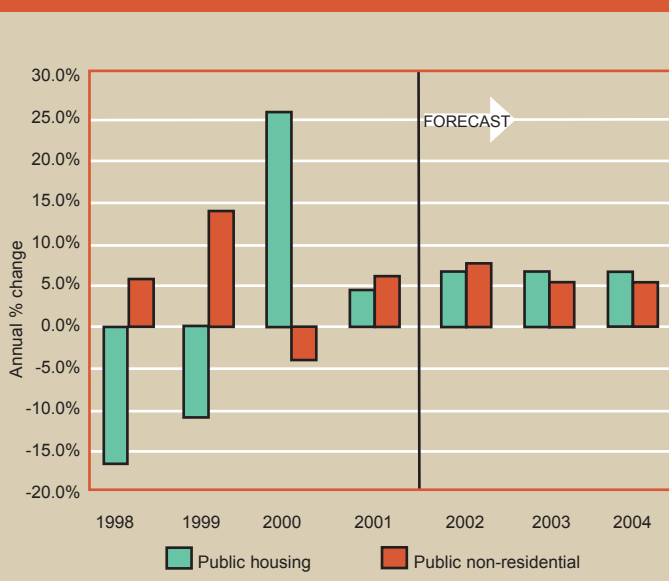
Public housing and non-residential

With the private housing market so buoyant at the present time, more and more potential homeowners are being excluded by high prices. This problem is most acute for those on lower wages in the southeast, of greatest significance the 'key workers' (nurses, teachers, police officers, fire fighters etc.). The government has been charged with providing affordable homes for this group and forecasts reflect the resulting high activity of 7% growth in 2002 and 7% in 2003. We expect public housing RM&I output to rise due to the government's policy of stock transfers, which carry with them guarantees of refurbishment. Based on the success of this policy, forecasts of 3% growth in 2002 and 8% in 2003 are anticipated.

New build private housing and private commercial output 1998 to 2004



New build public housing and public non-residential output 1998 to 2004



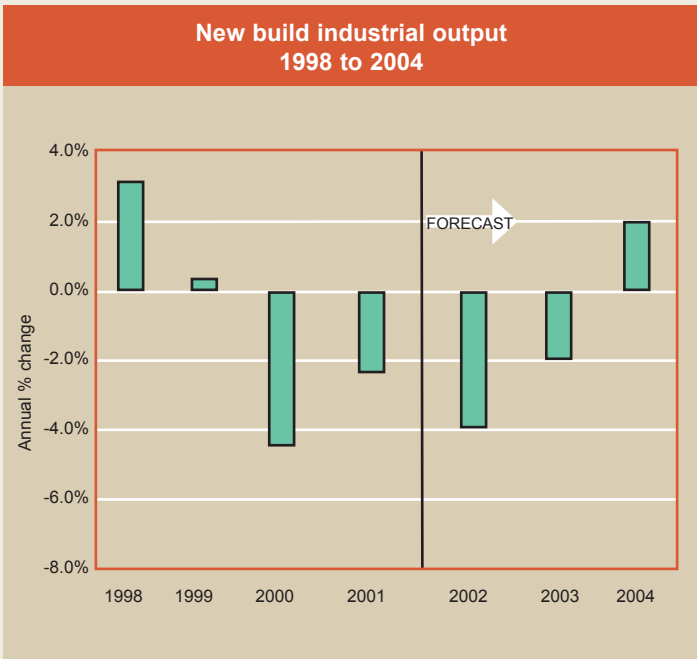
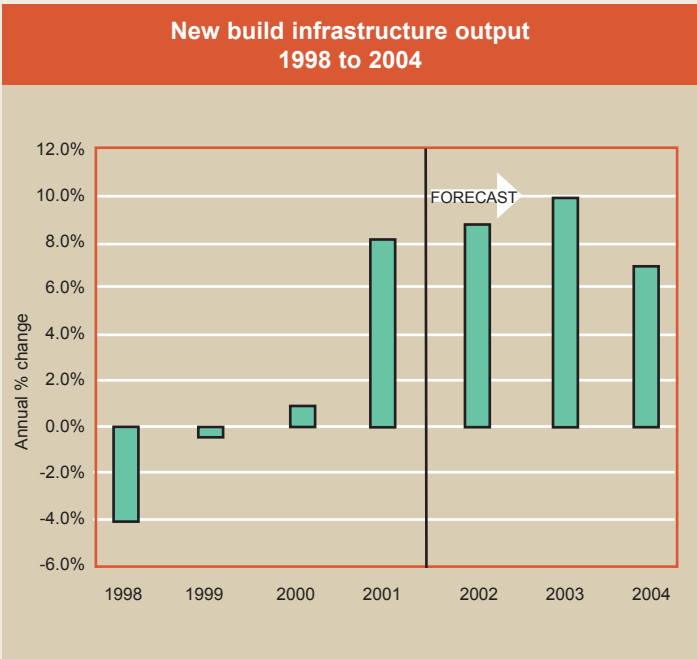
Central government policy will also benefit the public non-housing sector. Attempts to fulfil pledges on the delivery of improved services will be made by increasing investment levels. Certain areas, such as health and education, will be particularly fortunate and it will be in these sub-sectors that the majority of output growth will be concentrated. Overall we expect new works output to grow by 8% in 2002 and 6% in 2003. The increasing investment is also likely to percolate down to RM&I as part of an integrated improvement strategy, and as a result our forecast is that RM&I output will grow by 3% in 2002 and 8% in 2003.

