Tender Cost Update UK
Q4 2018

IMPROVING INFRASTRUCTURE SECTOR SUPPORTS GROWTH IN THE THIRD QUARTER BUT WORRIES ABOUT 2019 INCREASE

	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%

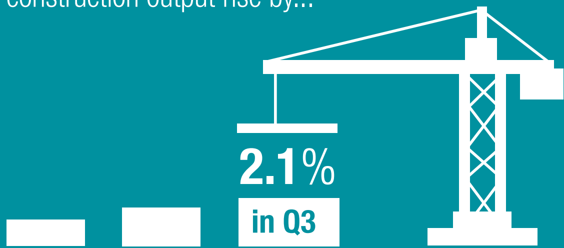
Inflationary pressures from rising materials and wages eased slightly in the third quarter and output jumped significantly. Infrastructure strengthened substantially, rising to its fastest rate in three years while the housing sector continued to hit new record highs. Despite this, there are doubts about the next 12 months continuing in the same direction which could limit tender price increases.

"2018 continues to be a year of mixed messages and contradictions, with strong third quarter growth in the construction sector and easing material and wage growth being tempered by the continuing sense of unease and uncertainty around the strength of the UK economy in 2019.

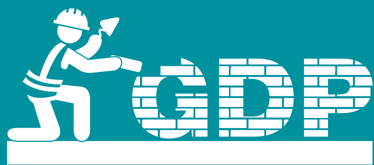
Despite this sense of deja vu and caution in the market place, we see no sign of input costs going down and continue to expect a small increase in tender prices in the year ahead."

Steven Mason
Managing Director
Mace Cost Consultancy

The infrastructure sector expanded at its fastest rate in three years, helping construction output rise by...



The strong rise in construction also helped push GDP...



⬆ 0.6% higher

New orders were...

⬇ 6.5% lower in the second quarter than the first and this ongoing slump seems certain to hit output at some point.

Regular construction earnings have started to ease but in August were still...

⬆ 4.6% higher than a year ago.

TENDER PRICE INFLATION FORECAST

A difficult first quarter followed by, at least in some sub-sectors, a recovery in the second, meant there were a number of questions about how construction would behave in the third. It turned out that there was a continuation of many of the trends we have seen over the past two years backed up by a solid increase in output. While large increases in housing, alongside weakening commercial and non-residential public work, has been a common theme, there has recently been a substantial increase in the infrastructure sector. The expansion in infrastructure has been a long time coming and with several of the large projects still at early stages it should continue well into our forecast period. At the recent Budget, the Government promised additional spending on top of previous guarantees for several infrastructure schemes and funds, which will also help the sector.

In addition there were similarities with new orders, material prices and labour cost numbers. As they have done since the referendum, new orders continued to struggle and in the latest quarter we also saw a reversal in private housing. There were also further increases in construction earnings and material prices and, although the pace of inflation eased for both over the last quarter, they remain high by historical standards.

Overall, and based on our cost consultancy experience, we believe tender prices have increased, but only marginally in 2018. While contractors and sub-contractors have managed to absorb the majority of increased costs, there are circumstances where this has not been possible. An incredibly busy market has not prevented developers and clients from keeping a close control of these increases. One factor limiting all parties' willingness to push for, or accept, higher tender prices is the uncertainty of Brexit. Moving into 2019 there is more uncertainty about the British economy than at any other point in recent times. Survey data shows that there is caution about the next year and this will hold back any surge in tender prices.

Exiting the EU is likely to result in a transition period of at least two years and will provide some support to investors. In the immediate aftermath of reaching an agreement, projects delayed by firms who adopted a wait-and-see approach are likely to get the go-ahead. This should provide a brief fillip to the sector and while inflation pressures might ease we expect there to be a slight uptick in tender prices next year.

ECONOMIC CONDITIONS

Even with the political noise around Brexit and the uncertainty of when, or if, a deal will be reached, growth in the third quarter was faster than at any point since the end of 2016. In addition, unemployment remains low and there are some signs that wage growth is improving so if it weren't for the Brexit backdrop, firms would be considerably more upbeat. This lack of corporate confidence can be seen both by a 1.2% reduction in business investment in the third quarter and the recent large declines within the new construction order commercial series.

