Tender Cost Update UK
Q3 2018

mace

GROWTH RETURNS TO THE INDUSTRY IN THE SECOND QUARTER WHILE INPUT COSTS SURGE UPWARDS

	2018	2019	2020	2021	2022
NATIONAL	1.5%	1.5%	2.0%	2.5%	3.0%
LONDON	1.0%	1.5%	2.0%	2.5%	3.0%

The construction sector enjoyed a return to growth in the second quarter while many projects are still coming under considerable cost pressures. The pace of earnings and material prices have risen at a faster rate than for a number of years and any significant slowdown appears to be some way off. However, tender prices are failing to keep up as clients push back on costs and some contractors and sub-contractors accept less favourable terms.

"An increase in construction output in the second quarter has done little to settle nerves in an environment of increasing uncertainty surrounding Brexit and spiralling increases in input costs. While the overall impact of these conditions will continue to have a small positive effect on forecast tender prices for 2018, the continued unease and desire to secure workload in 2019 will continue to squeeze margins throughout the supply chain for the foreseeable future."

Steven Mason
Managing Director
Mace Cost Consultancy

Pressure from labour costs continue to mount and in May were...

5.6%
higher than a year ago – the fastest pace of growth in over a decade.

After the difficulties of the first quarter, construction output rebounded in the second, rising...

0.9%

There was another slump in new orders, falling...

4.6%
in the first quarter.

The Bank of England raised interest rates to...

0.75%

TENDER PRICE INFLATION FORECAST

After challenges that were felt in the first three months of 2018, notably from the collapse of Carillion and the effects of the "Beast from the East" the industry got some much needed respite in the second quarter with output rising 0.9%. More concerning is the cost data. Material prices, which earlier in the year had shown some signs of easing, have seen a noticeable increase mainly due to higher oil and steel prices. This has led to material price inflation rising to 6% - faster than at any point last year. Labour costs are also causing difficulties with the pace of earnings growth continuing to accelerate and similarly to material prices hitting multi-year highs.

Under normal circumstances we might expect that such large increases in input costs would also trigger sizeable rises in tender prices. However, this is not something we are currently seeing and there are two main reasons for this, both of which are strongly linked to Brexit.

- Developers are pushing hard on costs given that the viability of schemes has often now been called into question with less certain returns. With future demand for properties at risk it has become more common to see projects pushed back or even cancelled. The clearest indicator of this is the struggling new order figures which is also having an impact on the behaviour of contractors. Other than the reduction in the first quarter output, official figures show strong growth in the construction industry since the referendum but this has clearly not helped all market participants.
- Well aware that market conditions are likely to toughen, some contractors are willing to reduce their margins in order to keep a solid pipeline which is helping to limit tender price increases this year. Along with applying more pressure on the supply chain, different procurement strategies are also being used with construction management becoming more popular.

Looking further ahead to 2020 and 2021, Mace has adjusted down our forecasts from 3% in both years to 2% and 2.5% respectively. The reasoning behind this is there seems little chance of Brexit getting fully resolved soon meaning firms will continue to worry about investing large sums of money. Similarly, the difficulties new orders have faced since the referendum, and the lagged effect on output this will have, means pressure on tender prices is likely to remain subdued for longer than previously thought. However, the strong infrastructure pipeline will provide tender prices with some support. It should be noted that these medium-term forecasts are still reliant on a soft Brexit occurring where the UK stays close to many European Union rules. Were a hard Brexit to take place we would be likely to revise the numbers further downwards.

ECONOMIC CONDITIONS

Uncertainty remains the watchword when it comes to the economy and is only likely to worsen as we get closer to the UK leaving the European Union. The chances of reaching an agreement in time for the EU summit in October have diminished with little softening of either the UK or EU's red lines. Such lack of clarity will only hold back spending from businesses and households, and limited growth is the likely result for the rest of the year.

GROWTH

While there has been an improvement on the first quarter, it is difficult to take too much comfort from second quarter growth of 0.4%. Firstly, manufacturing (the sector supposed to benefit the most from the pound's depreciation), has now fallen into a technical recession. Secondly, the largest contributor to growth came from a build-up in inventories which is generally not sustainable. Finally, while quarterly growth of 0.4% might now be considered the new normal, whereas a few years ago it would have been seen as weak. The World Cup and warm weather did help boost retail sales, and a reversal in the poor net trade figures should lead to similar growth levels in the second half of 2018.

