Tender Cost Update UK
Q3 2019

CONSTRUCTION INDUSTRY TREADING WATER AS IT WAITS FOR BREXIT

	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%

Both the wider economy and the construction industry had a difficult second quarter and as a result total growth in the first half of the year has been low. Many of the issues hindering growth and affecting key sectors such as residential and commercial look set to continue until the Brexit fog clears although office new orders continue to surprise.

Weaker domestic demand, as well as geopolitical issues curtailing global commodity prices, have helped slow the pace of material price inflation. However, construction earnings growth remains high, as does the squeeze on contractors and sub-contractors, who have a limited ability to pass on costs.

"The overriding sense of unease in the UK construction market continues as the impact of Brexit uncertainty, domestic political turmoil and global economic concerns take their toll. While there is a growing appetite to secure workload for 2020, for now tender prices remain steady as the downside risks continue to be offset by strong input costs.

"However, the likely impact of a no deal Brexit will put more pressure on the supply chain. As the combination of potential reduced demand with further increases in material and labour costs will inevitably affect margins, tender prices will feel a downward pressure."

Steven Mason

Managing Director
Mace Cost Consultancy

After growing 1.4% in the first quarter, the construction industry contracted...

GDP fell...
0.2%

in the second quarter, its first decline in seven years.

New orders had a strong start to the year, rising...
9.6%

Material price inflation eased to...

3%

...its lowest level since 2016.

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.

TENDER PRICE INFLATION FORECAST

In our last report, we downgraded our tender price forecast for 2020 to 1.5%. This quarter our forecasts are unchanged but the downside risks, in particular around next year, have increased. The current forecasts assume a smooth Brexit, but were there not to be a deal we would likely have to revise down our forecasts.

While we have discussed the likely impact of a no-deal Brexit before, given the potential magnitude of the changes, it is worth highlighting these again. The biggest risk, and the reason why if the UK leaves the EU on October 31st without a deal, is that tender prices would come under downwards pressure, because of the effect on demand. In several no-deal scenarios, the Bank of England forecasts large drops in both house prices and commercial real estate. Were these to materialise, they would result in a sizeable reduction in investment and significantly damage the construction industry. In addition to lower demand, a no-deal would cause contractors problems resulting from higher costs. The rising likelihood of a no-deal and ongoing statements from the new Government Cabinet have already resulted in the pound depreciating significantly over the summer and a further large drop would occur with a no-deal. This would push material prices higher. Tariff and non-tariff barriers will also lead to higher material costs. European workers play an important part in the construction industry especially in London. If they view the UK as a less attractive destination, something the weaker pound automatically does, it could drive earnings higher and exacerbate skills shortages.

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For the meantime, and despite the rising odds, a no-deal is not the Government's aim and our forecasts are still dependent on a smooth Brexit. Survey and data releases over the past quarter have shown both construction and the wider economy continuing to battle against major headwinds. Stockpiling and other decisions made around the first Brexit deadline mean we shouldn't read too much into the fall in GDP in the second quarter, but growth of 0.5% in the first half of the year is very slow. Construction output was also only 0.5% bigger in the first half of 2019 than in the second half of 2018 with private housing suffering its worst half-year since 2012.

For contractors and sub-contractors the slowdown in material price inflation provides some respite but 3% is by no means low. Additionally, offsetting any relief businesses have found from an easing in material price inflation is the continued pressure they are facing from labour costs. Regular construction earnings are 4.4% higher than a year ago, but facing such a competitive market means that firms' ability to pass on these costs is limited. A good start to the year for new orders is only a small move in the right direction and given the ongoing uncertainty there is a strong chance of a reversal. As such, there is little to warrant a change in our forecasts of modest tender price growth this year and next.

ECONOMIC CONDITIONS

There was little to cheer in the second quarter as Brexit uncertainty intensified and GDP fell. Political upheaval ended in Boris Johnson becoming prime minister and led to the pound depreciating considerably. Global issues are also hurting confidence, with potential for an escalation in the US-China trade war and further disruption in the Strait of Hormuz. The main bright spots in the first half of 2019 were the stability in the labour market and inflation although figures may modestly wane in the second half.

