mace

UK MARKET VIEW

MATERIAL PRICES CONTINUE TO SURGE

Q3 2021

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While there are indications that some material prices may be starting to ease, there is increasing expectation that the labour market is starting to tighten with the potential to drive costs up further.

As market confidence and the work pipeline improves, the supply chain has become more reluctant to absorb these sustained increases in input costs. The underlying expectation that market activity will continue to increase as the workforce starts to return to the workplace only heightens the sense that tender prices will continue to rise as we progress towards the final quarter of the year, and we have adjusted our forecasts for 2021 upwards to reflect this.

	2021	2022	2023	2024	2025
National	3.0%	3.5%	3.5%	2.5%	2.5%
London	3.0%	3.5%	3.5%	2.5%	2.5%

This 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 exclude risks relating to Covid-19 – such as programme delays and prolongation, material shortages and disputes – these figures do so as well.

In Q2, material prices rose more than...

6%

and they are now over...

20%

higher than a year ago.

Construction output increased...

3.3%

in Q2, but a fall in private housing repair and maintenance suggests material shortages could be negatively affecting some parts of the industry.

Construction vacancies hit...

38,000

in June – a record high – but for the time being, this has not noticeably fed into higher regular pay.

New orders jumped...

17.6%

in Q2, to their highest level in almost four years.

SETTING THE SCENE

Rising material prices and lead times continue to cause headaches for the industry. In Q2, material price inflation accelerated, with prices 6.6% higher in June than in March, and prices rose a further 4.5% in July. It is likely that material shortages are damaging output in the private housing repair and maintenance sector, however, it is not as clear what impact this has for other sectors.

It is impossible to ignore material price increases when it comes to our tender price forecasts and as such, we have revised our numbers up by 1.5% for this year and next. These rising costs are forcing the supply chain to push back, despite market confidence continuing to return, as contractors remain competitive with their bids. As the industry continues to rebound, some of this forced absorption of costs, from across the supply chain, will lessen. In addition, labour costs, which are currently fairly steady, may pick up, adding to tender price pressures.

The changes to material costs have led to some clients asking whether it makes sense to delay projects or when would be the best time to send them out to tender. We don't see tender prices falling, meaning that, on average, delays will likely result in higher costs. Timing markets is also notoriously difficult and not something we would want to encourage. During the first half of this year, it may have been possible to obtain incredibly competitive bids from contractors desperate to secure turnover. For many, this trend has since reversed, and bids are rising rapidly. Over the next six months, the cost of some commodities may peak, which will lead to substantially higher tenders for some packages. The hope with delaying going to market would be that costs would ease if material prices do fall back.

Tender values could increase in response to bidding contractors returning turnover to desired levels, meaning that they may feel confident enough to use higher material prices for profiteering. Others may be unwilling to take the risk of further material changes and choose to push up prices accordingly.

The link between commodities and materials used on construction sites is still not exact, with lengthy supply chains often absorbing and delaying changes paid for by the end-user. Even if input costs fall, given that prices often fluctuate, there is no guarantee of when they would settle. Alongside additional risks surrounding increased labour costs, it is inadvisable to try and time when to go to market.

We are not the only ones to revise our forecasts. The Bank of England (BoE) recently made several significant revisions to its forecasting. In May, the BoE expected the Consumer Price Index (CPI) to peak at 2.5% towards the end of 2021. They have since upgraded this to 4%. Such a large increase reflects the rapidly changing environment, the difficulty of forecasting in the current market, and additional risks, particularly for construction, as a rise in interest rates would make new projects – which are typically funded through borrowing – less viable.

At their latest meeting, the Monetary Policy Committee (MPC) discussed whether conditions needed for interest rates to rise had been met, and while there is no consensus, some members think the criteria has been achieved. Currently, there is a fairly even split between independent forecasters who believe there will be a rate rise next year and those who don't. However, were inflation to rise faster than expected, or, if it proves less transitory than forecast, the MPC may be forced into action, which could have a damaging effect on a still-fragile construction sector.