LABOUR MARKET

The labour market continues to perform well with unemployment unchanged in the three months to May at 4.2%. A jump of 137,000 in the number of people in work helped push the employment rate to a new record high while vacancies are also at record highs. All this suggests earnings growth across the economy should be bouncing along. However, while the key reasoning behind the Bank of England's decision to raise interest rates has been the tight labour market and expectations of future wage rises, over the past three months earnings growth has dipped marginally. At the moment, only the construction sector, where regular pay is rising at post-financial crisis highs, is enjoying rapid growth.

EXCHANGE RATES

The pound has had a dismal past quarter against the dollar, falling to its lowest level in a year. Its performance against the euro hasn't been quite as bad but it has still depreciated over 4%. Likely interest rate rises in the US have provided the dollar with particular help but the never ending concerns around the eurozone has meant the shift in the pound has been less marked. This renewed bout of weakness could lead to further pressure on imported goods, in particular those coming from the US. However, for construction products, where the majority of imports come from the EU, price increases are less likely to be forthcoming unless the pound sinks further. Unfortunately the chances of this happening appear quite likely. One of the main reasons behind the pound's fall since the start of August has been rising fears about a 'no deal' Brexit and the longer the government fails to produce a plausible plan the more markets will be spooked.

INFLATION

Despite rising oil prices earlier in the year the inflation rate of the Consumer Prices Index has remained unchanged at 2.4% for the past three months. Weaker core inflation from, for example, food and clothing, has helped offset upwards pressure from fuel prices. On average forecasters expect a slight easing of consumer prices over the next 18 months albeit not enough for them to fall below the Bank of England's 2% target. This should give households some breathing space after real incomes fell in 2017 but won't be enough to support huge increases in consumption.

MONETARY POLICY

The Bank of England increased interest rates to 0.75% in August - the highest level in almost a decade. This followed their decision not to raise rates in May after a few weak data points led to them holding back. Although the economy has hardly seen a stellar performance over the past three months it did evolve in-line with the Monetary Policy Committee's expectations and so the rate rise came as no surprise. With rates still so low it seems doubtful that any move will have a significant effect on the wider economy, but it may further slow the already feeble housing market. The uncertainty caused by Brexit means the Bank is unlikely to increase rates again until after March next year.

GLOBAL OVERVIEW

In the second quarter of 2018, annualised US growth of 4.1% was at its fastest rate since 2014, while quarter on quarter growth of 1.4% in China was its best performance for six months. Second quarter eurozone growth was more subdued, rising just 0.3% - its weakest in two years. One explanation for the slowdown in Europe is lower confidence, in part due to fears about a trade war, and there is clearly potential for this situation to worsen. An agreement between US President, Donald Trump, and EU Commission President, Jean-Claude Juncker, that they would suspend all threatened tariffs may not last but steel and aluminium tariffs currently remain. Additionally, the spat between the US and China shows little sign of reversing, with the US proposing an increase on tariffs from 10% to 25%, leading to Chinese plans on retaliation. One reason UK growth was only at 0.4% in the second quarter was due to a large reduction in exports, and given the precarious nature of the UK economy, a trade war could cause further damage.

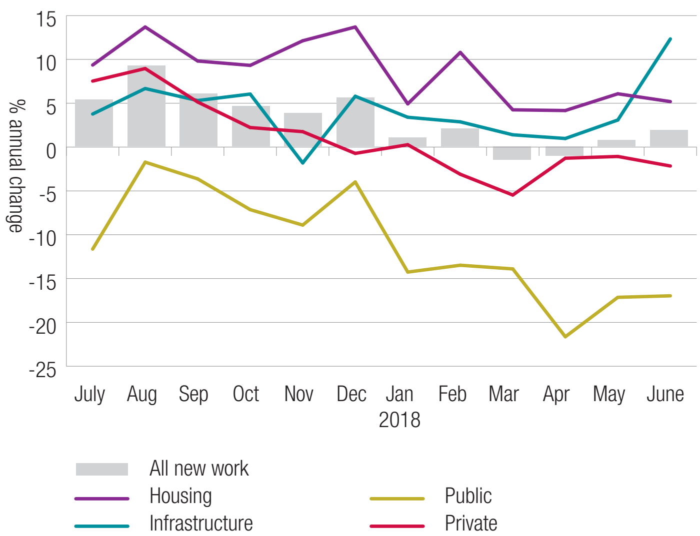
CONSTRUCTION OUTPUT AND ORDERS

After a torrid first quarter where Carillion collapsed and the weather held up many projects, construction output enjoyed a recovery in the second quarter. Growth of 0.9% in the quarter was the fastest pace since early 2017 and well above the long-run average. Driving this improvement was repair and maintenance as new work was flat over the period. In particular, what held back new work was private housing which suffered its first decline since 2015. With all new work being lower than in the final quarter of 2017 it suggests little of the lost output from the first quarter has been recouped.