GROWTH

Q2 was the UK economy's worst quarter since 2012 as it contracted 0.2%. The manufacturing sector had a particularly tough time as some car plants, fearing Brexit, closed for maintenance in April. With the shutdown not taking place during the summer, it should boost Q3 growth. Further stockpiling may support growth next quarter but the unwinding of the first quarter's stockpiling, in preparation for the original Brexit deadline, damaged Q2 GDP. However, it wasn't just manufacturing which did poorly and the weakness was broad-based. 0.1% quarter on quarter growth was the services sector's weakest in three years while output in construction fell 1.3%.

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LABOUR MARKET

On the face of it the labour market remains strong but some of the signs of weakness we mentioned in our last report have worsened. The key headline figures show unemployment falling to 3.8% and the 3.6% growth rate of regular earnings is its fastest since 2008. However, the number of vacancies has now fallen for five successive months and while employment is still rising, this is solely down to self-employment with the number of employees falling. If we have reached a peak, conditions need not change rapidly. Firms typically only let workers go as a last resort and, as long as we avoid a no-deal Brexit where changes may have a more dramatic effect, unemployment should only increase marginally.

EXCHANGE RATES

Over the past quarter, the pound has descended steadily against both the euro and the dollar. It has depreciated from a high of US$1.31 at the start of May to US$1.21 in early August while also falling from €1.17 to €1.08 over the same period. From the local and European elections in May to Theresa May's resignation and Boris Johnson taking her place as prime minster, each of these events have persuaded investors the chance of a no-deal Brexit has increased. As a result, the pound has lost 7% of its value and extended falls are highly likely if a deal that is agreeable to both sides is not found.

INFLATION

Consumer Price Index inflation has barely moved in the first half of 2019 and in June was 2%. Before the pound's recent substantial depreciation, most forecasters had been expecting inflation to hover around this level for the rest of the year as well as throughout 2020, suggesting few underlying issues. While the coming months may see some upwards pressure from the depreciation, the impact is likely to be less significant than from the fall in 2016. In part this is because, at least so far, the pound has depreciated less. In addition, oil won't have the same effect on inflation as it did in 2016 and 2017 when prices more than doubled.

MONETARY POLICY

The Bank of England faced some criticism following its most recent interest rate announcement on August 1st. While it was no surprise that all nine members of the Monetary Policy Committee voted to leave interest rates on hold, the lack of no-deal Brexit analysis frustrated some market commentators. The Bank has provided little detail on whether they expect such an outcome to result in downward pressure from falling demand outweighing upwards pressure from the pound depreciating. This is what many expect and would likely trigger an interest rate cut, but so far the Bank has been steadfast in saying a no-deal Brexit will not trigger an instant reduction. Instead, they have maintained their assumption of a smooth Brexit transition, leading to faster GDP growth from the second half of 2020 and interest rates rising gradually.

GLOBAL

At a time when Brexit uncertainty is hitting the domestic economy, exporters are also facing troubles abroad. The well documented tension between the US and China is clearly having an effect and forecasts for both countries are that GDP growth will slow this year. One result of this is the Federal Reserve cut interest rates in July and problems in the eurozone mean that the European Central Bank may soon follow suit. In particular, Germany, a country that relies heavily on exports, is facing difficulties. The European Commission's July construction survey found activity at its lowest level this year, potentially reducing the attractiveness for UK-based European workers thinking of avoiding Brexit and returning home. A second upside for UK construction firms of the ongoing global problems is weakening commodity prices.