Two of the most interesting challenges facing the industry over the next year will be how companies adapt to hybrid working and what happens to imports once new Brexit regulations come into play. Imports account for around a quarter of construction products, but for timber and steel, where prices are rising at the fastest rate, the share is much larger.

We have already seen the impacts of material price inflation following the Brexit referendum and the subsequent pound depreciation. Therefore, navigating new import rules will be important in preventing problems.

As well as exploring these issues, we also discuss the fit-out market. Speaking to senior colleagues within Mace Construct and Mace Consult, we look at what has been a difficult year for the sector. We consider how optimism is returning, supported by a growing desire to improve facilities for returning staff, alongside energy efficiency concerns.

IMPLICATIONS FOR TENDER PRICES

GDP

After tighter restrictions at the start of the year, GDP slipped back in the first quarter, before rebounding 4.8% in Q2. Encouraged by the reopening of indoor hospitality and non-essential retail, GDP recovered to 2.2% below its pre-pandemic level in June. It is now likely that GDP will outstrip its February 2020 figure before the end of the year.

Along with month-on-month declines in construction output, another worrying sign from the latest data is the relative lack of business investment. While this part of the economy has grown, it is mainly due to higher spending on ICT equipment, with an overall reduction in buildings and structural investment.

Business investment is still over 15% lower than Q4 2019, and although uncertainty appears to be easing, it remains high. Within construction, the combined value of private commercial and private industrial account for around a quarter of all new work. Certainty in the business community will need to improve if the headwinds affecting these sectors is to end.

Construction output

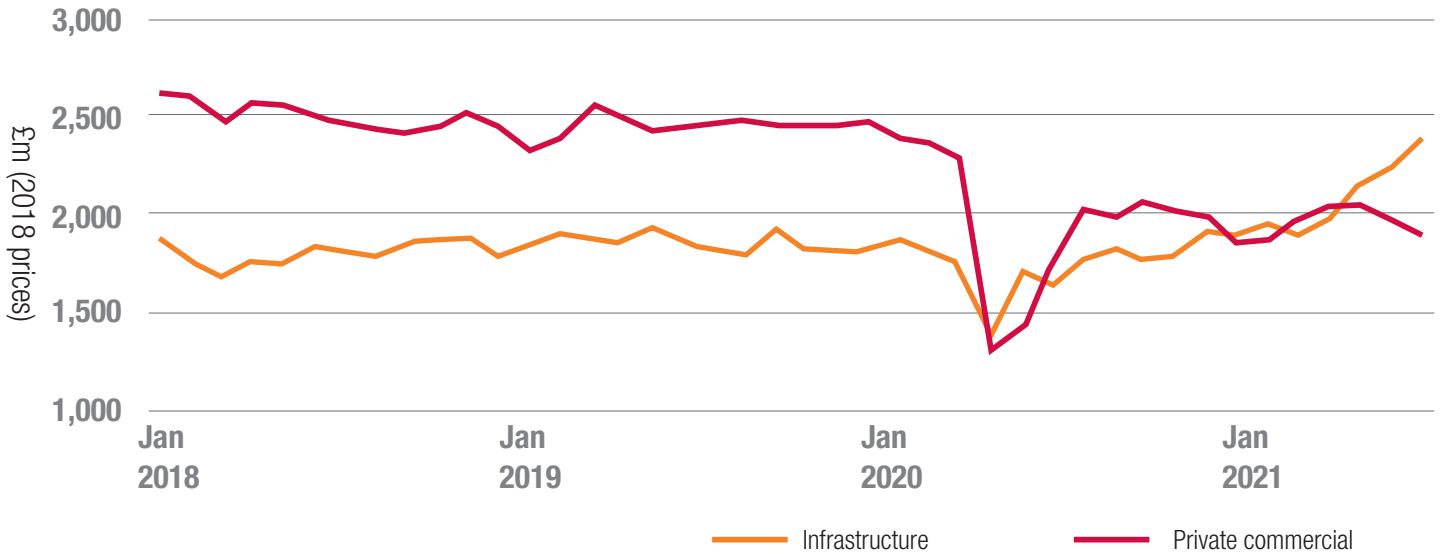
Despite the 3.3% rise in the second quarter, there have been worrying signs that material shortages have had an adverse impact on the construction sector. The month-on-month growth rate remained negative in April, May and June, with private housing repair and maintenance a particular problem. With output produced by firms with fewer than 20 employees accounting for around a quarter of all new work, in private housing repair and maintenance, this share rises to over 80%. Material shortages are more likely to hurt smaller firms, with difficulties obtaining the necessary products limiting the sector this past quarter.

