Tender Cost Update UK
Q3 2017

mace

MARKET CONDITIONS WEAKEN AS CONCERNS GROW FOR 2018

	2017	2018	2019	2020	2021
NATIONAL	2.5%	0.5%	1.5%	3.0%	4.0%
LONDON	1.5%	0.0%	1.5%	3.0%	4.0%

It was a difficult quarter for construction as the industry fell into a technical recession and a large drop in new orders indicates little respite over the coming year. Adding to the pressures are ongoing strong material price growth and a rebound in earnings. These factors could result in wider variations in tenders than usual with those companies with a healthy grip on their supply chain and labour force being better placed to manage risk. However, on balance we have left our tender price forecasts unchanged, expecting to see muted growth outside London and no change in the capital, before a slow recovery takes hold.

"The last quarter has seen little change in market sentiment, and the stuttering progress in Brexit negotiations has done nothing to ease increasing concerns that tougher times may lie ahead.

In spite of this, the construction sector remains remarkably resilient, with activity in the residential, public and infrastructure sectors counteracting declines in commercial market activity.

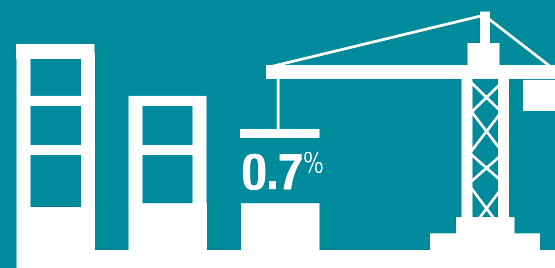
As the market appetite to secure pipeline work in 2018 and 2019 increases, we are starting to see the ongoing upward pressure on input prices be offset by falling margins. We fully expect this trend to continue with our forecast tender prices holding steady at levels reported in recent quarters."

Steven Mason
Managing Director
Mace Cost Consultancy

Compared to last year, second quarter new orders were down...

12.6%
as the commercial market suffered a reduction of 20.4%

After two consecutive quarters of negative growth the construction industry is in a technical recession. In the third quarter the sector contracted...



There were better signs for the wider economy as GDP growth rose to...

The Bank of England raised interest rates to...

TENDER PRICE INFLATION FORECAST

Subdued official construction output figures and survey data are so far not having much effect on tender prices which continue to rise mainly due to the ongoing increase in material costs. Overall, Mace Cost Consultancy has maintained its forecasts of 2.5% nationally and 1.5% in the UK in 2017. There are however clear differences between services with rising material prices having a particular impact on MEP, with copper wire prices almost 20% higher than a year ago. Similarly, while we are seeing lower price pressures in London, significant regional variations exist. One example being the new Hinkley Point C nuclear power station causing substantial wage growth in the South West.

A dramatic reduction in new orders in the second quarter will make next year difficult for many in construction. Lower new orders in the second half of 2016 has contributed to falls in output this year and given the scale of the most recent reduction, tougher times are likely in the future. Order books may currently look strong but a lack of replacement new work is not the only headwind likely to be buffeting construction firms next year. Anecdotal evidence of falling migrant labour is starting to appear, which could cause wages to rise. Material prices also continue to rise and combining these increasing costs with less work could cause considerable discomfit for firms, particularly those already operating on tight margins. We expect these forces to cancel each other out somewhat with limited inflation growth in 2018.

Moving into 2019 and beyond we would hope to see steady price rises. However, this is almost completely dependent on Brexit negotiations ending with a transitional agreement helping confidence return to the economy. If there is no deal and a hard Brexit takes place immediately after March 2019, then it is almost certain we would have to downgrade these forecasts. Recent weeks suggest an increasing possibility of such an outcome with the EU currently unwilling to move onto the next phase of talks.

ECONOMIC CONDITIONS

An interest rate rise often takes place when the economy is booming and policymakers are trying to cool the market down. However, even with inflation at 3% and unemployment at its lowest level since the 1970s no-one would argue this is currently the case. Rather than being driven by consumer demand, inflation has risen largely as a result of rising import costs due to the weaker pound. At the same time, increased employment has not led to faster earnings growth and negative real wages is one element behind annual growth currently standing at just 1.5%.

GROWTH

The UK economy grew by 0.4% in the third quarter, slightly up on the previous two quarters and beating expectations. Services grew by 0.4% helped in particular by computer programming, motor traders and the retail sector.