CONSTRUCTION OUTPUT AND ORDERS

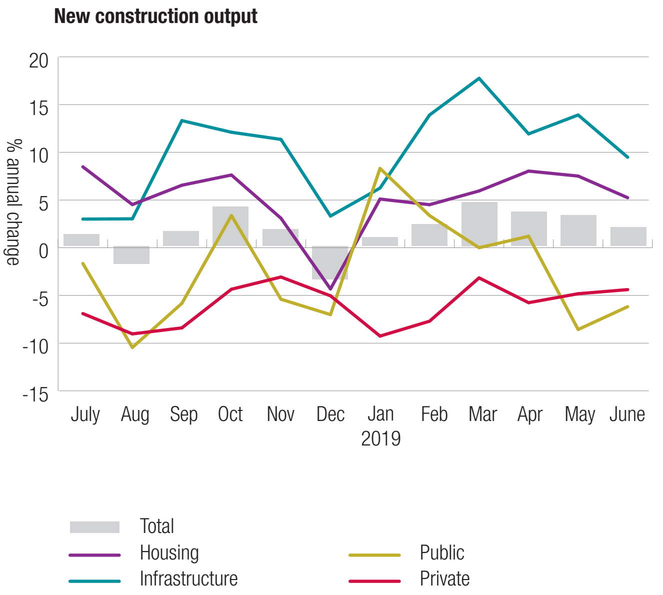
The gains construction enjoyed in the first quarter were nearly all lost in the second, meaning output in the industry is virtually flat relative to the end of 2018. Overall, all new work rose 1.4% in Q1 2019 with the second quarter figures showing a 1.3% drop. The largest drag came from repair and maintenance with private housing faring particularly badly. Despite rising real wages, households are reluctant to spend on bigger ticket items such as new cars and house improvements.

Output in the construction industryis virtually flat relative to the end of 2018

Similar dynamics also occurred in all new work where a 0.5% fall in the second quarter followed growth of 0.6% in the first. Standing out from the data is the reversal in trends for the commercial and private housing sectors. Starting with a small positive, the commercial sector has now grown in two of the past three quarters. Unfortunately, the 2.1% increase in the second quarter was considerably lower than the 4.1% decline in the first. The sector is also 4.9% lower than in the second quarter of 2018, 11% smaller than at the start of 2017 and until firms better understand what the long-term position of the UK will be, is likely to continue facing difficulties.

Private housing's fortunes have taken a turn for the worse this year, the pace of the downturn increasing from a 0.3% first quarter decline to 1.9% in Q2. However, while commercial is trying to recover from a relatively low base, private housing output is coming off a record high. As such, it is still 3.2% larger than in the second quarter of 2018 but importantly it seems the industry can no longer rely on the sector to drive growth. Public housing may account for only 6% of all new work yet it has been rising strongly for the past year, capped off by a 13.3% jump in the second quarter. That public housing output increased substantially in the second half of 2018 shows there is more to the growth than just the lifting of the Housing Revenue Account borrowing cap, which only happened in October. This should give the sector additional impetus going forward but there was a drop in first quarter housing association starts and Standard & Poor's recently downgraded a number of these organisations.

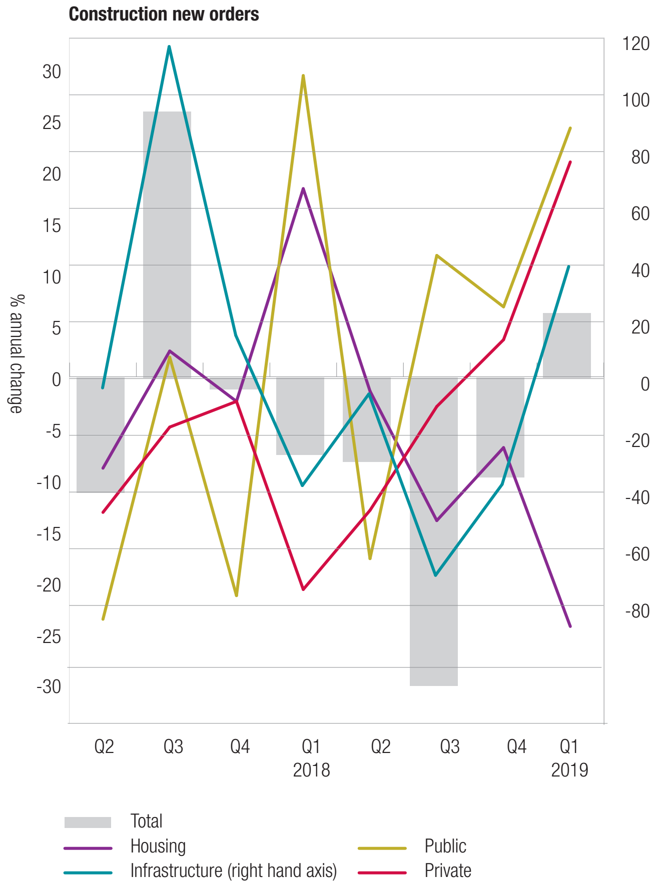
Finally, infrastructure had a disappointing quarter, seeing a 0.6% reduction. Output in the sector is often more volatile than other areas and it has also seen robust growth over the past two years. Overall, growth in the first half of the year was still 7% so it would be a mistake to think infrastructure is performing weakly. Nonetheless, the lack of growth in Q2, alongside several comments in recent surveys about a lack of replacement work provide some doubt about the sector. Compounding these issues are the lack of bidders for two large parts of HS2, delays to the start of the civils works and the Government's decision to review the project.



