

UK Market View

Q2 2020

NEW CHALLENGES  
AND FAMILIAR  
PROBLEMS





*As the construction industry continues to adapt to the full impact of Covid-19, we are faced with a period of market uncertainty and potential volatility that is unprecedented in modern times.*

*The usual inflationary or deflationary pressures of construction input prices that have such major influence on market forecasts have, at least in the short term, been heavily disrupted due to material and labour shortages, prices spikes and significant uncertainty in output and productivity levels.*

*We expect this uncertainty to continue until the final quarter of 2020 along with the level of suppressed tender prices that such market sentiment usually brings.*

*As the economy stabilises and our industry adapts to a more collaborative approach to the management of these risks, we expect tender prices to reduce in 2021 due to the combined impact of businesses re-sizing to reflect demand and an increased appetite in the supply chain to secure workload.*



**Steven Mason**

Managing Director

Mace Cost Consultancy

	2020	2021	2022	2023	2024
<b>NATIONAL</b>	<b>0.0%</b>	<b>-2.5%</b>	<b>0.5%</b>	<b>1.0%</b>	<b>2.0%</b>
<b>LONDON</b>	<b>0.0%</b>	<b>-2.0%</b>	<b>0.5%</b>	<b>1.0%</b>	<b>2.0%</b>

The table gives our current tender price inflation forecast. The figures should be treated as averages and there will always be variations due to procurement methods, project type and local factors. With contractors likely to be excluding risks relating to Covid-19 – such as programme delays and prolongation, material shortages and disputes – these figures do so as well.

Even though restrictions on movement only came into place from the middle of March...



JAN



FEB



MAR

GDP fell...

**▼ 2%**  
in the first quarter.

Estimates suggested by the end of May, almost

**700,000**

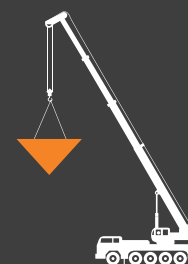


construction employees had been furloughed, costing £1.8bn.

Construction output declined...

**40.1%**

in April, the sector's worst month on record.



New orders were...

**▼ 35%**

lower in March than last year's monthly average.



# Setting the scene

Construction activity has been severely affected by Covid-19. Output dropped at a record rate in April and, for many organisations, it was necessary to furlough a substantial proportion of employees. Unlike some other sectors, working from home is not an option for most in construction, and the industry has had to rapidly adjust.

Until social distancing stops being a requirement, the industry is likely to face considerable challenges. In having to stop work, cashflow completely dried-up. But even where sites have reopened, limits on the number of people on site means lower output. At best, output is expected to be 20% lower than pre-Covid levels while social distancing protocol is in place. Contractors, with exposure to associated commercial risks, face a cash flow time bomb as project programmes inevitably extend, exacerbating their already weakened financial position.

Further complicating matters are potential material shortages and, in London, labour ones. The supply chain's robust response to the crisis has limited the impact, but lead times for certain materials have extended. MEP equipment, plasterboard and drylining, and bespoke precast stone products are currently most affected.

Near-term, contractors may try to exclude risks covering programme delays, material shortages, disputes and, in accounting for this, we believe tender prices will stagnate this year before starting to fall in 2021, although this is far from a foregone conclusion.

Looking ahead, forecasters anticipate a 5.8% drop in GDP this year, on average, before it rises 5% next year. However, of potentially more importance than each year's numbers, is the overall growth rate. When combined, they show GDP at the end of 2021 will be 1.1% lower than at the end of 2019, essentially ruling out a V-shaped recovery. Next year's growth will not bring the economy back to its earlier level and there is no doubt that construction will have to take its share of the pain. In particular, the residential and commercial sectors seem vulnerable and it should come as no surprise if, compared to pre-coronavirus levels, there is a substantial drop in new projects over the next 18 months.

Higher unemployment and lower disposable income will deter housebuilders. When the economy turns, the housing sector often reacts faster than other parts of the industry. In both 2008 and 2009, output fell by more than 20% while the number of new housing starts halved between 2007 and 2009. Last year, housing accounted for almost 40% of all new work. This is noticeably higher than in 2007 and a decline here will hit the industry hard. For the commercial sector, which accounts for around a quarter of all new work, the outlook also appears concerning.