One sector that appears to be coping fine with material shortages is infrastructure. In Q2, output rose 15.9% as the sector continues to drive growth in the construction industry. By contrast, private commercial only rose 0.8% over the past quarter and output in June was still 20% lower than in February 2020. These two sectors, the second and third largest components of all new work, have diverged considerably over the past 18 months.

At the end of 2019, the commercial sector was 36% larger than infrastructure, a ratio that has since flipped. Not only is infrastructure the bigger sector, but output is also now over 10% more than in private commercial. While we only provide tender price forecasts for the industry as a whole, contractors looking to win work in the commercial sector will need to be more competitive with their bids than those focused on infrastructure.

HOW INFRASTRUCTURE OUTPUT CAUGHT UP WITH COMMERCIAL

Source: ONS



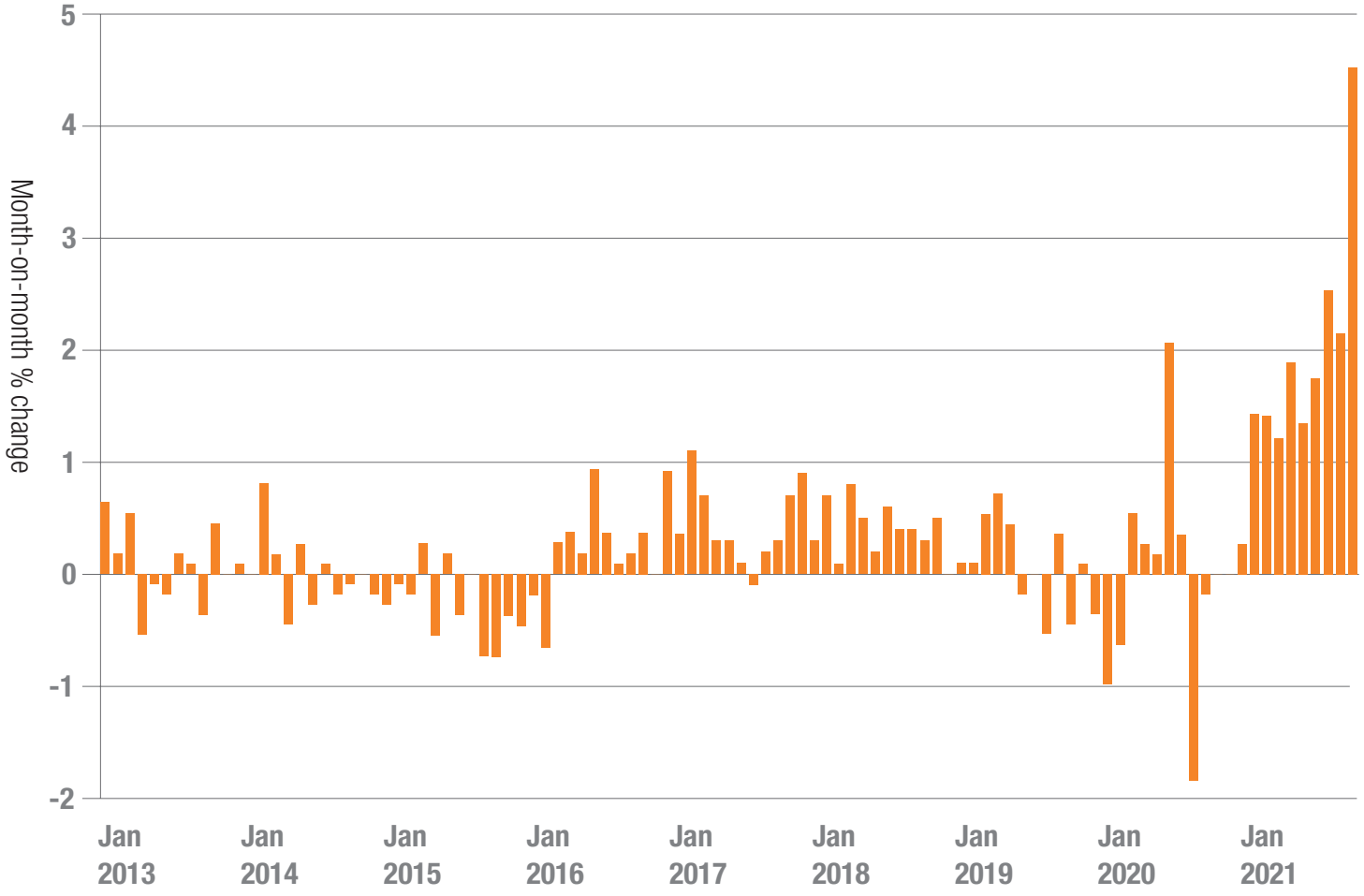
New orders

New orders have had their best quarter in four years, with the first real signs of pent-up demand appearing in the data. The pipeline of work – indicated by new orders – is key to determining the ability of those in the industry to pass on higher costs and their willingness to respond to demands to keep them down. Following the crash in new orders in Q2 last year, the recovery in the third and fourth quarters wasn't overly impressive. The figures in the second half of 2020 were noticeably lower than those in the second half of 2019 – a fairly weak period. This means that despite strong new orders in Q2, secured turnover for many contractors remains potentially problematic. Confidence is slowly returning, but it may not be until late 2021 or early 2022 that we see a complete end to aggressive bidding.