Q1 2019 was a strong quarter for new orders; excluding the volatile infrastructure series, it had its best quarter-on-quarter period of growth since before the referendum. The private commercial sector had a particularly strong start to the year growing by 15% with both the entertainment and offices sub-sectors expanding. Offices in particular have experienced a number of very poor quarters over the past two years, affected by lower business confidence and investment. However, in the second half of 2018 they somewhat recovered and this has been followed by a much stronger start to 2019. This has meant a small improvement in the four-period rolling average of commercial new orders, but as it is still far below not only the pre-Brexit referendum levels but also all periods in 2017, conditions will remain tough.

HS2 continues to provide considerable support to the infrastructure sector. The Office for National Statistics, who produce the new orders numbers in conjunction with Barbour-ABI, highlighted the £1.65bn upgrade to Euston. As the total number for railways was only £2.05bn, it therefore appears that the Old Oak Common scheme was not included in the Q1 numbers, possibly due to the legal challenges around the project. If this £1bn project is included in next quarter's numbers it will once again give the impression of a strong infrastructure sector. However, the Q1 total value of new orders was only £3.6bn so were we to take away the Euston project, the sector would have actually had a tough start to the year and in some ways HS2 is exaggerating its strength.

The two sectors that grew the most in the first quarter were the two public sectors, housing and non-housing, both increasing by almost 30%. While public housing only makes up a very small proportion of total new orders, the non-housing public sector is more important, accounting for over 10%. Its first quarter growth was driven primarily by the entertainment sector, possibly related to the Commonwealth Games and an arena in Swansea. By contrast, but also more importantly, the private housing sector also continued to weaken in the first quarter. New orders shrank 6.6% and it is becoming increasingly clear that the sector can no longer support industry growth as it has in recent years. Its four-period rolling average is now 10% lower than Q1 2018 and is also at its lowest level since early 2016. With house prices also stuck in the doldrums, and the Bank of England saying a no-deal Brexit would lead to substantial price drops, the declines in private housing output growth we have seen so far this year may well continue.



MARKET VIEW

According to the IHS Markit/CIPS UK Construction PMI, activity has fallen in all three of this quarter's surveys, including dropping to a decade low in June. Commercial and civil engineering have struggled all year but the residential sector, while still the strongest, is now also reporting falling activity. In addition to a lower volume of work, order books have been contracting for the past four months, demand for materials has weakened and confidence is at its lowest since 2012 when output in the industry shrank by almost 7%. Fortunately, this has not yet resulted in major job cuts and most of the reduction in employment numbers is due to not replacing voluntary leavers.

Having hit a six-year low in Q1, there was a small improvement in the Q2 2019 RICS Construction and Infrastructure Market Survey. Those reporting rising workloads increased from a net balance of 9% in Q1 to 16% and despite being a relatively low score, it does reveal a moderate proportion of more surveyors are seeing growth rather than decline. Public housing saw a very large jump in its net balance making it the brightest sector. Private housing and infrastructure also performed well. Not only did current activity improve but expectations for the next 12 months for all three of workloads, employment and profit margins also strengthened. This improvement has only pushed the net balance for profit margins to 0 meaning as many respondents anticipate them to rise as to fall.