The reduction in private housing over the quarter comes as somewhat of a surprise given the strength seen in surveys, but the large rises seen through 2016 and 2017 had to come to an end sooner or later. Even with a 2.4% dip, private housing is 5.5% higher compared to the second quarter of 2017 and almost 30% higher than in 2015. This is a huge increase and a small slowdown would be little to worry about. New order figures, as well as unmet demand for housing, means output is unlikely to really nose dive unless house prices drop considerably.

For the first time in over a year the private commercial sector enjoyed positive quarter on quarter growth. Survey data has also given the impression that the sector is doing better than it had been, but it would seem premature to expect too much from the sector over the rest of the year. Output fell in both May and June meaning there was no momentum moving into the third quarter. Similarly, when comparing the second quarter of 2018 with the second quarter of 2017, output was 4.3% lower underlining just how badly the sector has performed. Even worse, the non-housing public sector saw a 20% fall in output in a year, largely as a result of lower spending on schools and health. On the other hand, infrastructure has now enjoyed two successive quarters of solid growth with further expansion coming.

New construction output



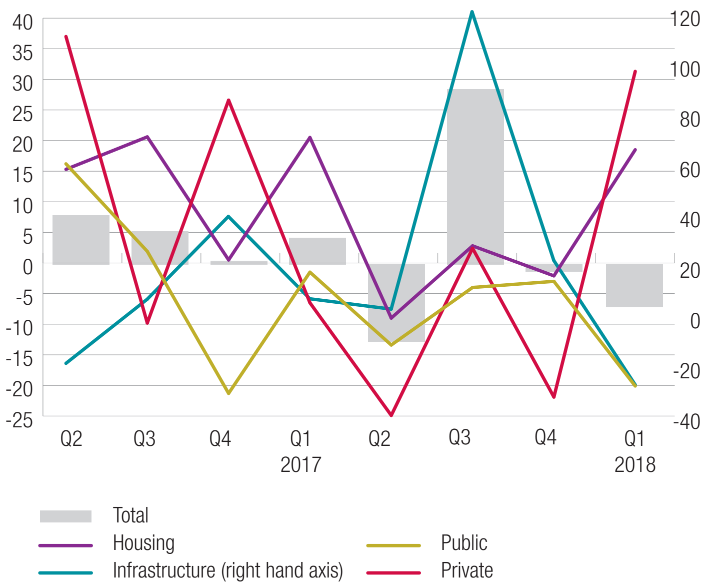
Unlike with output, the bad weather cannot explain the poor first quarter in new order figures. On a quarter on quarter basis they were 4.6% lower than at the end of 2017 while also being 6.6% lower than in the first quarter of 2017. Not even private housing reaching its highest level since 2006 was enough to prevent a fall, as slowing infrastructure and another decline in the private commercial sector dragged the figures down.

What pushed the commercial sector down in the first quarter was a large reduction in entertainment, but it is the continued weakness of offices which will be really hurting pipelines. Brexit is the main reason for this as firms wait for clarity on the type of deal the Government will achieve.

The large jump in housing can mainly be attributed to stronger orders in London, but there was also solid regional growth in the South West of England. House prices in the capital are softening but clearly not enough to deter investment yet. Despite the blip seen in the second quarter, we would expect the construction output dynamics of rising private housing offsetting a fragile commercial sector to continue.

One bright spot is the private industrial sector as warehouses continue to see growth. However, while industrial work is clearly important for certain regions, most notably the East Midlands, it makes up less than 10% of total new orders nationwide. Since 1985, in only five quarters has the size of new orders for warehouses been greater than those for shops - all of which occurred after 2013. Undoubtedly the movement away from the high street towards distribution and logistics centres will create new opportunities for construction firms but overall, given the different requirements and specifications of the two sectors, it is likely to have a negative effect on the industry.

Construction new orders



MARKET VIEW

Over the past quarter there has been a strong recovery in the IHS Markit/CIPS UK Construction PMI survey. Improving from such a low base is to be expected but the strength is still pleasing to see. The headline index has now reached its highest point in over a year with all three sub-sectors enjoying growth. The residential sector continues to outperform the other two while the robustness of commercial is somewhat surprising given output fell in both May and June. Over the period, input costs have continued to rise at a strong level and, along with Brexit uncertainty, are likely to be contributing to the weak levels of optimism.

