Tender Cost Update UK
Q4 2019

CONSTRUCTION OUTPUT RETURNED TO GROWTH AMIDST FURTHER SIGNS OF A SOFTENING ECONOMY

	2019	2020	2021	2022	2023
NATIONAL	1.5%	1.5%	2.5%	3.0%	3.0%
LONDON	1.5%	1.5%	2.5%	3.0%	3.0%

One piece of good news this year for contractors and sub-contractors has been the easing in material price inflation. It now stands at its lowest in almost three years, but this is where the positivity ends. Against a backdrop of ongoing uncertainty, the economy has continued to struggle, and total construction output remains marginally lower than six months ago.

With house prices falling in some parts of the UK, businesses unwilling to invest until Brexit is resolved and HS2 plagued by delays, conditions are tough in all of the three largest parts of the industry. With the large reduction in new orders numbers as well as projects taking time to get off the ground, 2020 is likely to prove another difficult year.

"The construction market continues to be remarkably resilient despite the global economic and UK political uncertainty. Whilst the slowdown in material price inflation offers the industry some level of respite, this is being off-set by the sustained growth in labour costs and the subsequent pressure on supply chain margins. Against the backdrop of this mix of contrasting and often conflicting economic and market performance data, we expect only a limited increase in tender prices next year and have maintained our forecasts with our predictions in the last quarter."

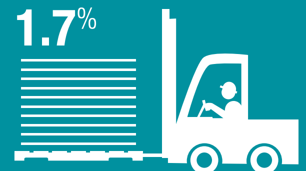
Steven Mason

Managing Director
Mace Cost Consultancy

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.

In part as a result of global trade tensions, material price inflation has slowed substantially to...

1.7%



Third quarter growth of...

0.6%

in construction output helped prevent the economy from falling into a recession.

New orders slumped...

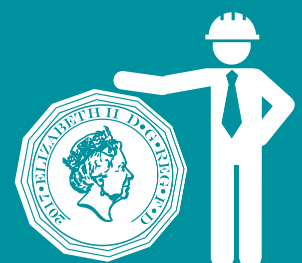
13.3%

in the second quarter to a six-year low.

Construction's

5.6%

annual growth in regular earnings is the second fastest rate in over a decade.



TENDER PRICE INFLATION FORECAST

Over the past quarter, there has been some progress on Brexit but another extension and the announcement of general election on 12 December is likely to lead to uncertainty lasting well into the new year. Prime Minister Boris Johnson managed to get his Withdrawal Agreement Bill past the second reading in Parliament, something Theresa May couldn't, yet by failing to get it to follow the timetable he desired, he chose to go for a general election instead.

Pollsters have proven less accurate in recent elections, but the two most likely outcomes appear to be a Conservative majority, or another hung parliament. If the country is once again unable to return a majority, then finding a resolution to Brexit may also remain out of reach leading to further uncertainty. Nonetheless, a Conservative majority would also not end the uncertainty. While it may result in Mr Johnson's Bill passing through parliament and the UK finally leaving the EU at the end of January, the transition period proposed is only until the end of 2020. Most commentators expect reaching a trade deal with the EU will take longer than a year and as such there is potential for another cliff-edge no-deal Brexit to emerge. Therefore, a Conservative majority may provide an initial boost in confidence, but this would only prove temporary, and is one reason why we have not altered our tender price forecast for 2020.

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The second key reason why we continue to expect only a limited increase in tender prices next year is the lack of positive economic data. Material price pressures have eased dramatically this year and with commodity prices subdued, as well as the pound's appreciation, they appear unlikely to pick-up in 2020. The rapid pace of earnings growth suggests the labour market is currently more problematic for contractors and sub-contractors. However, vacancies are falling, and surveys also indicate employers are holding back from hiring, both of which should lead to lower pay growth next year. Just as importantly as the input costs facing businesses is their ability to pass these on, and official statistics show further headwinds facing construction. Output in the third quarter may have rebounded but overall the industry has barely grown since early in 2019. The latest data release also showed new orders falling to a six-year low and firms experiencing low order books will be reluctant to push up tender prices.