There was also solid growth in both agriculture and production, each rising by 1% over the quarter. The only sector experiencing negative quarter on quarter growth was construction which fell 0.7% but strong performance in the final quarter of 2016 and first quarter of 2017 may help explain some of its current weakness. Compared to one year earlier, construction had grown more than any other sector. Its yearly growth of 2.8% beat manufacturing's 2.7% increase and helped GDP rise by 1.5%. Forecasts for 2018 suggest growth will continue to stutter at 1.5%, some way below the post-financial crisis average.

LABOUR MARKET

It was more of the same in the labour market over the past three months with unemployment dropping from 4.5% to 4.3% whilst employment rose by 94,000. This is a slightly slower pace than in the previous quarter but there are few warnings of any weakness other than the ongoing poor performance of earnings. Real wages have now been falling for five consecutive months and it may be a while before we see any reversal.

EXCHANGE RATES

Since our last report at the start of August, the pound has seen some fairly large movements but overall it is little changed against either the euro or the dollar. By early September it had weakened against both currencies before rising as expectations of an interest rate rise increased. An interest rate rise would often result in a currency strengthening as investors find it more attractive but in the case of this move, the pound actually fell. This was due to a more dovish tone perceived by strategists in the accompanying statements meaning further interest rate rises may not be as likely as previously thought. Those hoping for a stronger pound to alleviate some of the material price pressures may need to wait a while longer.

INFLATION

September's inflation figures showed consumer prices rising at their fastest rate in over five years, increasing from 2.6% to 3% over the last three months. Further small rises are expected before the end of the year but 2018 should see pressures ease as base effects and the impact of the pound's depreciation unwind. How inflation changes beyond then will very much depend on the type of deal achieved in Brexit negotiations. There are obvious risks from no-deal leading to further sterling weakness but reaching a transitional agreement should lead to steadier price growth.

MONETARY POLICY

On 2 November for the first time in more than a decade, the Bank of England announced that it would increase interest rates. While in some ways a momentous move, pushing up rates 0.25% to 0.5% only returned the rate to where it was last summer. The vote in favour of a rate rise came as

no surprise with policymakers providing more than enough clues since their last meeting. One potential impact of the rate rise is to knock already hard-pressed consumers but the immediate effect on the construction market is likely to be minimal. Further rises that may have more of an effect, are unlikely to take place immediately. In the Committee's minutes it was suggested two more rate rises may be needed over the next two years but much would depend on how Brexit develops.

GLOBAL

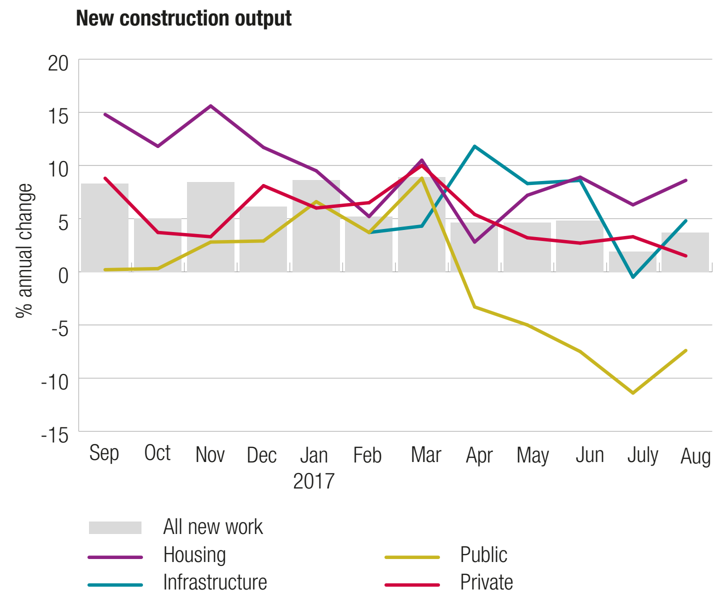
As the UK economy continues to stutter, other countries have strengthened and the global economy is performing well. In the first half of the year UK growth was slower than in any other G7 country. The eurozone has picked up compared to last year, encouraging the European Central Bank to cut quantitative easing starting from January 2018. Hurricanes failed to dent US growth in the third quarter as it hit 3% on an annualised basis while there was a marginal slowdown in Chinese growth to 6.8%.