Of recent surveys, the Q2 2018 RICS Construction and Infrastructure Market Survey was probably the most downbeat. While it still found workloads to be increasing, the pace slowed considerably in the second quarter, and with a net balance of just 15%, this is the worst level in five years. Other than public housing, which only makes up a small proportion of the industry, there were reductions in all other sectors. Confidence also worsened and the balance of surveyors expecting profit margins to rise over the next year is now close to 0%. More positive, compared to other reports, was the slight dip in the proportion of reported skills shortages, although these remain at elevated levels.

After such a poor start to 2018 the results from the second quarter of the Construction Products Association State of Trade Survey was more positive. In particular, the number of heavy side manufacturers (those typically involved with structural products) reporting a rise in sales since the last quarter, went from a negative net balance of 15% to a positive one of 40%. There also seemed to be little concern that light products, such as doors and windows, had a negative balance as this was explained away by lagged issues from the first quarter. Expectations have improved slightly and a good proportion of companies are anticipating rising sales over the next year. Cost pressures are still an issue for the majority but have eased over the quarter, especially for light side firms.

The Bank of England's second quarter Agents' Summary of Business Conditions found output broadly flat compared to a year ago. Capacity constraints had meant lost activity from the first quarter had not been fully made up and, as such, there was a delay in some completion times. Importantly, the survey found bank credit availability to be tightening for construction and development firms and a reduction in trade credit availability, possibly as a result of Carillion's collapse. Since the release of the survey, interest rates have risen and are likely to restrict financing further. The report also noted that labour shortages were constraining headcount growth in construction, although employee turnover appears to have reduced.

These surveys had two common themes. Firstly, there is ongoing input cost pressures that continue to affect the majority of construction firms. Rising costs have been a significant issue ever since the referendum, but in the latest quarter capacity problems were also commonly mentioned. This is likely to be down to attempts to catch up with weather disrupted programmes and so may be less of an issue in the second half of the year. It does, however, indicate that the industry is currently performing close to full capacity so were a good Brexit deal to be achieved, leading to a strong increase in demand, tender prices could jump substantially.

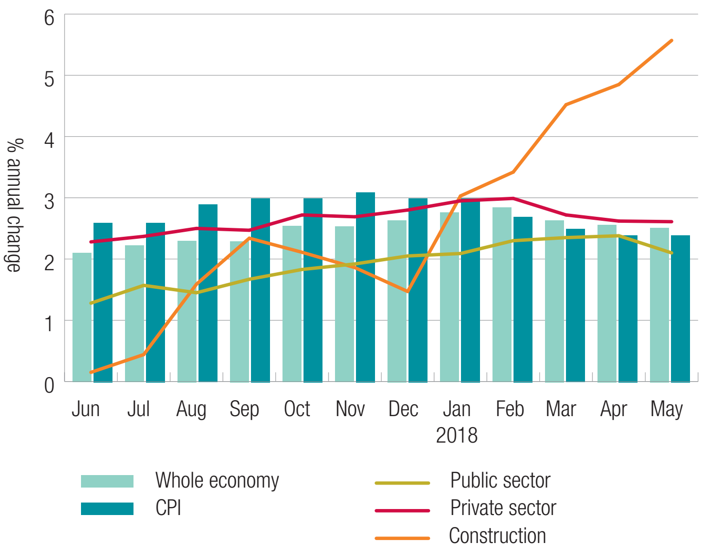
INPUT COSTS

Labour

The growth rate of regular weekly construction earnings has increased to its fastest rate in a decade. At 5.6% this is twice the pace of growth of wages across the whole economy, highlighting the acute skills shortages currently facing the industry. Providing evidence of this issue, the Federation of Master Builders State of Trade Q2 survey showed that for most skills, finding workers was becoming more challenging. It is difficult to ascertain what impact Brexit is having on these skills shortages, but with 7% of construction workers from the EU, rising to 28% in London, it appears that the situation could considerably deteriorate.

Bonuses on the other hand are slightly weaker than a year ago, indicating this is one area through which firms are finding it easier to control costs. Similarly, if staff turnover has been higher than usual it is possible there are fewer employees eligible for a full bonus. Total pay is also rising at 5.6% which is slightly below the levels hit at the end of 2016 but still far above its long-run average. Even with worsening skills shortages, the uncertainty facing the industry along with a slippage in the number of vacancies, suggests this pace of pay growth cannot last. Similarly, at some point wage increases are likely to stop being viable.