Beyond 2020, much will depend on Brexit and the general election but one thing both main parties have announced is an increase in spending. Some of this will undoubtedly feed into construction but such a change in fiscal policy will take time before truly coming into effect. Including infrastructure, the public sector accounts for over a third of all new work so if the next government does adopt a more expansionary approach, it could provide the industry with much needed support in several years' time.

ECONOMIC CONDITIONS

GDP may have returned to growth, but conditions remain tough. There are mounting signs that the labour market is starting to turn and in addition to a small uptick in unemployment, the number of vacancies has fallen further. Business investment was unchanged in Q3 as firms held back from making long-term spending decisions. Adding to the uncertainty caused by Brexit, poor global growth is also hurting confidence. Underlining this weakness, and with inflation below the 2% Bank of England target rate, two members of the Monetary Policy Committee voted for an interest rate cut when the Committee met at the beginning of November.

GROWTH

GDP grew 0.3% in the third quarter meaning the economy avoided entering a recession. Yet it is difficult to take too much comfort in simply not having two successive periods of negative growth. Compared to the same quarter a year ago, GDP was only 0.9% higher, its weakest yearly increase since 2010, and over the past six months the economy has barely improved. Construction, where output increased 0.6%, was the fastest growing sector. Meanwhile, services expanded 0.4% and due to being by far the largest sector, contributed the majority of growth in the quarter.

LABOUR MARKET

Conditions in the labour market are very slowly starting to deteriorate. In the three months to August, unemployment rose to 3.9% while there was a small drop in earnings growth and vacancies slipped to their lowest level since 2017. While all three series are still in a good position by historical standards and the strength of real wage growth is providing consumers some support, forecasts suggest that unemployment will pick-up, if only marginally, to 4.2% by the end of next year. With some surveys also reporting job losses it appears that the lagged effect of a weakening economy leading to higher unemployment is finally starting to occur.

EXCHANGE RATES

Since the summer, when no-deal fears were at a high, the pound has appreciated considerably against both the dollar and the euro. October saw the pound rise 5% against the dollar, its second strongest month this decade. The new Prime Minister provided sterling with support by bringing a new Withdrawal Agreement Bill to parliament. While it failed to pass, it increased confidence that a no-deal Brexit could be avoided.

INFLATION

For all of 2019, the Consumer Price Index 12-month rate has stood around the Bank of England's target of 2%. In both August and September, it stood at just 1.7% with firms facing little pressure from higher input costs and little ability to burden consumers with higher prices. There were also very few signs of inflationary pressure in the pipeline. The latest yearly change for factory gate prices was 1.2% whereas input prices have fallen to -2.8%. While the drone attack on Saudi Arabia initially led to a large spike in oil prices, they have settled back quickly and are well below levels seen earlier in the year as well as during most of 2018. The pound's appreciation, if it lasts, should also temper inflation.

MONETARY POLICY

For the first time in over a year, there was disagreement amongst the Monetary Policy Committee. At their meeting on 6 November, they voted 7-2 in favour of leaving interest rates on hold. Those who dissented felt that the labour market was turning and the downside risks from Brexit uncertainty and the global slowdown warranted immediate monetary stimulus. However, the majority felt that for the time being these were still only risks and it would require more evidence of the situation worsening for interest rates to be cut. The other notable change is the Bank of England has now adjusted its forecast to take account of the latest Withdrawal Agreement. In doing so, and by making the fairly heroic assumption the transition period will only last a year, the forecasts for GDP growth in 2021 and 2022 have been brought down markedly. Similar to other economists, the Bank believes the new agreement will be more damaging to the economy than Theresa May's.

GLOBAL

The global economy continued to slow in the third quarter. Both China and the US reported weakening GDP with data from a number of European countries also soft. As a result, the Federal Reserve cut interest rates for the third time this year while the European Central Bank has also eased monetary policy. This slowdown in growth has led to lower prices for several key commodities, helping bring down construction material price inflation in the UK. Another factor potentially having an impact on domestic construction is the situation in Hong Kong. Not only has this pushed the country into a recession but there are anecdotal reports of investors looking to move money into London property.