Overall, our central position is that finding new work next year will prove tough and, as such, we expect tender prices to fall by 2.0% in London and 2.5% elsewhere in 2021. Firms' main focus is likely to be on winning work to maintain a pipeline with costs only a secondary consideration.

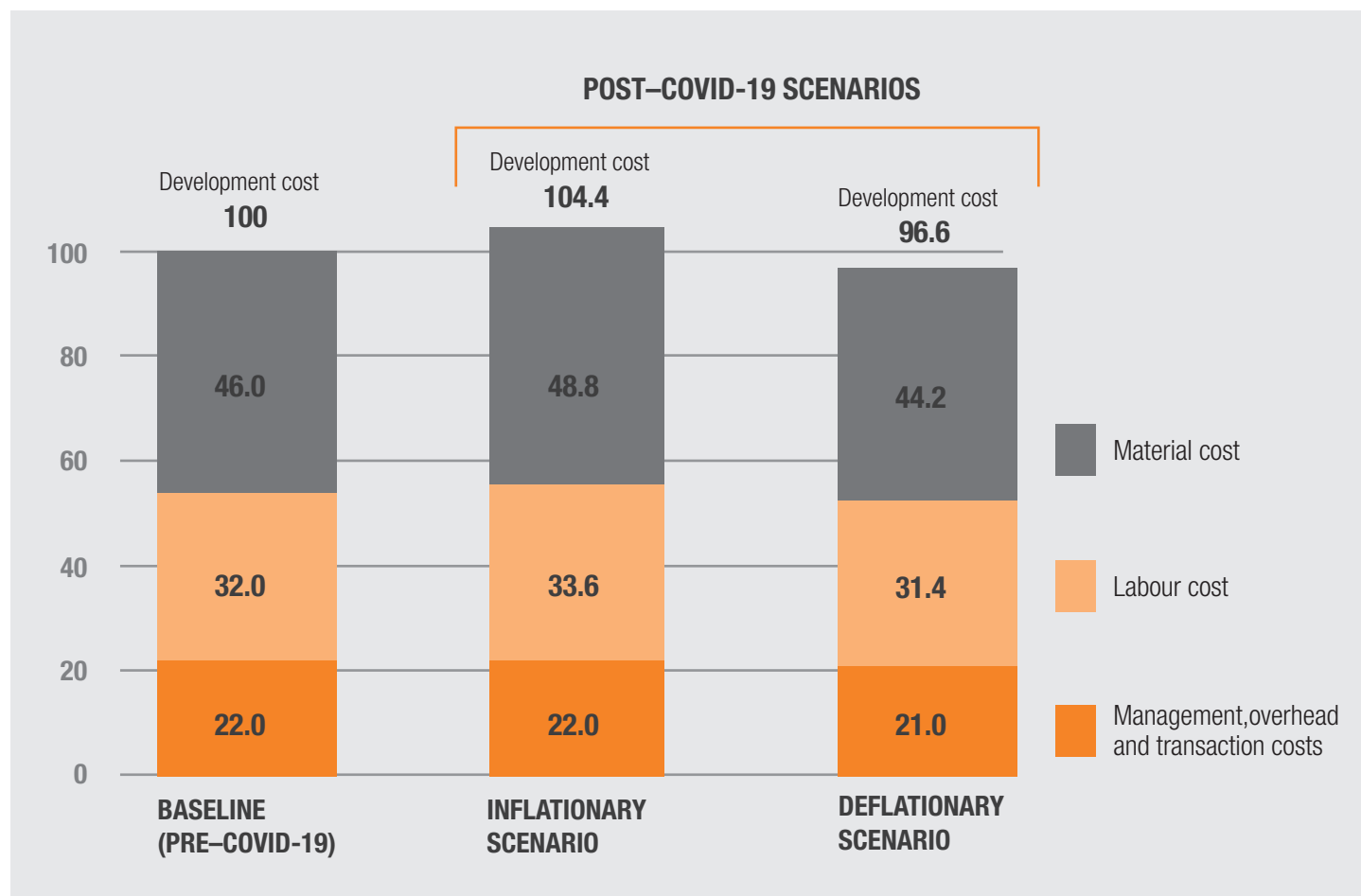
However, this is not a typical downturn and we cannot assume a typical response. Contractors' tender pricing decisions will need to reconcile a broad range of competing factors. Upside and downside risks to delivery costs are equally prevalent and the relative influence of these risks on pricing is far from certain. The dynamic generated by Covid-19 simultaneously provided pause for strategic planning and fundamentally weakened contractor balance sheets at the outset. It has disrupted how projects are delivered and has the potential to challenge deeply ingrained aversion to risk that exists throughout the industry. Firms are likely to respond in very different ways and we can expect tender spreads to increase.