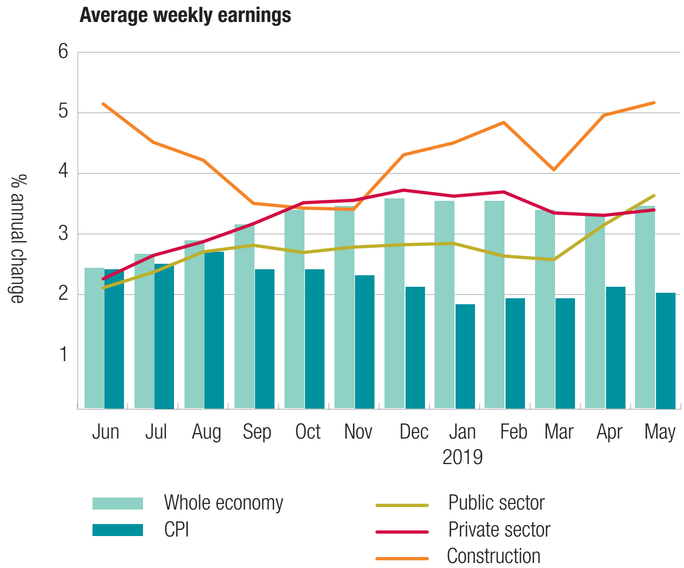
The Bank of England Agents' summary of business conditions for Q2 found activity little changed relative to a year ago. Uncertainty around student numbers and fees had led to universities becoming cautious and it was suggested that higher education projects, including student accommodation, had peaked. In addition, there remain reports of house builders scaling back some projects although this was somewhat counteracted by the social and affordable sectors. Delays to infrastructure projects were causing some concern with the only real bright spot being the warehousing sector. Skills shortages are also a major issue, with some vacancies unfilled for a considerable amount of time.

Asking different organisations, not having identical methodologies and wording questions differently are three reasons why surveys about the construction industry could produce contrasting results. In particular, the RICS and PMI surveys have again reached conflicting conclusions about whether the industry is growing or not. The main advantage about surveys is they are an early indicator of how a sector is performing and for this reason they still hold value. However, Brexit uncertainty has shown respondents can be taken in by poor news reacting more negatively than official data, once released, shows. In addition both the PMI and RICS had poor second quarters compared to the data. In June, the PMI slipped to its lowest level in a decade but the month on month drop in output was just 0.7%. RICS did poorly because output did fall in the second quarter even though their respondents felt conditions improved. However, once we take account of both, we get something closer to the true picture.

INPUT COSTS

Labour

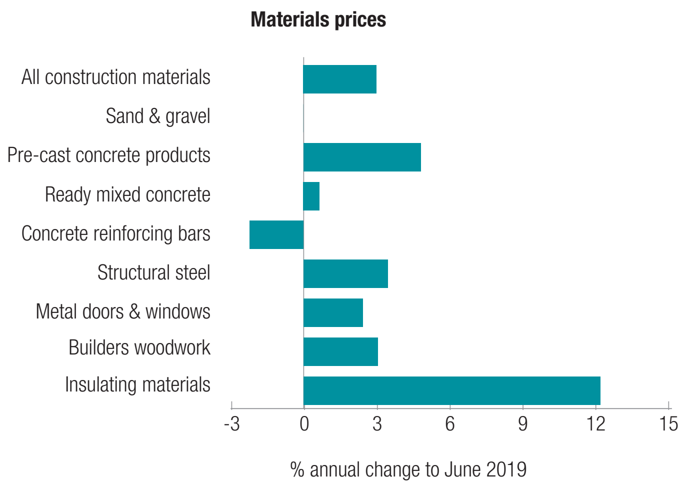
Total construction earnings grew at their fastest rate in a year in May. Some of the recent upwards pressure has come from considerable bonus payments but regular pay growth is also robust. Earnings are now 4.4% higher than a year ago, substantially above pay increases seen in the wider economy. Other than a slight slowdown in the autumn last year, regular earnings growth has been around 4% since the start of 2018, the longest period of sustained growth since before the financial crisis. Given the lack of output growth the industry has seen over this period, it highlights how skills shortages are forcing costs up. Surveys over the past three months have discussed lower employment and the official figures for employment showed an increase of just 1,000 people between December 2018 and March 2019. Yet despite a recent very small drop in construction vacancies, they remain high and firms are clearly not finding it easy to source the right people. With such weak output growth alongside the high levels of uncertainty firms are facing, it would seem unlikely if 4% growth can continue.