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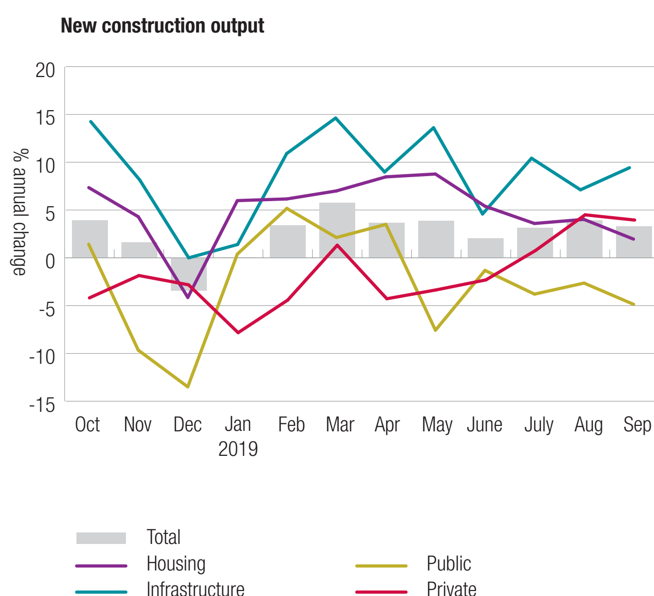
CONSTRUCTION OUTPUT AND ORDERS

Growth was modest in the third quarter with total output increasing just 0.6% on a quarter-on-quarter basis. All new work grew 1.4% but there was another drop in the repair and maintenance sector as the private housing portion continues to struggle. Households reluctant to spend on home improvements meant the sector was 6.6% lower than a year ago, its largest yearly decline since 2012. However, labour market conditions are vastly better than seven years ago, when unemployment stood at almost 8% and real wages had fallen noticeably, highlighting the detrimental effect Brexit is having on parts of the economy.

Within new work, all sectors bar public housing grew in Q3 and this widespread expansion was enough to push all new work to a new high. Moreover, public housing's fall came on the back of a number of periods of strong growth and the sector is almost 10% larger than it was in 2018. How the sector develops in the medium-term will depend on policies enacted by the next government, but indications are that it may weaken in the more immediate future. Not only have new orders figures softened but new starts from housing associations and local authorities in England have declined for three successive quarters. While there was a rise in output in private housing, momentum has faded from the sector and it is facing similar issues based on new orders and new starts.

The large increase in demand for warehouses helped make private industrial the fastest growing sector in the quarter, with output increasing 7.2%. There was also good news from the commercial sector, which rose 1.5%. This was the third time in the past four quarters where it has grown, and it now has a positive yearly growth rate for the first time since 2017. However, doubts remain about whether this growth can persist and for the rate of pace to increase, it is likely that market fundamentals will have to improve.

With the difficulty the ONS has in providing a breakdown on the infrastructure output statistics, it can be tricky to evaluate the sector in too much detail. What is clear is that overall it returned to growth in the third quarter and is over 8% larger than a year ago. However, momentum has slowed since the extensive growth rates seen in the final quarter of 2018 and first quarter of 2019, although it is not possible to say with certainty whether this is due to delays in projects such as HS2 or other parts of the infrastructure sector which are slowing.



After positive first quarter numbers, new orders fell back with a bump in the second quarter. Ignoring the distorting effect of the HS2 contracts in 2017, new orders had their largest quarter-on-quarter decline in almost eight years. This was a broad-based drop and the only sector which grew in the second quarter was infrastructure. As is often the case, one very large scheme contributed to the bulk of this figure. In the first quarter, it was HS2 and for the second quarter it was the construction programme at Sellafield. Nonetheless, this is a twenty-year project and as such it will only provide limited support to infrastructure output. The sector remains far more dependent on HS2, an issue the ongoing delays and questions around the project will not help.