GROWTH

The economy rose 0.6% in Q3 as all three output sectors grew, including a return to growth in manufacturing which had fallen in the second quarter. However, the upturn is limited and GDP growth for 2018 is only forecast to achieve 1.3%, with a slight increase of 1.5% predicted for 2019. One downside to the release was the loss of momentum as we moved through the quarter with most of the growth coming in July. In September construction was the only sector which saw any noticeable level of growth and overall for the quarter it was by far the leading performer.

LABOUR MARKET

Evidence is starting to emerge that the tight labour market is finally starting to drive faster earnings growth across the economy. In August, regular pay grew 3.1% (its highest level since January 2009) helped by an unemployment level of just 4%. Similarly, the faster pace of earnings growth will need to persist for some time if the Bank of England is to feel truly vindicated in increasing interest rates at their August meeting. Earnings in the construction sector continue to outpace other sectors but recent months have seen growth slow from a peak of 5.7% in May to 4.6% in August.

EXCHANGE RATES

While many economic data points have shown few signs so far of Brexit affecting them, the pound continues to fluctuate within a range. This is particularly the case against the euro where it has barely moved outside €1.10 – €1.15 over the past year. There was a considerable depreciation against the dollar in the first half of the year but recent months have seen limited fluctuations. As time runs out on the negotiations additional large moves are possible but for construction costs the biggest risk comes from a no-deal, a further substantial drop in the pound and renewed import inflationary pressures.

INFLATION

After rising to 2.7% in August, inflation dropped back to 2.4% in September. Since the end of 2017 pressures have eased and as the effects of the pound's depreciation continue to recede inflation should reduce to around 2% at the end of 2019. However, the recent volatility of higher oil prices alongside ongoing heightened currency risks mean that the slowdown may not be smooth.

MONETARY POLICY

Unsurprisingly the Bank of England chose to leave rates unchanged at 0.75% at their November meeting with all nine members of the Monetary Policy Committee voting the same way. The accompanying inflation report showed the Bank had made little change to their GDP forecasts but were forecasting inflation to be marginally higher than expected in August. As a result the projected interest rate path was for a slightly quicker tightening than was previously the case but as with every current economic forecast there are significant Brexit caveats. Similar to other forecasters the Bank is assuming there will be a smooth Brexit with a transition period followed by close economic relationship. However, if Brexit proves more disruptive, in particular in the case on a no-deal Brexit, the Bank has said it is willing to move interest rates in either direction.

GLOBAL

Worries about a global trade war, tightening by the Federal Reserve, fears about Italy and whether their budget will be acceptable to the European Commission, Brexit and potential spillover effects from Turkey and Argentina all contributed to equity markets across the world enduring a tough October. The correction is unlikely to have a material effect on the real economy and latest third quarter figures for the major economies only show weakness in the EU. While US growth slowed from an annualised rate of 4.2%, it remains robust at 3.5%. Similarly, Chinese growth slipped slightly but is above its quarter one level. Only in the euro area where growth halved from 0.4% to 0.2% was there a real surprise to the figures. However, given we had some fears earlier in the year that a stronger European market could lead to labour shortages and higher material import prices in the UK, only minimal growth may help costs at home.

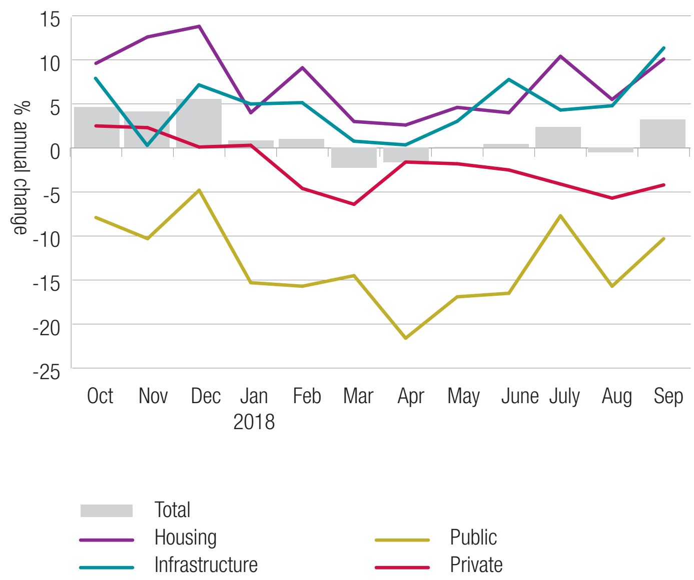
CONSTRUCTION OUTPUT AND ORDERS

The sector enjoyed its fastest rate of growth since the first quarter of 2017 as most parts saw strong improvements. A 2.8% rise in all new work, and a 1% increase in repair and maintenance, helped lead to the sector expanding 2.1% in the third quarter. After a surprise reduction in private housing in the second quarter, there was a return to growth Q3. The difficulty that house prices are facing has had a softening effect on new orders figures, but so far output continues to go from strength to strength. Similarly, we are aware of several residential projects that have been delayed, but it may take time before they affect overall output. There is a possibility of a small boost early next year if some of the projects that are close to starting, receive the green light once there is greater clarity over Brexit.