CONSTRUCTION OUTPUT AND ORDERS

October's construction output data release saw the ONS make a number of changes to their methodology and as a result the performance of the industry following the Brexit referendum appears to have been better than previously thought. These revisions led to all construction work growth improving between July 2016 and July 2017 from -0.4 to 2.7% with the industry now around 5% bigger than in previous estimates. While these changes certainly paint construction's recent performance in a more optimistic light, they do not completely overwrite the sector's weakness this year. After reaching a high point in January, all new work had shrunk 1.7% by August.

Comparing the three months to August with the previous three months' figures showed infrastructure 1.4% lower and private commercial down 2.9%. This is commercial's largest drop since 2012 and comes after four consecutive month on month falls. The largest sector, housing, has again been the industry's bright spot but growth is far slower than a year ago. Additional funding plans for the Help to Buy scheme may offer some support but concerns exist about a worsening market, particularly in London where house prices are falling.

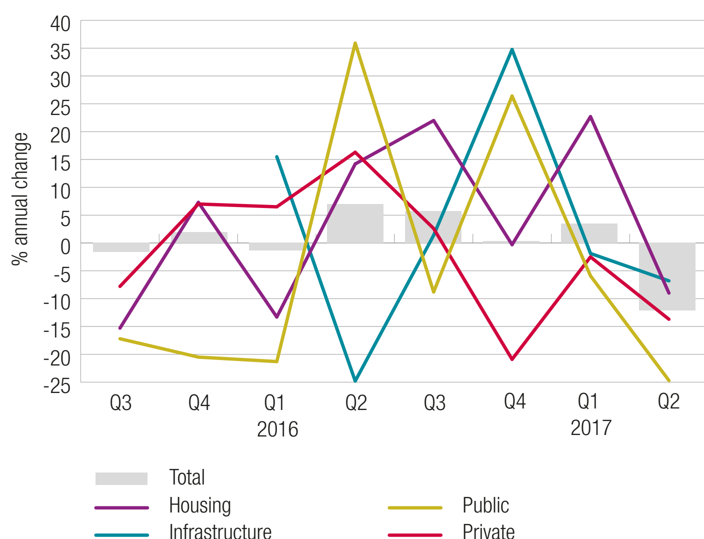
Top level figures for construction, released as part of the third quarter GDP preliminary estimates, showed the industry had fallen into a recession for the first time since 2012. There is still a considerable way before the downturn seen five years ago is matched, with the recent falls of 0.5% in the second quarter and 0.7% in the third not large by historical standards. Additionally, it is important to recognise that the industry is still considerably larger than it was a year ago. Even if the final quarter suffers a larger drop than the previous two quarters, growth in 2017 as a whole compared to 2016 would still be above 3%.



Helping explain some of the difficulties output has faced this year are the poor new order figures in the second half of 2016. However, these falls of 3.1% and 2.6% in the third and fourth quarters of 2016 pale in comparison to the most recent drop of 7.8% in Q2 2017. These figures are based on an older methodology so may be revised up in December but such a shift is unlikely to be enough to push yearly growth positive. The current year on year new orders drop of 12.6% is the largest decline since the final quarter of 2011.

It is therefore unsurprising that with such a substantial fall most sub-sectors have suffered. Infrastructure orders were worst hit but there were also noticeable reductions in private housing and commercial. Several surveys have cited a lack of new orders for infrastructure to be of particular concern and may create difficulties when current projects are finished. Accounting for nearly all of the commercial sector's decline was London where the fall was larger than any quarter during the financial crisis. There were also significant falls for infrastructure and private housing in the capital. The best performing region in the second quarter was the South West but Yorkshire and the North East also grew strongly.

With contractors and sub-contractors thinking about their pipeline, and the fall in new orders almost certainly damaging many, it could exert downwards pressure on tender prices. The lag between new orders and delivery can vary considerably but without a quick reversal, which surveys suggest is unlikely, firms may already be feeling the need to be more competitive with their bids. As the lack of orders feeds through this situation is only likely to worsen in 2018.



MARKET VIEW

Over the three months to September, the IHS Markit/CIPS UK Construction PMI has taken a sharp turn for the worse, falling below the level indicating no change in activity for the first time since August last year. Throughout this period the commercial sector has struggled and in the September survey there was also a significant decline in civil engineering leaving the residential sector as the only one where growth is taking place. New business also dropped throughout the period and optimism was at its second-lowest level since April 2013. Input cost inflation rising to a seven month high added to the industry's difficulties.