For several quarters, the resilience of the commercial sector, and in particular offices, has been somewhat surprising given the tricky economic backdrop. However, in the second quarter, there was a 24% reduction in the total commercial sector with new orders for offices almost halving. As a result of the strong first quarter, the four-period rolling total remains larger than at any point in 2018 but it is still far below 2015 and 2016's figures. Of the major sectors, Brexit uncertainty has damaged commercial more than any other. The UK still faces housing shortages, large, long-term investments have boosted infrastructure, while public estates are also often less concerned with the immediate future. Businesses on the other hand have struggled to understand what exactly Brexit entails and how it will affect operating conditions. With the possibility of a no-deal rising to a crescendo in the second quarter, the retrenchment in new orders was unsurprising. Little clarity over Brexit was reached until October so third quarter new order numbers could also be weak and were there to be two poor quarters, we would expect output next year to once again struggle.

It was also a disappointing quarter for housing providing statistical evidence to the survey reports that large developers were scaling back on some projects. Both the public and private housing sectors saw a reduction in new orders and the four-period rolling total for the two sectors combined is now at its lowest level since 2013. With house price growth slowing, and falling in London, there appear few signs of any immediate turnaround.

From a regional perspective, the North West had the largest value of new orders, but this was primarily due to the Sellafield scheme. More importantly, the regional data shows that it is not just one or two areas faring badly, but large swathes of the country that are facing difficulty. Between Q1 and Q2, only three of the 11 regions the ONS reports on, had a rise in both total housing and private commercial new orders on a rolling four-quarter basis. With such widespread problems, and the huge levels of uncertainty, there seems little reason to have different tender cost forecasts in London than elsewhere.

MARKET VIEW

Workloads continued to increase according to the Q3 2019 RICS Construction and Infrastructure Market Survey, though at a slower rate than in the second quarter. While the net balance of 10% is not the lowest it has been since the referendum, it is below the average from the past three years. Nonetheless, respondents' views on what was limiting building activity changed little over the quarter with financial constraints remaining the most significant factor. Counter intuitively based on other factors, there was a small reduction in the proportion citing insufficient demand. Profit margins are forecast to fall over the next 12 months whereas workloads and employment will continue to rise but at a slower pace than expected at the time of the previous report.

For the past six months, the IHS Markit/CIPS UK Construction PMI has been reporting activity as falling. For five of these months the residential sector has dropped and in October it declined at its fastest rate in three years. Civil engineering hit a ten-year low and while the commercial sector had a small rebound, it has consistently been the worst performing part of the industry this year. With all three sectors struggling and seven consecutive months of new order declines it is possibly no surprise that respondents are facing intense competition and having to cut prices. Similarly, a lack of demand for materials has led to input cost inflation weakening to its lowest level since early 2016 while firms continue to choose not to replace voluntary leavers.

There was little to cheer for the construction industry in the Bank of England Agents' summary of business conditions for Q3. Industrial and warehouse schemes continued to grow but alongside increased government funding for social housing, these were the only bright spots in the report. Elsewhere, public and commercial projects were facing delays and leading to weakening construction output growth. A lack of interest from investors is likely to be damaging the commercial sector and this is especially the case with retail property. Similarly, housing developers were commonly having to offer incentives and finding sales taking longer to complete, leading to some cutting build rates. The report also mentioned weaker demand for construction consulting services, a lack of demand for construction products and construction firms finding conditions tight for both bank credit and trade credit insurance.

There continues to be a large divergence between surveys with the Bank of England and PMI far gloomier than RICS. There is also disagreement about just how poorly the individual sectors are doing. While there is universal agreement on the commercial sector's weakness, views on the infrastructure sector are less aligned. RICS reports infrastructure as having the highest workload whereas the PMI finds it as the weakest sector. Both surveys also disagree on whether activity is increasing or not in the residential sector, although they are a bit clearer on the trend, having found conditions worsening.