Looking at sectoral data, there are a few important takeaways. An almost 50% increase in private commercial helped it to its third-largest level since the global financial crisis, the highest since the Brexit referendum. Refurbishment of offices, rather than new towers, was the driving force behind this, and as usual, London was the stand-out region. In Q1, private industrial had its best quarter in fifteen years, and Q2 was only marginally less impressive. Most of this growth came from new orders for warehouses, but for the moment, there is barely any sign of this feeding through to output. For the fourth quarter in a row, housing new orders rose, although just by 2.9%. Surprisingly the majority of new housing growth came from London, despite the apparent trend for people moving away from the capital. Robust growth in the infrastructure sector has been supported by the new Curzon Street railway station in Birmingham and ongoing high levels of expenditure across roads.

MATERIAL PRICES

Source: BEIS



Material costs

The main factor behind why we have once again revised up our forecasts is due to the ongoing problems with materials. Not only have prices continued to rise over the past quarter, but the pace of growth has accelerated. Following on from Q1's 4.4% quarter-on-quarter inflation of the 'all work construction material price index', prices rose another 6% over the second quarter, with a further 4.5% month-on-month jump in July. Prices are rising both rapidly and consistently, as the chart, which plots historical month-on-month price changes, shows on the previous page. Rarely in the past have prices ever risen by more than 1% in a month, however, in the first half of this year it happened every month.