The third quarter Bank of England Agents' survey found modest construction growth with some signs of weakness and concern about short-term prospects. As elsewhere, house building was strongest and the commercial market underperformed. Of more note were two issues affecting the construction labour market which could exert upwards pressure on costs over the coming months. Firstly, construction (along with agri-food and haulage) is starting to see a weaker supply of migrant labour. Secondly, the well-known industry issue of high skills shortages is causing faster labour cost inflation than in most other sectors.

Respondents to the third quarter Federation of Master Builders State of Trade survey were positive as workloads grew albeit at a slower rate. Even with a large slowdown in residential workloads the sector still managed to outperform non-residential where workloads remained unchanged. Looking ahead firms remain confident expecting workloads to increase for both the residential and non-residential sectors and they anticipate this will help push employment up. The number of firms reporting rising output prices eased slightly in the third quarter but remains at elevated levels with the vast majority of firms seeing higher wages and material costs with expectations this will persist.

With such poor official commercial market statistics, it is useful to take a look at the latest RICS Commercial Property Market Survey. Overall, respondents saw occupier and investor demand rise in the third quarter whilst rent and capital value expectations also both improved. The figures are by no means strong by historical standards but do show some confidence in the market. Looking into the detail behind the figures, the industrial sector is performing considerably better than the office market with the retail sector lagging further behind.

Recent surveys, whilst in many cases still pointing to growth, are now starting to show a slowdown. Confidence about what the future holds seems to vary by survey and it may be that different types of respondent have different views. Larger firms who focus on a longer pipeline could already be starting to feel the heat of lower output and new orders while smaller builders whose current workload is strong are yet to notice any change.

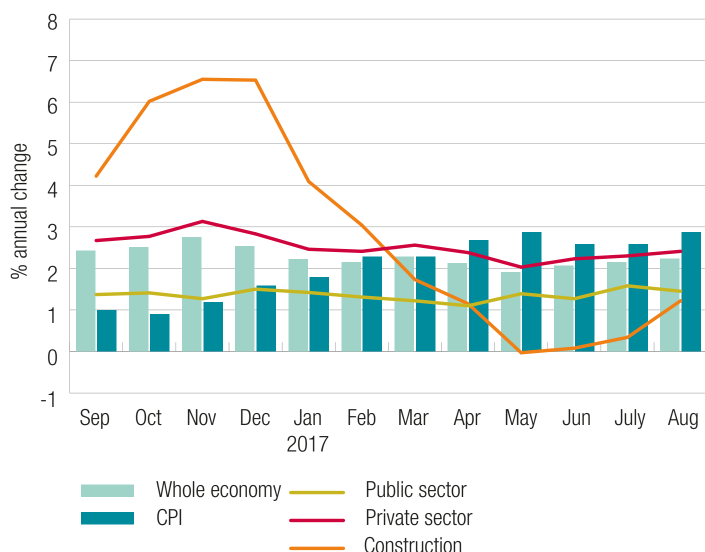
INPUT COSTS

Labour

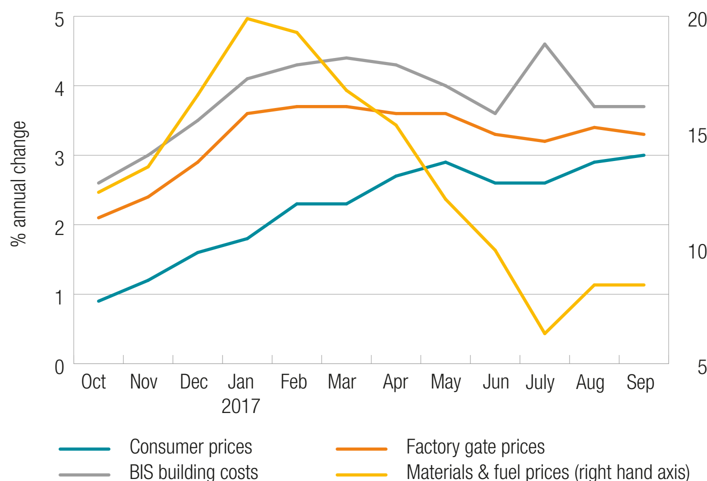
Having fallen earlier in the year, earnings in construction have picked back up in recent months. In May, total yearly growth had dipped just below 0% having been rising at over 6% as recently in December 2016. Since then wages rebounded, rising 1.3% over the three months leading to total yearly growth of 1.2%. With bonuses having fallen over the period, regular pay growth is more impressive and at 1.9% stands just below that seen across the entire economy although this is still some way from matching inflation. Recent data on employment and vacancies within construction provides some background behind these changes. Firstly, between March and June, employment in the industry fell 0.7% while more recently vacancies have risen. Given the relatively weak performance of the sector this year, rising vacancies could mean firms cannot find the right workers rather than they have too much work on.