Infrastructure

Recent government proposals to expand the air carrying capacity of UK airports and the provision of a modern rail system are likely to have a great impact on this sector. On the premise that these begin to come to fruition during the forecast period, growth in new works output for 2002 is put at 9% with a higher increase of 10% for 2003. Furthermore media fuelled speculation over the safety of the current rail system, especially in light of the Potters Bar disaster, will lead to a boost in the overall RM&I output for this sector, achieving 7% growth in 2002 and 6% in 2003.

Industrial

New works output has been declining in the industrial sector since 1999 due to a recession in manufacturing. The strength of Sterling against both the US dollar and the Euro, and more recently uncertainty on the global market, conspire to reduce the likelihood of any turnaround in the short-term. As a result forecast output for 2002 indicates a drop of 4%. Although it is believed that a recovery may be possible in 2003, new works output will not be a beneficiary for some time to come. The expectation is that output will drop by a further 2%. It is more likely that any investment in construction by this sector will be directed to the area with lower capital cost, that is RM&I works, and therefore we believe that RM&I output will grow by 7% in 2002 and by 5% in 2003.





Spotlight on Singapore

Profile

Singapore is a small island republic in Southeast Asia with a population of nearly 4.5 million (est. 2001) and at 647.5 sq. km covers an area slightly bigger than the Isle of Wight. Despite its small geographic size, Singapore is the fifteenth largest importer in the world. GDP growth has averaged at 8% over the past decade, the fifth highest per capita GDP in the world, indicating a very buoyant economy.

Singapore's economy is founded on free market principles and is considered one of the most competitive in the world. The city-state has excellent sea and air transport links in the form of the Port of Singapore (MPA) and Changi Airport.

Macro-economy

Due to the relatively small domestic market Singapore's economy is dependent on the growth and well being of others. Therefore the global economic uncertainty of 2001 did not bode well. A decline ensued despite a neutral exchange rate policy and attempts to stimulate through fiscal means.