Materials

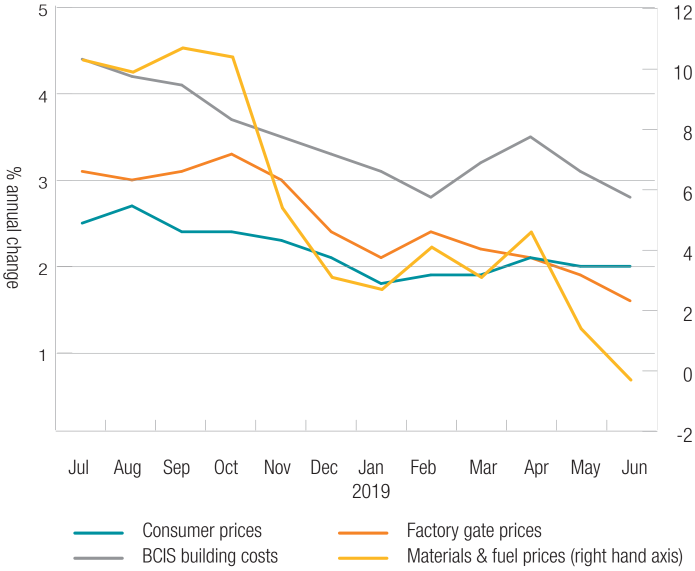
In dropping to 3% in June, the inflation rate of the 'all work construction material price index' fell to its lowest level since 2016. A number of factors are likely to have helped dampen material prices this year, most notably the limited demand due to the slowing industry. Additionally, a number of key materials are going through a soft patch. Oil prices rose in the first few months of the year but have since fallen back with global demand weak. Trade tensions and slowing global growth have also damaged steel prices while timber fell substantially in the second half of 2018.

As we mention in our package spotlight section, the Hackitt review has led to in some cases higher costs for brickwork and has the potential for sprinklers to be required in in accordance with the government fire safety consultation document.



Inflation may pick-up in the second half of the year with the weaker pound making imported products more expensive. However, the dynamics which have contributed to inflation easing in 2019 show few signs of ending. Issues with the Strait of Hormuz or other geopolitical problems could flare up leading to higher oil prices but importantly, subdued domestic demand for construction products looks set to persist.

Inflation indicators



PACKAGE SPOTLIGHT: BRICKWORK

Thanks to conversations with Swift Brickwork we are able to provide a spotlight on brickwork, offering information on the issues facing this package.

With regards to costs, the area with most uncertainty is cavities. A requirement from the Hackitt review is for the cavity to no longer include combustible materials. This will have a huge impact on the specification of damp-proof courses (DPC) within cavities. Previously this was a standard off the shelf product; the only option currently available is to use a bespoke steel product from a single supplier leading to significantly higher costs and lead in periods. A suitable alternative would be to revert back to a 'traditional' blockwork internal skin. In addition to this, insulation costs can rise twice a year. Not only does this obviously mean higher costs but is in some ways more problematic as it makes managing risk and providing an accurate tender more difficult.

Two parts of input costs which have been less difficult to predict over the past few years are bricks and labour. While both have risen, the increases have typically been consistent.

Much of the workforce, including a reasonable proportion of foreign labour, have been at Swift for numerous years and finding labour to date has not been too problematic.

Part of this is due to the considerable effort made to train and retain staff, helping to keep costs under control and deliver schemes to a high standard. In sharp contrast, the Federation of Master Builders finds the brick laying trade in shortest supply.

Overhead costs are also currently coming under pressure from technology improvements, (greater use of BIM) and the need for extra staff. In addition, while BIM should help bring down the costs of a scheme, contractors sometimes use it as a way of passing on risk and when it does, costs inevitably go up.