# Factors influencing tender prices:

	Upwards	Downwards
<b>Demand</b>	If economic activity recovers in line with analysts' expectations, construction demand could bounce back relatively quickly. Even if demand post-Covid is ultimately lower, relative to pre-Covid levels, contracting capacity may struggle to respond to abrupt swings in demand - especially as industry re-sizing is currently underway. Furthermore, estimating capacity is fixed in the near term which can influence decisions to tender and pricing decisions.	A prolonged contraction in industry demand would intensify competitive pressure and exert downwards pressure on pricing.
<b>Materials costs</b>	Re-sizing is occurring throughout the supply chain as businesses prepare for challenges that potentially lie ahead. Until there is greater clarity around the medium-term outlook for demand, it is difficult to establish the extent to which manufacturing of construction products will come back on stream. If demand proves to be relatively resilient, raw materials price reductions may not fully transfer through the supply chain. Furthermore, abrupt changes in demand may generate localised inflationary pinch points for certain products.	Raw materials prices have fallen sharply. If demand in the wider economy remains subdued, it is likely that reductions will pass through the supply chain to clients.
<b>Preliminaries</b>	Working in accordance with safe operating practices on site is restricting productivity and will extend delivery programmes. This increases delivery costs and may influence tender pricing decisions. Implications of adapting to the 'new normal' are still being understood, making pricing with certainty difficult.	If the outlook for 2021 deteriorates, the core cost of preliminaries items such as labour and crane hire may fall. If social distancing restrictions remain in place, this will be counterbalanced by extended programmes, but some cost reductions will potentially allow room for manoeuvre. When social distancing restrictions are lifted, normal site activity can resume, and programmes will reduce accordingly.
<b>Risk</b>	Supply chain aversion to risk has increased significantly. If procurement strategy seeks to transfer excessive, unmanageable risk, contractors may be deterred from tendering or baseline tender pricing may account for the worst-case scenario.	A pragmatic approach to project risk management may ease pressure on initial tender pricing but this should be supplemented with comprehensive outturn cost analysis and scenario testing.
<b>Labour costs</b>	As firms undergo rationalisation, sourcing appropriately skilled labour is not an immediate concern but if demand bounces back in line with forecasters' expectations, this could swiftly change. Migrant workers may have relocated, and pending changes to UK immigration policy may deter skilled labour from returning.	If the decline in activity becomes more entrenched, it is likely that wages will respond accordingly.

# What does this mean in reality?

The complexity of and, interrelationships between, these competing factors can generate a wide range of tender pricing outcomes and we can estimate what these are using a £100m pound project as an example. Relative to a pre-Covid baseline, a spread of approximately 8% can be expected between the most inflationary and most deflationary scenarios due to the volatility in materials prices, the perceived and actual impact on preliminaries, wage variability and approach to risk.



While our forecasts show tender prices falling next year, there are two downside macroeconomic risks which would lead to greater reductions and reset our baseline forecast. A second wave of infections resulting in heightened restrictions and further damage to the economy is one such risk. Another is the issue of Brexit and, though it is no longer headline news, it has not disappeared. With a number of fundamental differences between the UK and the EU, the possibility that the transition period will end at the end of 2020 without either an extension or a trade deal remains. Were this to occur, it would only increase the difficulties facing the economy next year and we would anticipate having to downgrade our forecasts.



# Immediate and longer-term factors

We believe that coming out of this crisis will involve two stages. Initially firms will be most focused on getting sites fully functional, maintaining cashflow and ensuring business resilience (stage 1), before the focus shifts to stage 2 – winning work against a weaker demand backdrop.