INPUT COSTS

Labour

Despite the size of the construction industry workforce shrinking in the three months to June, noticeably fewer vacancies and the limited growth in output this year, pay in the sector continues to rapidly increase. The annual increase in regular earnings reached 5.6% in August, up from 4.5% three months ago and is the second fastest rate since 2007. The PMI construction survey has also spent the past six months highlighting falling staff numbers with firms reluctant to hire, adding to the number of indicators which suggest such strong pay growth is not sustainable. Skills shortages, a common refrain within construction, provide an easy explanation as to why growth is so much faster than other industries but there is limited evidence of these worsening. The latest State of Trade Survey from the Federation of Master Builders reported increasing shortages for some skills but not all, and in general, they appear to have eased relative to the past few years. In addition, the Q3 RICS Construction and Infrastructure Market Survey found fewer respondents reporting shortages for all four skills it focuses on with most of them at multi-year lows. Immigration figures also don't provide anything conclusive. While EU immigration has fallen, and emigration risen, net migration remains positive. For Central and Eastern European countries who joined in 2004, net migration is negative, but the decline has been relatively small and is likely to only have had a significant effect on earnings in London.

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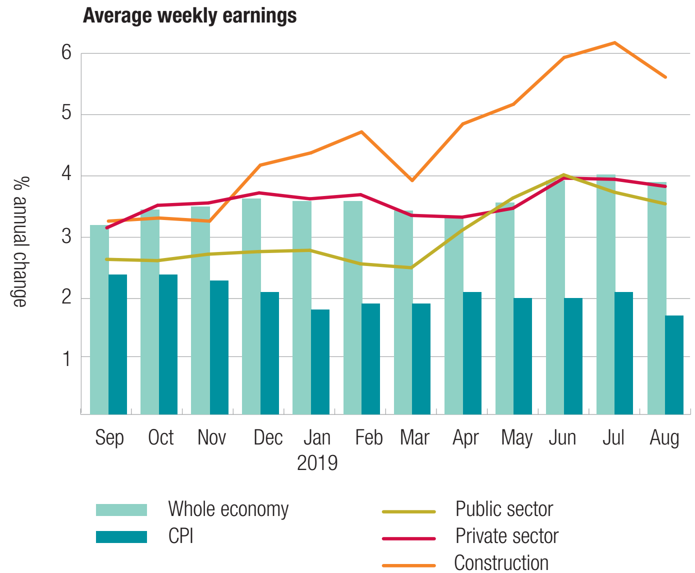
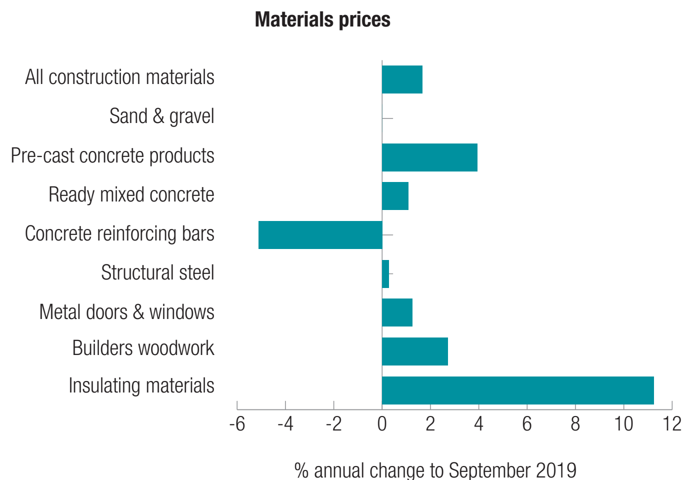
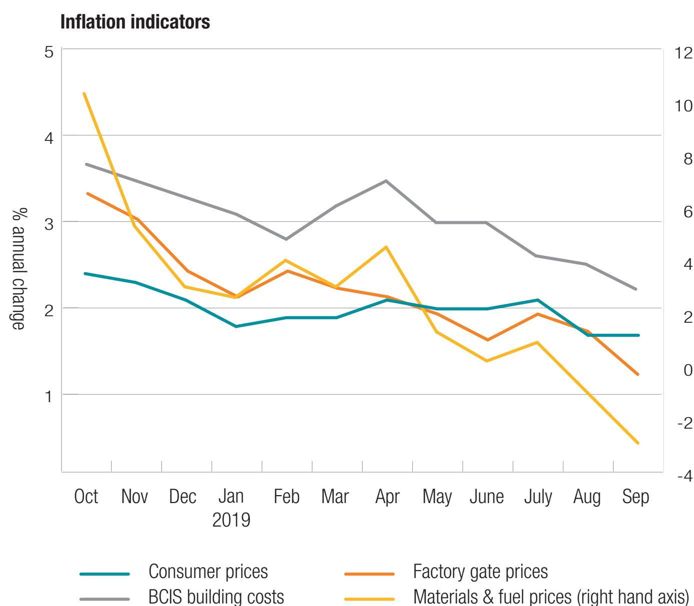