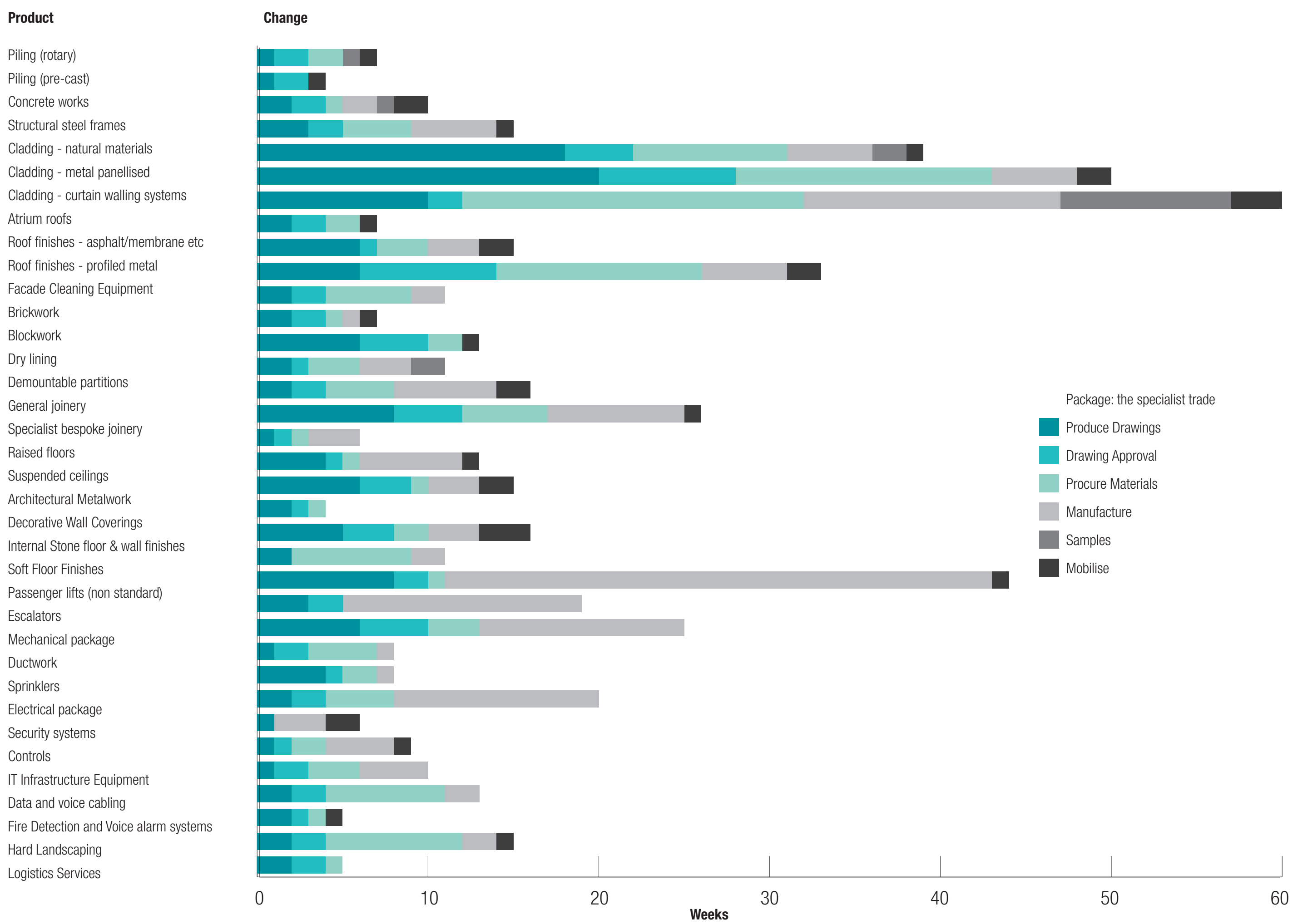
A shift in trends and ongoing strong levels of activity have made faring with some of these changes easier. While there was a drop-off at the end of 2018, activity has rebounded this year. In particular, the public and commercial sectors are seeing noticeably more tenders coming in. Moreover, the residential sector remains strong, particularly at the lower end of the market and in areas outside central London.

SUPPLY CHAIN FOCUS

"There continues to be very little change in lead times with only non-standard passenger lifts reporting an increase of three weeks in the manufacturing process. The forecast is generally for little change with workload and enquiry levels remaining static."

Brian Moone
Director of Supply Chain Management at Mace

Lead times



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