Electronics exports fell steeply, and GDP declined by 2% during 2001, down from a growth of 10.3% in 2000. The manufacturing sector bore the brunt of the slowdown, contracting by 11.5% in 2001, compared with a 15.3% growth in the previous year. The decline was mainly due to a double-digit decline in electronics, pulled down by a plunge in output of semiconductors, telecommunications equipment, and computer peripherals. This also reflected a drop in those areas supporting electronics production, particularly fabricated metals and machinery, as well as printing and publishing. The services sector recorded slower expansion, given reduced international trade flows. Growth in transport and communications moderated to 2.7% in 2001 from 8.5% in the

previous year, on account of falls in tourist arrivals and the volume of air and sea cargo handled. The retail and wholesale sector fell by 2.8% compared with a 15.2% growth in 2000, dragged down by weak consumer sentiment and a deteriorating economic situation. The financial services sector decelerated to 2.2% growth in 2001 from 4.6% in 2000, as a result of weak equity markets and reduced regional demand for insurance and investment advice.

Consumer price inflation fell to 1% in December 2001 from 1.3% a year earlier. In the financial markets, the Singapore dollar depreciated by 6.7% against the US dollar during 2001, and weakened marginally against the Thai baht and Korean won. Domestic interest rates softened over the year, in light of monetary easing in the major economies and low inflationary pressure.

Economic development strategy

The Government has continued restructuring and revitalising the economy to retain its global competitiveness. They have come up with three main strategies to meet the economic challenges. In the short term, they hope to keep business costs down by cutting taxes and urging wage restraints. They are also pursuing opportunities in fostering new high-tech industries in the medium term, e.g. the life science industry, and intends to spend billions of Singapore dollars over the next five years to transform itself into the bio-medical node for Asia. In the longer term, the Government has encouraged Singaporeans to become more entrepreneurial.

Key economic sectors, notably financial services, telecommunications, energy, and the media, were reformed to enhance efficiency and competitiveness. In particular, as part of the comprehensive reform of domestic banking announced in 1998, the retail and wholesale banking

	Singapore: major economic indicators %			Forecast	
	1999	2000	2001	2002	2003
GDP growth	6.9	10.3	-2.0	3.7	6.5
Gross domestic investments/GDP	31.9	31.6	24.3	23.6	24.1
Gross domestic savings/GDP	48.8	49.3	45.8	44.5	45.7
Inflation rate (consumer price index)	0.1	1.3	1.0	0.4	1.4
Money supply (M2) growth	8.5	-2.0	5.9	5.9	6.5
Fiscal balance/GDP	2.6	3.5	1.9	-0.5	1.2
Merchandised export growth	4.5	20.4	-11.9	5.0	10.0
Merchandised import growth	9.0	22.2	-14.0	6.0	11.1
Current account balance/GDP	20.0	17.2	20.9	19.8	19.0
<i>(Source: Singapore Ministry of Trade and Industry)</i>					

Table 1: Major economic indicators

markets were liberalised further in 2001, to allow foreign banks to engage in broader business across these markets.

With worsening economic conditions both world-wide and domestically, the Government introduced a series of one-off budget measures to support the economy and help households and local companies during the slowdown. The packages amounted to S\$2.2 billion and S\$11.3 billion in July and October 2001 respectively, including measures to accelerate expenditures on economic and social infrastructure projects, and to cut business costs through property tax and rental rebates. Taken together, the two packages added up to 8.4% of GDP. Given the severe external slowdown weighing heavily on the domestic economy, the measures helped market demand, but could not kick-start the domestic economy.

The Government also emphasised assistance to the workforce to upgrade skills and knowledge. These measures were intended to reduce the economy's vulnerability to exogenous shocks. In the future, cultivating an entrepreneurial and less risk-averse business culture will be necessary for the development of high-value, knowledge-driven industries.

Economic outlook for 2002–2003

The global economy is expected to begin a recovery during the latter half of 2002 and as the export markets return, GDP is forecast to achieve an average of 3.7% over the year. However, the prospects for 2003 are better with an expected 6.5% rise. This is based on further recovery in the global economy improving Singapore's export revenues and increased domestic consumer expenditure brought about by growing wages. As a consequence a rise in inflation is also expected reaching 1.4% in 2003.