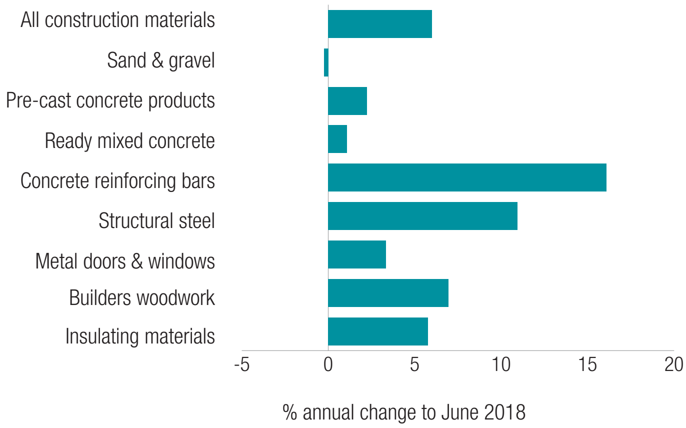
Average weekly earnings



Materials

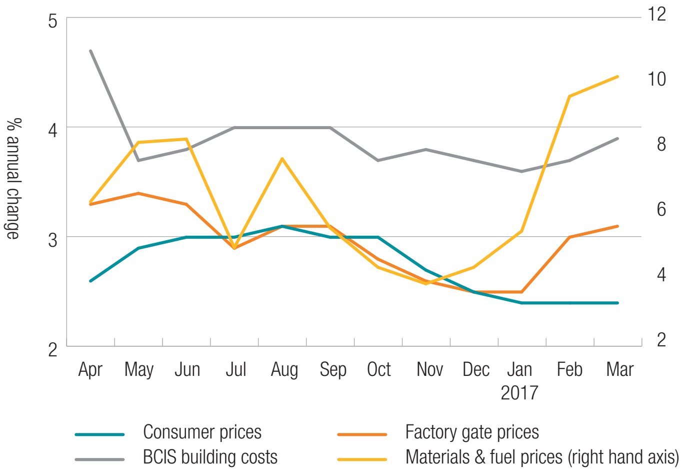
Consumer prices in June were unchanged but the rising price of oil has had a more noticeable impact on material prices. One result of higher transport costs was the pace of growth of the 'all work construction material index' which rose to 6%. This is faster than at any point seen over the past two years, even with the depreciation led increases seen during this time. There have also been further rises in the price of steel and related products. Driving this increase has been the EU's retaliatory response to US steel tariffs.

Materials prices



One factor which could push up costs further, particularly as we move into 2019 and new deals are negotiated, is rising brick prices. At the end of July, Ibstock, the UK's largest brick producer, announced a profit warning due to not meeting production targets. In order to rectify the situation, increased maintenance is necessary, and may, in some cases, result in certain plants shutting down. As a result, UK brick production over the next year is likely to fall and with lower supply we can expect higher prices

Inflation Indicators



PACKAGE SPOTLIGHT: FAÇADES AND ENVELOPES

Thanks to conversations with Permasteelisa, as well as Mace's in-house team, we are able to provide a spotlight on façades and envelopes, offering information on the issues facing this package.

A significant cost driver is the substantial increases in wages. Currently there is a considerable amount of work, meaning high demand for skilled labour. The nature of the work makes it possible for labour workers to pick and choose where to work, leading to these higher costs. In addition, the majority of workers are from Continental Europe and while there is no evidence of workers choosing to leave the UK, this is clearly a risk going forward.

Another significant driver is the cost of materials, such as aluminium, which have also been rising, but perhaps to a less noticeable extent. Here, once again, the potential exposure to changing conditions after Brexit is high with the manufacture of a large proportion of façades taking place in Europe.

While competition in the market has been increasing, absorbing rising costs is not always possible. Some firms are more willing to squeeze their margins than others and given expectations are that the market will tighten over the next couple of years clients may find it easier to push back on price. However, this gives no guarantee of quality and can also lead to issues with the programme.