Adding to this idea is the findings of the latest Bank of England Agents' survey where skills shortages and a reduction in the availability of migrant labour are helping push up wages. In one case Mace Cost Consultancy is aware of 25% of Eastern European workers failing to return to work after their summer holidays. Skills shortages are a common issue faced by the industry and migrant labour has helped pick-up the slack. If the UK is now seen as a less attractive place, either due to their home countries strengthening economies or the weaker pound reducing the amount they can send home, a drop in numbers will only exacerbate these issues. This will be particularly true in London where the proportion of migrant labour is far greater than elsewhere.

Average weekly earnings



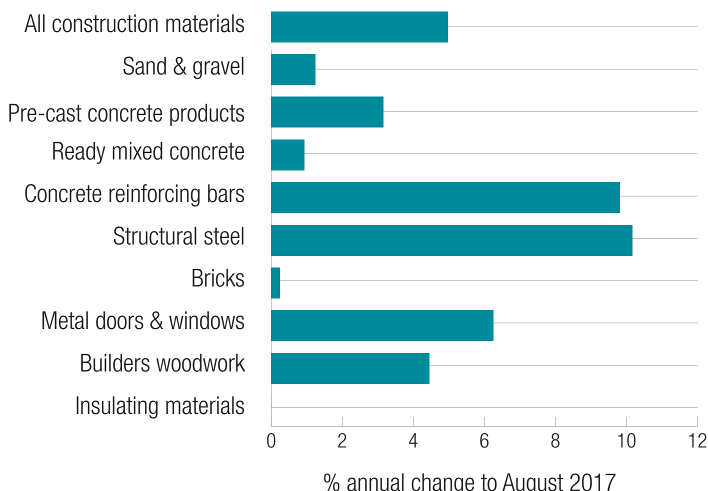
Inflation Indicators



Materials

Material prices, which had started to slow at the time of our last report, have rebounded over the past two months. After inflation peaked at 5.8% in May, the all work construction price index dipped to 4.7% in June but rose back to 5% in August. This backs up the headline of our previous report that the worst of material price rises were likely to be over, and the monthly growth of 0.4% in August was still slower than seen between November last year and February 2017. Prices are however still rising, adding to the burden of contractors facing a slowing industry. One reason for the recent jump in prices may be due to the pound's depreciation over the summer. Additionally, the price of oil has been increasing since the end of June due to robust global demand and a high compliance of Opec supply restrictions.

Materials prices



Within material prices, concrete reinforcing bars which had seen minor falls between January and July, shot up in August causing it to be once again one of the fastest growing materials. Rebar prices are now almost 30% higher than where they were in January 2016. There were also further rapid rises in structural steel and metal doors and windows.

PACKAGE SPOTLIGHT: SUB AND SUPERSTRUCTURE CONCRETE

Thanks to conversations with Morrisroe we are able to provide a spotlight on sub and superstructure concrete, offering information on the issues facing this package.

The price risks of the two main materials used are at opposite ends of the spectrum. Concrete has been rising at a steady rate for a number of years and while cement is imported, the existence of several major suppliers has helped keep costs under control and easily predictable. By contrast steel rebar prices are volatile and dependent on international markets. Pre-buying and hedging strategies come with their own difficulties so are usually avoided but it is often possible to pass on steel price movements to clients.,