The natural question to ask is how long material prices can continue to rise. There is evidence, at least with some materials, of prices starting to ease. Lumber provides the clearest example of this. In early May, prices were more than four times their recent average (2017 – 2019), but they have since collapsed from over US$1,600 to around US$500. These changes in global commodity prices are not yet visible in domestic material price data, partly due to lags with data releases. The most recent publication from the Department for Business, Energy and Industrial Strategy (BEIS) covered July and showed a 64% increase in the cost of imported plywood from the year previous.

Oxford Economics is forecasting that prices for a variety of commodities will start to ease in the second half of this year. This leads to another important question, which is to what extent will prices decline. Given the consistent rise in costs, even if prices drop considerably, they are likely to still be some way above where they were. As such, there is no guarantee that falling commodity prices will feed into lower material prices. Similarly, if material prices fall, contractors or suppliers may not pass on cuts if they chose to not pass on increases.

Labour

When considered against materials and overheads and profit (OHP), the impact of construction sector pay on tender prices, both now and over the next year or two, is probably the hardest to judge. There are several conflicting statistics about future trends and the risks that exist, although as it stands, regular pay is currently rising at a moderate pace. Compared to a year ago, pay is 12.3% higher, however, this is because a large proportion of the workforce were on furlough last summer. Relative to the final quarter of 2020, regular weekly earnings were only 1% higher this Q2. Going forward, we must consider whether this is sustainable, or whether greater inflationary pressures will start to develop.

The level of slack in the labour market will determine how quickly earnings rise and there is mounting evidence that conditions are tightening. Vacancies jumped to 38,000 in the three months to July, over 10,000 more than seen on average in the few years before the pandemic. So far, this has not fed through into higher regular pay, but an abnormally large value of bonus payments in June suggests some companies may be incentivising staff in other ways.

What happens at the end of September, when the Coronavirus Job Retention Scheme ends, will influence the trends in pay. Based on HMRC data, there were still over 100,000 employments on furlough at the end of June. Accounting for around 10% of all employments, if this portion of the workforce were to all return to the labour market in October, this could keep a lid on wages.

Despite the number of people on furlough easily covering identified vacancies, there could be skills mismatches, as the furlough take-up rate is much smaller in infrastructure type jobs and not all skills are transferable. In addition, HMRC data contrasts with survey data conducted by ONS. The latter estimate that the proportion of the workforce on furlough is closer to 1%, rather than over 10%. While HMRC data is more likely to be accurate, as with skills mismatches, it points to not putting too much faith into the end of the furlough scheme dampening wage growth.

THE IMPORTANCE OF IMPORTS

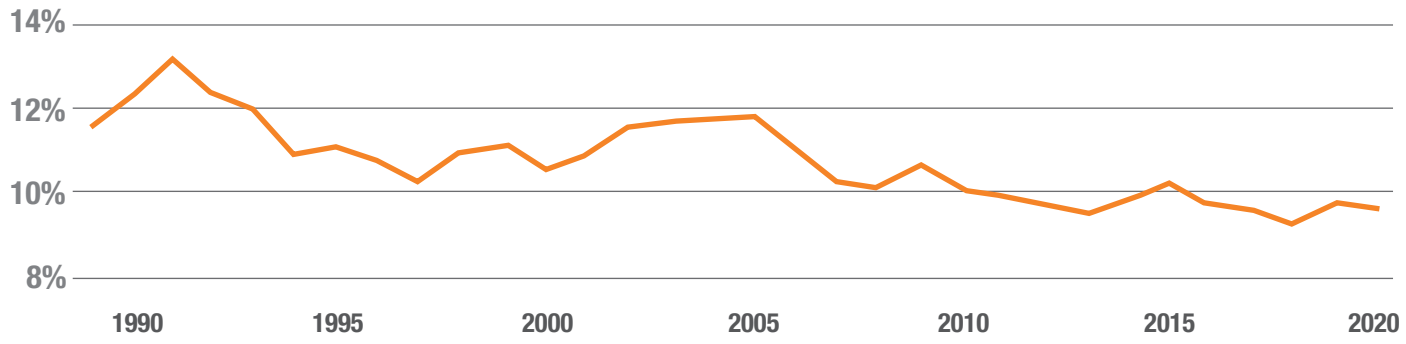
In 2019, the UK imported over £18bn of construction materials, which according to the Construction Products Association, accounted for 24% of total products used. With a quarter of materials coming from abroad, it is useful to provide some context behind imports in the construction industry. Taking data on the value of imports from BEIS and on construction output from ONS, we can see over the past 30 years, the share of imports used in the industry has fallen slightly. Estimated at around 12% in the early 1990s, the ratio has fallen to a little under 10% more recently. Over the past decade, this share has been stable, and while it fell slightly between 2016 and 2018, the proportion of imports coming from the EU during this time rose. It would not be possible to disaggregate currency movements from this data and it might have been that due to the pound's depreciation, the number of goods coming from the EU fell, even if their value increased.