## STAGE 1: MAINTAINING CASHFLOW AND ENSURING BUSINESS RESILIENCE

### Output and productivity

April's 41.2% drop in all new work, due to government restrictions forcing many sites to close, provides only a snapshot of the difficulties facing the industry. With no or substantially reduced work taking place, revenue collapses and a firm's cashflow may come under severe pressure, unleashing a potential time bomb later in the year. Despite most sites now being back open, the majority are not operating at full capacity and cashflow problems are likely to trouble the industry until after restrictions end.

Social distancing creates a number of obstacles in terms of output. Firstly, it leads to fewer people on site, which inevitably drives down output. Some trades, such as M&E, may also find working 2 metres apart tricky with employees less efficient. While changes in regulations mean sites can stay open longer, staggered working could mean workers on site for fewer hours or having to work at inconvenient times. All of these factors have the potential to push costs up, lengthen programmes and reduce revenue.

Unfortunately, these issues will also incentivise some to break the rules. However, as well as the strong moral case for health and safety, there are good economic ones. If a sub-contractor's staff catch the coronavirus and are unable to work, output could grind to a halt and the entire programme may experience greater delays than if productivity was below the optimum level. In some cases, this will require strong leadership from main contractors making sure sub-contractors comply with current Site Operating Procedures.

### Risk management

For new contracts, where work on site might start almost immediately, firms will be acutely aware of the ongoing risks and likely difficulty in managing programmes. Contractors and sub-contractors will therefore try to exclude these costs from their bids and, as such, tender prices will mainly reflect their keenness to win work.

Nonetheless, it is important to recognise these risks and they include cost pressures from rising preliminaries as a result of programme delays. Similarly, any second wave of the coronavirus with sites closing again is unlikely to trigger force majeure. Potential material shortages due to producers encountering problems and labour shortages from those in ill health only add to the conundrum.

With programme delays and the pressure from falling cashflows, an increase in disputes seems almost certain. A Construction News Survey found one in four respondents are either already in or expecting a dispute because of the virus.

### Materials

The coronavirus has triggered a simultaneous supply and demand side shock across the globe, disrupting materials extraction, manufacture and distribution. Global commodities prices have fallen sharply, in particular oil. Starting the year at over US\$60 a barrel, Brent has traded at under half this price for much of the past two months. Metal prices have also weakened, and the World Bank predicts on average they will fall 13% during 2020, before recovering in 2021.

Restrictions on the manufacture of construction products are easing, but Mace supply partners report extended lead times for plasterboard, MEP, specialist EU sourced items, metalwork and joinery. Impacts of these developments at project level will vary. Material stocks will help to cushion near-term gear changes in demand, but localised capacity pinch points may emerge.

### Labour

According to the ONS, which surveyed 1,714 construction businesses in May, almost 20% of firms had still paused trading while over 40% of employees were on furlough. In addition, the trade press has reported on extensive pay cuts across the industry. A workforce anxious about alternative employment prospects will find demanding higher pay tough and it is likely that the reduction in labour costs will help keep tender prices in check for the rest of the year.

One region seeing less downwards pressure on wages than elsewhere in the UK, is London. The capital has by far the largest proportion of non-UK employees and Mace is aware of a number of anecdotal reports of European workers leaving at the start of the crisis and not having returned. With the government introducing a 14-day quarantine for most arrivals into the UK, these employees may find it tough to return, even as sites reopen. While less widespread, as with materials, this could lead to pinch points and shortages, resulting in substantial price shocks.

## STAGE 2: WINNING WORK KEY IN 2021

### Demand for new work

The main driver of tender prices next year is likely to come from fierce competition over a relative lack of new opportunities. In particular, housing and private commercial, which between them account for almost two-thirds of all new work, are likely to be noticeably down at the end of 2021 relative to the start of this year.

Housebuilders are likely to scale down, forcing those dependent on the sector to compete for work elsewhere. Alongside falling household income, business revenue will also decline. The retail and hospitality sectors are currently suffering immensely but there will be a reluctance to spend by corporates across all sectors next year. Added to this, the success of working from home will lead to businesses reassessing their estate needs.