Construction industry overview

Singapore's construction industry accounts for just below 10% of the total GDP. The sector is primarily geared toward producing the infrastructure necessary to attract external investment. Although design and build has been growing in popularity as a procurement route, it still lags behind the favoured traditional system. The rise of design and build is expected to continue, driven by the trend towards an integrated construction process.

Construction foresight

With a substantial drop in private sector construction activity and cutbacks in public sector residential projects, the construction sector fell by 3% in 2001, following a 7.9% fall a year earlier. Construction output reached S\$15.4 billion in 2001, compared to S\$15.8 billion in previous year. Orders fell by nearly 33% in 2001, a possible consequence of the 54% surge a year earlier. The volume of orders in 2001 reached S\$13.6 billion, rising marginally on 1999, of S\$13.1 billion orders.

Although there was a significant drop in the volume of private sector contracts awarded over the past year, public sector projects, especially civil engineering works, took centre-stage in helping to support the industry. Major public sector projects, such as the light rail system (LRS), the Paya Lebar Expressway, and the development of the third university campus, are expected to boost construction sector performance for the remainder of 2002 and into 2003.

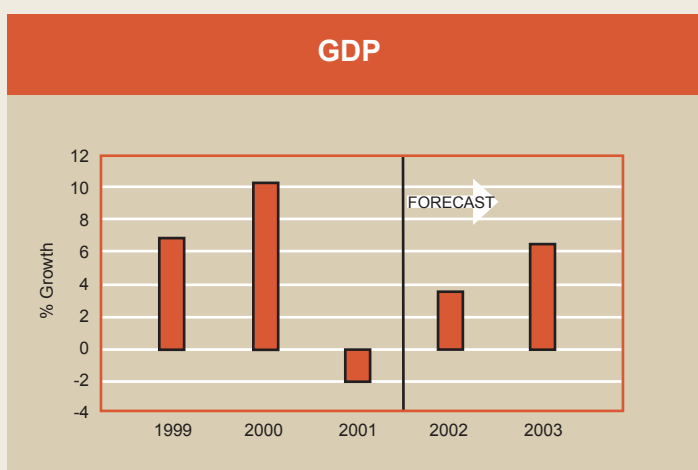


Chart 1

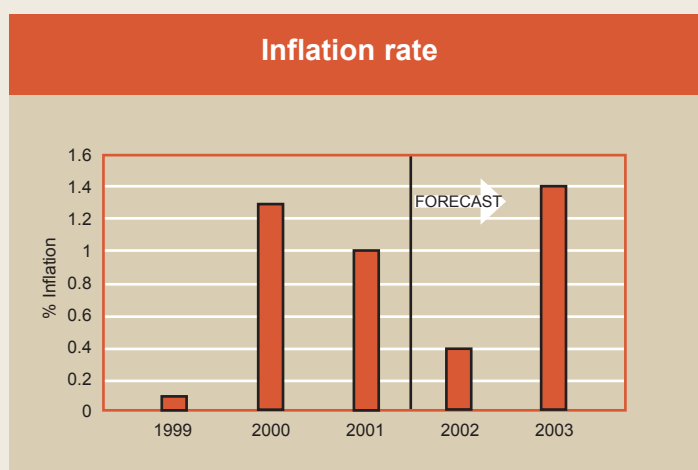


Chart 2



Inflation analysis

Education facilities

Updating the estimated cost of a project to reflect current prices often begins with the assumption that inflation drivers of construction projects are equally similar in impact for all projects. This leads in almost all cases to the use of one index to update all projects alike, that in reality differ considerably in their sensitivity to very different inflation drivers. To highlight this point Franklin + Andrews has conducted a number of project specific inflation studies on different building facility types. This is the first in a series of reports that examines the inflation drivers of different facilities. In this example we consider educational facilities.

The study examines the input cost inflation for contractors in respect of building resources i.e. labour, materials, plant and equipment since January 2000. The results have been summarised into elements to allow ease of comparison.