Remembering that the pound's depreciation in the aftermath of the Brexit referendum contributed to material prices rising 10% over the following two years highlights the impact of higher import prices. Were it not for the pound appreciating over the past year, it is possible prices would now be even higher.

One product where reliance on imports has increased is steel. Last year, an obvious anomaly due to Covid-19, saw the share of demand on domestically produced steel rise to around half. This is its highest level since the global financial crisis, and during the 2010s, the share of imports rose to over 60%.

While UK steel production used domestically has remained constant, exports have fallen, with British steel struggling to be competitive. Along with steel, the only other type of product which BEIS reports has seen annual price rises of more than 10% is timber, with imports growing to now account for two-thirds of UK consumption. Even if the UK didn't rely on importing these goods, prices would have still risen. As mentioned in our Q2 Market View, there are global forces and supply-demand imbalances at play that have impacted prices, regardless of where goods have come from. Nonetheless, fewer imports may have provided a buffer against the worst of these movements.

RATIO BETWEEN IMPORTS AND CONSTRUCTION OUTPUT



Source: ONS, BEIS

New regulations, due to come into force from January 2022, will create additional complications with EU imports. Before Brexit, goods from the EU could move freely. However, from the start of next year, importers will need to provide various pieces of information, including on the type of good and its value upon import. Along with potentially being inflationary, the extra requirements could lead to delays and reduced delivery reliability.

Fortunately, the change to certification rules has been delayed. It was expected that from January 1st 2022, construction products, which currently only need the EU CE mark, would need the new UKCA mark. This has now been pushed back a year. The limited amount of testing facilities and expensive accreditation process means this delay will not fix the issue completely. Some material suppliers may view the UK market as too small to justify testing their products, in which case, they would cease to be available. For those who get the certification, costs would go up, whereas those who don't may need to stop selling until they get the necessary certificate.

While the share of imports from the EU is approximately 60%, China is the largest individual country for trade, with roughly a fifth of construction products originating there. No doubt many of those reliant on these goods are facing difficulties due to the ongoing problems in the shipping industry. Over the past year, the cost of shipping from China to Europe has risen drastically. Different sources provide different answers, but at a minimum, the price for a 40ft-container has risen 500%. Due to problems at ports, ships are often having to wait days before they can unload and the HGV crisis in the UK delays delivery further. This feeds through to higher prices and potential goods shortages and the bad news is that shipping analysts do not expect a resolution to these problems this year. If anything, prices may carry on rising, with Ningbo-Zhousan - China's second-busiest port – partly closing in early August.

THE FIT-OUT MARKET

The push to get workers back into the office is in full swing, making now the perfect time to provide an analysis of the fit-out market the challenges it has faced over the past 18 months and the difficulties ahead.

Mace, by virtue of having large, well-resourced teams that both consult, construct and operate office schemes and buildings, is uniquely placed to provide such an assessment. We spoke to Stewart Ward, Managing Director of Mace Interiors, and Matt Bittles, who is the Cost Consultancy Director for Workplace, to get their views on the sector.