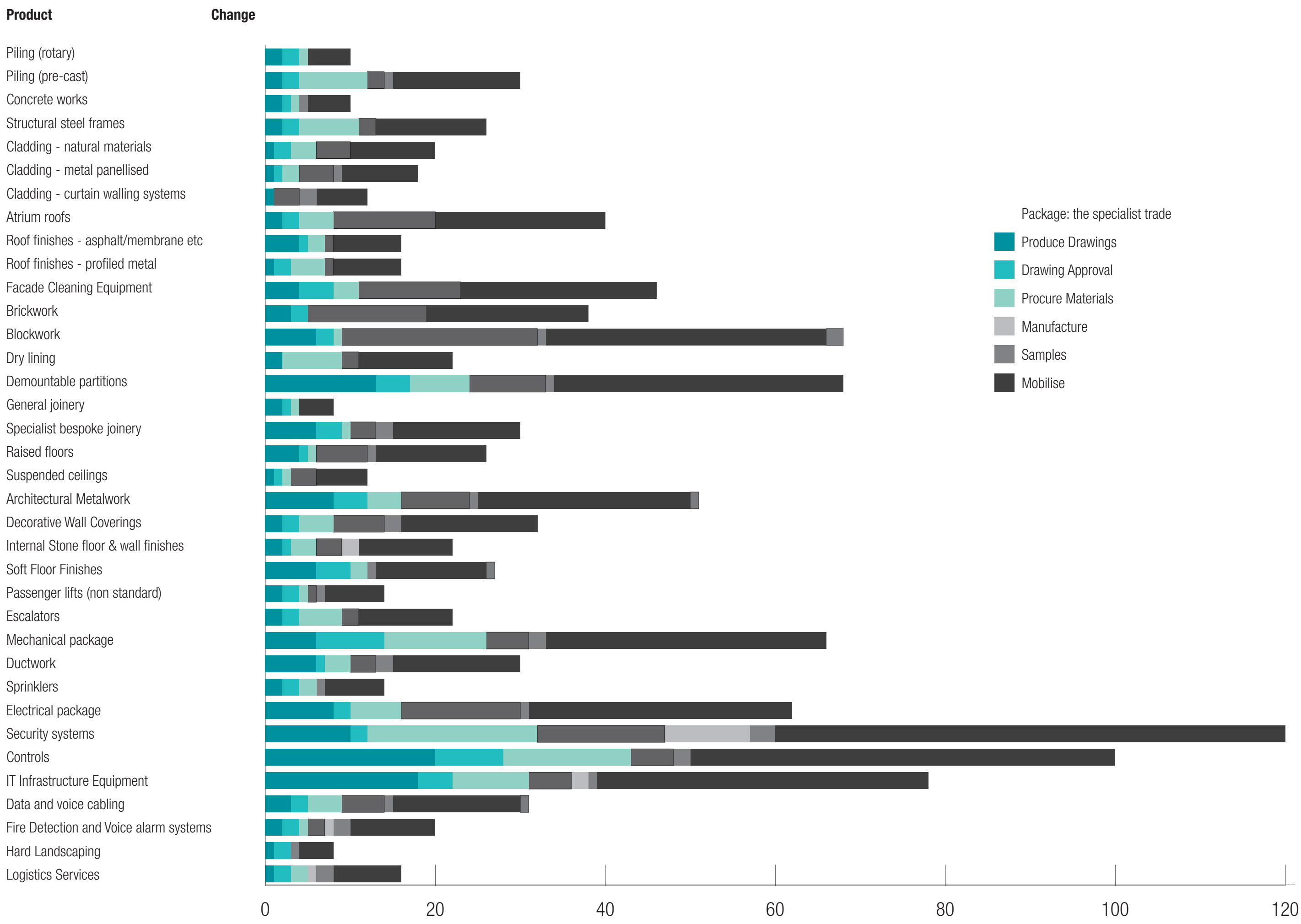
One of the best ways in helping offset cost pressures is bringing in the specialist contractor at an early a stage. This allows for a more efficient and intuitive design process, improving risk identification, mitigation and management, all of which has become even more important in the wake of recent events in the market. These events will also lead to rising costs through higher insurance premiums. Efficiency and productivity can also be improved through off-site manufacturing and pre-assembly.

SUPPLY CHAIN FOCUS

"Lead times continue to bounce around the highest levels since these records began in 1998. The dip in lead times across three packages last quarter, potentially signalling that the market had reached its peak, has been replaced by an increase in lead times across four packages; steelwork, dry lining, specialist bespoke joinery and non-standard passenger lifts. Many companies are reporting that while enquiry levels and workload remain the same, shortages of skilled labour is becoming an issue and a number are expressing concerns about the impact of Brexit on the availability of labour going forward."

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