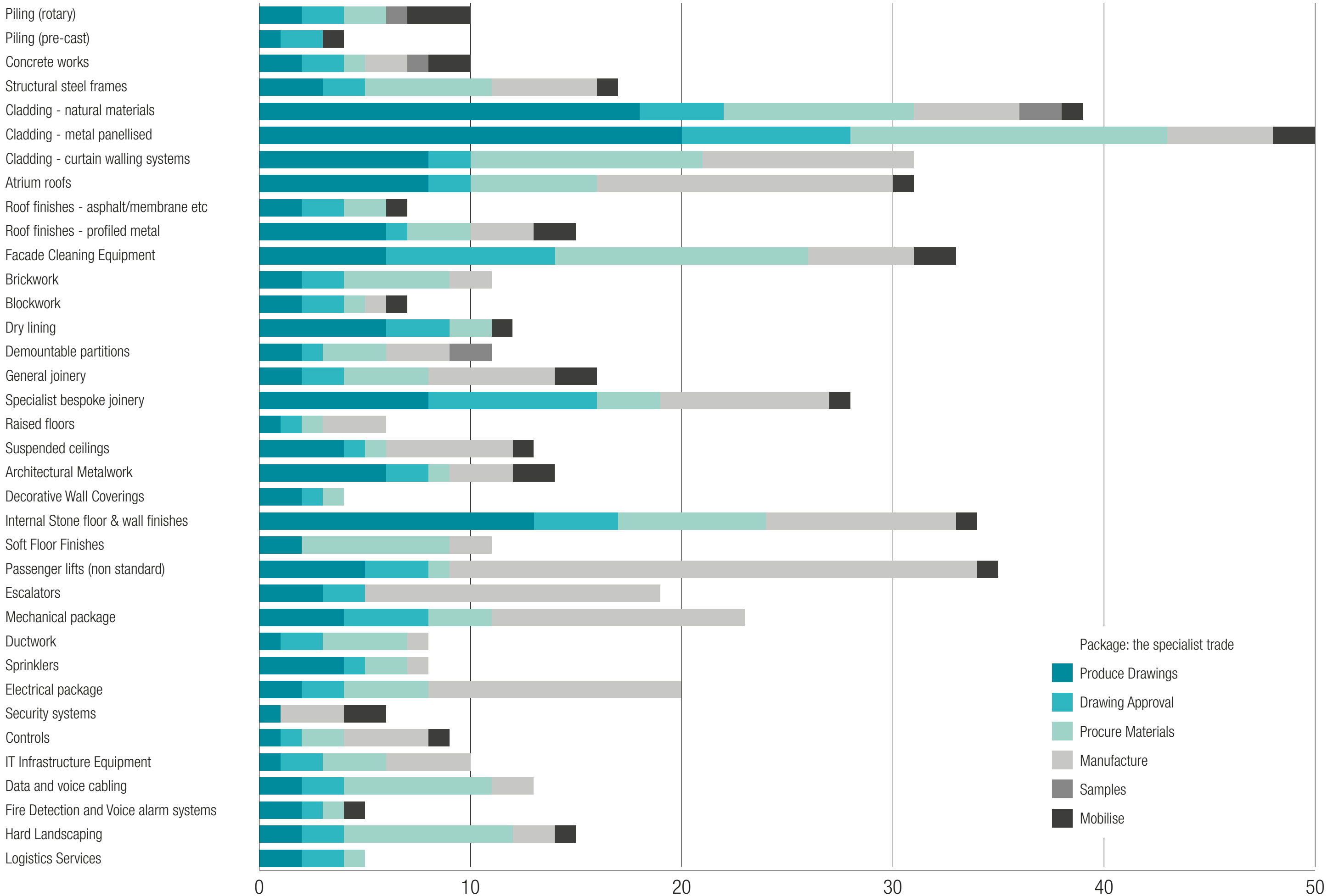
A good proportion of the labour force are European but so far there has been no difficulty retaining labour. Similarly finding labour at short notice is not an issue in part because it is possible to train on the job with the network offered from the many young migrant workers also proving advantageous. A number of schemes including apprenticeships and engaging with local school have been introduced to try to alleviate the risk of European labour disappearing but a noticeable gap in those at mid-career age will be harder to fix. If skills shortages become more of an issue, it may be possible to use alternative techniques such as moving from in-situ to pre-cast. For the time being transport from Ireland, a major production centre of pre-cast units, is fairly cheap but Brexit may also put this at risk.

For cost consultants, knowledge of BIM is becoming increasingly important but engaging sub-contractors early on can improve its effectiveness. If not enough time is allocated early on, costs can rise later. An additional risk that comes from BIM is that not all costs can be assessed just from the drawings and thought needs to go into what is excluded.

SUPPLY CHAIN FOCUS

"There are only three changes in lead times with two of the changes within the structural frame with a slight decrease in concrete lead times and a small increase in the steel frame. The only other movement is an increase in the profiled metal roof lead times. Many companies are reporting being busier but anticipate little or no change to their lead times in the next six months."

Brian Moone
Director of Supply Chain Management at Mace



Mace
155 Moorgate
London EC2M 6XB
+44 (0)20 3522 3000
www.macegroup.com

Contacts

Steven Mason	+44 (0)20 3522 3595	steven.mason@macegroup.com
Mark Williams	+44 (0)20 3522 4597	mark.williams@macegroup.com
James Donald	+44 (0)20 3824 3185	james.donald@macegroup.com