The workplace sector has been one of the most affected parts of the industry, with social distancing measures having a more intrusive impact on this type of construction, in addition to the high levels of uncertainty caused by the shift to home working. Nonetheless, things are improving, as shown by the latest new order numbers, meaning that prospects in the medium term look good.

Environmental, Social, and Governance (ESG) is becoming an ever more important driver, both from tenants with exacting corporate commitments, and due to regulations. In 2018, there was a ban on new leases for offices in the least energy efficient buildings and from 2023, this will also apply to existing leases. Improving the standards of existing buildings is not a straightforward task, often requiring considerably more work than a typical refurbishment. Such cut and carve projects are increasing in frequency and the expectation is this trend will persist. Not only will landlords want to be able to keep leasing their premises beyond the 2023 deadline, but there is a strong likelihood of tighter regulations coming into force in 2030. November's COP26 Conference may lead to new targets and it will be incumbent on clients, consultants and contractors to think of ways in which emissions can be cut in order to meet net zero goals. This will no doubt lead to an increased pipeline over the coming years.

However, this recovery has not been straightforward. During the initial lockdown period, Mace Interiors stopped operations for three weeks. Working indoors, often on relatively small sites, led to new safety initiatives to try and reduce Covid-19 transmission risks. This included taking advice from the Construction Leadership Council and their Site Operating Procedures. Not only was worker safety paramount during these testing times, but it was also necessary to make sure people were confident that their working environment was safe for them to return to work. As well as stricter cleaning regimes and providing more car parking spaces, the main way in increasing safety was having fewer people on site. Through double-shifting, opening sites for longer and splitting working times, it was possible to maintain the amount of work done, while reducing those on site at any one point. In addition, creating more space, such as extra entry and exit points, as well as operating one-way systems, helped limit people's contact. Overall, these changes were incredibly effective and full productivity only took a couple of months to return.

Even now, end user tenants are still unsure about what exactly new hybrid ways of working mean for the space they need. Many firms have said they will really start to encourage people to get back into the office after the school summer holidays, and it is likely to take until at least the end of this year for a realistic assessment of changing requirements to form. Given this uncertainty, it is unsurprising that some occupiers continue to take a cautious approach to adapting their offices. Others have taken advantage of lower occupancy to make modifications to their workplaces to reflect how they propose to work in a post Covid-19 or hybrid manner. For landlords, they are adapting to reflect the changing needs of their tenants, potentially repurposing the office environment for alternative uses.

In the current climate, many of the difficulties facing fit-out organisations are the same as in other parts of the construction industry, albeit possibly more acute as a result of a weaker pipeline. In particular, rising material costs are a growing concern. Already there has been a string of product price hikes, with further increases set to come into force from October. Notably this includes a 20% increase in the cost of metal ceilings.

A further problem is lengthening lead times. In many cases, clients are more concerned about the impact of material delivery on milestones than price. Delays to programme and not completing on time can be more costly and problematic than simply paying a bit, or even substantially, more for products. Acting against these factors, and limiting the potential for price increases, is a very competitive market. Some contractors, facing large deficits in their turnover targets, are particularly aggressive. Yet the only way of keeping costs down is through applying significant pressure to the supply chain, which is not sustainable. For some clients this provides an incentive to get tenders out early, especially as looking slightly further ahead, into next year and beyond, prospects appear more promising.

In addition to the ESG push, there are several reasons why the fit-out market should perform better in the coming years. Firstly, as already mentioned, many firms have still not decided how to repurpose their existing space, but this is likely to change soon. The lack of work in recent years also suggests the need for a lot more infrastructure and preparatory work to keep office specifications up to standard. Regional hub spending is also turning into an increasingly important part of the market. For new offices, London's share will remain far and away the largest, but this is forecast to decline, with an expectation that regional hubs, such as Bristol, Birmingham, Manchester and Liverpool will expand, resulting in more speculative projects.

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