Materials



Providing some respite from rising wages, material price inflation has eased considerably this year. The annual inflation rate of the 'all work construction material price index' slowed from 4.4% in January to 1.7% in August with prices falling in both July and August. Construction material inflation is noticeably more volatile than consumer prices and it is difficult to say just how low it could reach. Similarly, it is not possible to say just how much of the current slowdown is due to weak global commodity prices and how much has been caused by a lack of demand for materials. The price of Brent oil was around $US20 per barrel lower in October 2019 than a year earlier, European steel plate prices have fallen around 10% and imported plywood is 20% lower.

As way of comparison, in 2016 when material inflation hit -3.7%, oil prices had slumped from over US$100p/b to US$30p/b in two years suggesting conditions will have to significantly worsen for inflation to drop below 0%.



PACKAGE SPOTLIGHT: JOINERY

Thanks to conversations with SJ Eastern we are able to provide a spotlight on joinery, offering information on the issues facing this package.

Over the past six months, there has been a slowdown in the market, most noticeably the residential sector. This has led to margins tightening with firms having to adapt to the changing conditions. Given the difficulties in the market, high overheads can be a particular issue for businesses which own a factory. For those which do, winning work and avoiding the factory from sitting idle becomes increasingly important. These firms are then forced to cut prices in order to win work which naturally has an effect on other joinery businesses.

Many other overhead costs such as those around sustainability and health and safety are seen as part of best practice and essential in delivering a high-quality service. Nevertheless, one area related to sustainability, where savings and efficiency gains had proved possible was through cutting waste. Some time and thought and gone into this with the best results found from giving the site teams responsibility for reducing waste as opposed to a more top-down approach.