The results of the study indicate that different levels and choices of specification would have experienced different levels of inflation. A university library frame constructed out of reinforced concrete will have increased around 14.9% over the study period, whereas the steel frame of the sports hall has increased by only 7.7%.

Mechanical and electrical activity has experienced the largest inflationary impact. The sports hall costs in our study have

inflated by around 7.7% whereas the buildings with significantly more M+E content have all increased by 10-12%.

This increase has been displayed as a cost per pupil or a cost per floor area to help highlight the varying impact of inflation. The cost of a nursery school roof, for example, has inflated by 7.2% which actually equates to an additional £65.44 per pupil.

- These results highlight the need to adopt a different approach to the 'one size fits all' mentality for the selection of inflation indices.
- Consider designing project specific indices for calculating inflation on projects with different specification levels.

- Consider facility specific construction indices for calculating inflation.
- If specification decisions made even as close as 20 months earlier can still result in inflation increases of up to 20% on top of the cost of the element, perhaps cost forecasting should be mandatory throughout the design process.
- Inflation can impact significantly on capital cost over the construction phase, the inflationary variables during a 25 year life-cycle will dramatically affect whole life costs. Are you using the right life cycle costing techniques?

	University library		Secondary school teaching block		Nursery school		Technology block		Sports hall	
	Cost/pupil	%	Cost/pupil	%	Cost/pupil	%	Cost/m2 GFA	%	Cost/m2 GFA	%
Substructure	59.79	11.4%	38.80	9.9%	95.79	10.7%	6.04	9.6%	5.06	10%
Frame	15.35	14.9%	8.63	7.2%	-	-	7.42	7.6%	7.70	7%
Upper floors	59.26	14.9%	6.08	5.4%	-	-	2.85	12.2%	1.23	9%
Roof	49.54	6.7%	20.08	6.2%	65.44	7.2%	1.85	4.9%	4.29	5%
Stairs	11.76	7.3%	3.27	9.5%	-	-	1.35	9.8%	0.14	8%
External walls	33.34	8.3%	28.20	9.0%	21.38	9.1%	2.50	4.8%	4.54	8%
Windows and external doors	77.36	11.5%	16.13	7.4%	41.35	7.8%	5.12	8.8%	5.86	7%
Internal walls	26.72	7.7%	14.25	9.3%	25.08	8.6%	1.89	8.6%	1.97	8%
Internal doors	14.92	8.1%	13.45	6.4%	13.02	6.3%	1.45	6.1%	1.93	7%
Wall finishes	14.45	9.7%	9.55	9.0%	7.21	8.8%	1.43	10.2%	1.84	9%
Floor finishes	21.66	7.3%	28.68	9.4%	1.97	2.4%	4.37	9.4%	5.13	10%
Ceiling finishes	5.88	7.4%	3.75	3.4%	2.51	3.4%	0.93	5.7%	0.31	10%
Fixtures and fittings	40.10	9.2%	18.33	9.3%	4.93	8.3%	1.78	9.1%	2.59	6%
Sanitary fittings	9.90	10.4%	4.89	12.2%	11.54	11.3%	0.13	11.9%	-	-
Disposal installations	9.33	8.7%	5.98	10.7%	5.58	11.2%	0.96	10.9%	-	-
Water installations	9.84	10.8%	10.94	9.8%	16.66	9.6%	1.84	10.7%	-	-
Space heating and air treatment	51.31	9.6%	28.82	8.4%	14.27	8.8%	5.17	9.5%	-	-
Electrical installation	130.18	17.6%	62.84	16.6%	71.23	17.3%	10.46	17.9%	-	-
Lift installations	8.02	9.5%	3.63	7.6%	-	-	2.32	9.6%	-	-
Protective installations	4.21	19.2%	4.12	18.9%	-	-	0.99	21.4%	-	-
Communications/special installations	46.24	16.9%	22.59	19.7%	22.63	19.6%	7.26	18.4%	-	-
Facility increase	699.17	12.0%	353.00	11.2%	420.59	10.6%	68.11	11.8%	42.57	7.7%

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