As always, there will be some winners, and these are most likely to be pharmaceuticals and health, logistics centres and warehouses, and data centres. However, these make up a relatively small proportion of the industry and won't cover the losses from elsewhere. Infrastructure is likely to be the fastest growing sector, yet the majority of this will come from projects that have already started or had their contracts signed. This may leave a limited amount of new work to win. Furthermore, doubts now exist about whether the government announcements of an increase in spending in its March Budget, are still affordable.

### Procurement

A second way in which tenders may become more competitive is through the procurement route and the question of who holds the risk. Many will hope that the pandemic leads to greater collaboration between all parts of the industry. It may be possible to achieve savings by making sure those best placed to hold and manage risk do so.

However, a more cynical observer might suggest that contractors' desire to win work will lead to a change in behaviours. Along with bidding at lower prices, they may also take on projects with unfavourable procurement routes. In particular, single-stage design and build schemes will become more popular. A weakening of client finances and a keenness to pass on risk increase the likelihood of this occurring. For two-stage schemes, the client may find they can re-tender at the second stage and, due to increased competition, get a cheaper price.

One area that will receive a boost is offsite manufacturing. In being capital intensive, social distancing is less of a hindrance than the labour-intensive requirements of traditional construction methods. Similarly, offsite manufacturing becomes more attractive if labour costs do rise because of fewer foreign employees.

### Materials

After initial capacity pinch points in materials supply are ironed out, the strength of demand in the wider economy over the medium term will influence market dynamics and materials price inflation. Industry forecasters currently anticipate relatively bullish growth in 2021, but this is only following the large falls in 2020. Overall, prices are still likely to be lower than before the outbreak. Downside risks to this projection are numerous but if this recovery profile materialises, materials price inflation may strengthen.

On the supply side, bringing halted manufacturing capacity back on stream can be costly. In the current uncertain climate, there is a risk that manufacturers may err on the side of caution and take a staged approach to ramping capacity back up. Products with complex global supply chains are most at risk from further disruption.

Developments in trade policy may also play a role. Trade talks under Brexit negotiations have resumed, but valuable time has been lost and the clock is ticking. A transition period is currently in place until the end of 2020 and the UK government is resolute that an extension is not an option. The recruitment of additional customs officers is reportedly underway to deal with the additional administrative burden of importing goods from the EU which will increase transaction costs.

### Labour

The government's furlough scheme, now extended until October, has been a success, preventing the sudden loss of many jobs. However, sooner or later, a struggling economy will see a spike in unemployment. The Treasury's April release of "A comparison of independent forecasts for the UK economy" points to unemployment rising. They show it increasing to 6.9% by the end of 2020 before easing to 5.5% at the end of 2021. This suggests a considerably stronger labour market performance than after the global financial crisis.

One big difference this time is the widespread reduction in salaries. For the time being, furlough and lower wages will help limit redundancies. Nonetheless, once all sites have reopened and are back operating normally, there will be expectations of wages to return to pre-coronavirus levels. This will be true for all of those still in work, but a decline in new projects and a drop in output will mean a shrinking of the workforce. Overall, marginally lower labour costs seem plausible and this will provide another dampening effect on tender prices.

### Managing uncertainty

During this period of heightened uncertainty, the UK construction sector faces tremendous challenges. Finding the right solution to deliver the best individual project outcomes will take collaboration and tenacity. For more information on how clients and their professional teams can work effectively to mitigate these challenges to ensure effective project delivery, you can read our recent report, [\*\*'Managing the impact and risks on the construction industry'\*\*](#).

## **Mace**

155 Moorgate  
London EC2M 6XB  
+44 (0)20 3522 3000  
[www.macegroup.com](http://www.macegroup.com)

## **Contacts**

Steven Mason	+44 (0)20 3522 3595	<a href="mailto:steven.mason@macegroup.com">steven.mason@macegroup.com</a>
Mark Williams	+44 (0)20 3522 4597	<a href="mailto:mark.williams@macegroup.com">mark.williams@macegroup.com</a>
James Donald	+44 (0)20 3824 3185	<a href="mailto:james.donald@macegroup.com">james.donald@macegroup.com</a>