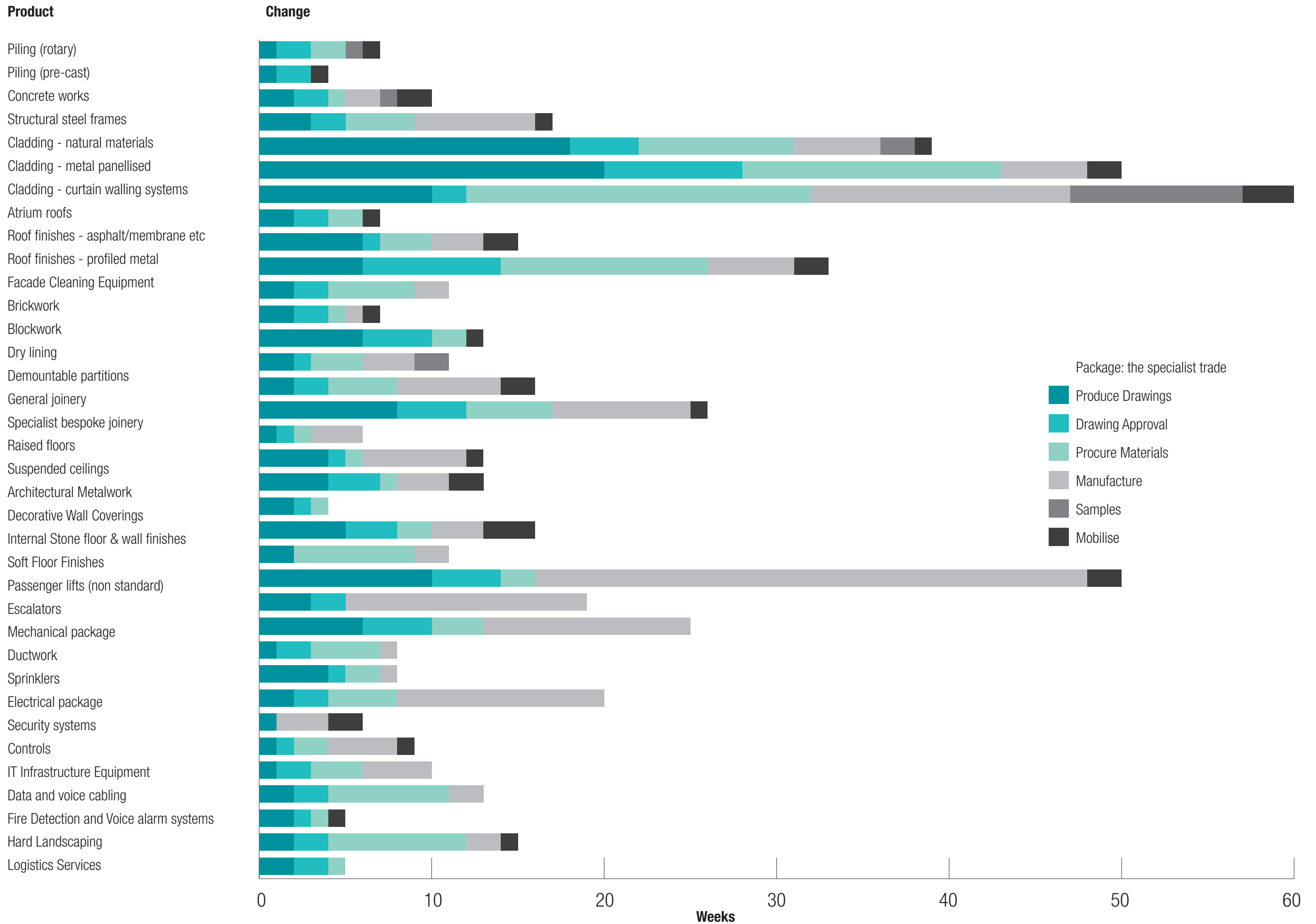
Helping to soften the blow of a tough market, the price of timber has been stable for most of the year. Importing timber directly is considered too risky so instead a close relationship with the supply chain has been fostered. Softwood typically comes from Scandinavian forests and due to the renewed focus on sustainability, it is increasingly common to use this where hardwoods may have previously been specified. Following the pound's depreciation in the aftermath of the referendum, there was a sizeable increase in import prices as merchants passed on the costs. As of yet, and possibly unsurprisingly, merchants have chosen not to reduce prices based on the pound's appreciation but in working closely with suppliers, this is a conversation that can be had.

Similar to materials, wages, which had also been rising rapidly last year, have stabilised in 2019. Carpenters are employed indirectly and made-up of a core of mainly British workers. Eastern Europeans supplement this principal workforce, providing flexibility dependent on the quantity of work required. There has been no change in the availability of such carpenters and nor has their quality or productivity dipped. While skills shortages do exist in the industry, much of this is due to a difficulty in finding apprentices willing and able to be trained-up.

SUPPLY CHAIN FOCUS

“Despite general uncertainty about the future workload, most companies are not forecasting changes to their lead times with only two packages increasing and one package decreasing. Non-standard passenger lifts lead time increased by a further six weeks – this was the second increase in six months. Structural steel frames have increased by two weeks while architectural metalwork lead times have decreased by two weeks.”

Brian Moone
Director of Supply Chain Management at Mace



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