Infrastructure also had a very strong third quarter, growing at its fastest rate in over three years. With the latest IHS Markit/CIPS UK Construction PMI survey also reporting civil engineering at a healthy level it is starting to look like the much anticipated developments in the sector are starting to have an impact. Given there is likely to be an acceleration in output from key projects such as Hinkley Point C, Thames Tideway and HS2, further strengthening within the sector is likely. Along with large schemes such as these, government funding for other projects should mean that infrastructure spending is more Brexit proof than other areas of construction.

Whereas the size of private housing output is almost 10% larger than a year ago and infrastructure 6.5% higher, private commercial has shrunk by 5.3%. Following the rebound in quarter two, the reduction in output seen in each of the previous four quarters continued. Although retail sales are holding up, the move to online continues to damage the high street. The digital services tax announced in the Budget will only be introduced in 2020 and at just 2% will not suddenly make online shopping unattractive. In addition, as long as real wage growth remains low and Brexit uncertainty persists it is hard to see a large jump in consumer spending.

New construction output

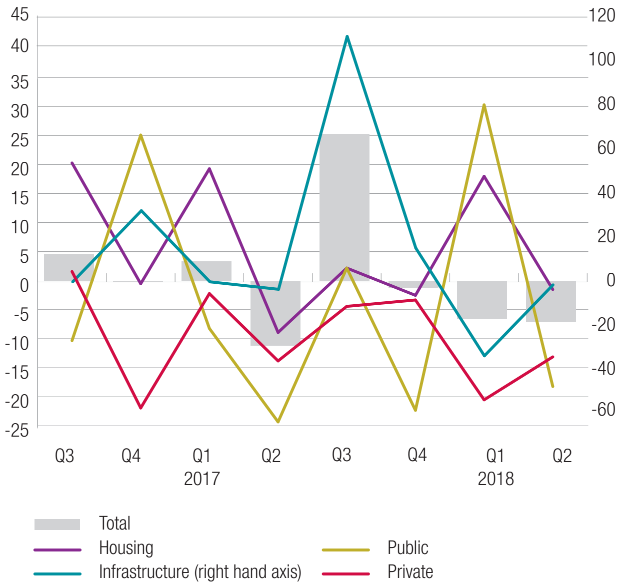


The second quarter produced another miserable set of new orders figures, suggesting that firms are continuing to hold back investment. A 6.5% fall means new orders are now at their lowest level in over five years. Most of this reduction came from private housing, meaning the large jump in the first quarter appears to be a one-off. Highlighting the temporary nature of the first quarter results were the regional breakdowns. London, the North West and the South West, which had each seen record highs in the first quarter, all fell back to more normal levels. Looking at the most recent four quarters helps smooth out the volatility of the series and in doing this, private housing still appears strong compared to recent levels. However, growth has slowed and the substantial support it has provided to construction output growth since 2013 is also likely to ease.

In total, new orders are now down almost 20% from the second quarter of 2016 with particularly large falls from the private commercial and non-housing public sector. Commercial did improve somewhat in the second quarter but it is difficult to see the sector enjoying any sort of robust growth until firms are given more certainty about what the future holds. One sector which did grow was infrastructure, jumping 28% due to new spending planned for roads and showing that it is not just HS2 which will be providing support in the coming years.

Since the referendum construction output has held-up well whereas new orders have faced more difficulties. While there isn't an exact relationship between the two series it is difficult to imagine that the plunge in new orders won't have an effect sooner or later. Due to the considerable lag between new orders and output, the decisions that have taken place recently will feed into the level of activity over the next few years, so irrespective of future Brexit developments there is likely to be an impact.

Construction new orders



MARKET VIEW

Having fallen to its lowest level since 2013, there was a slight rebound in the Q3 RICS Construction and Infrastructure Market Survey. Supporting the larger workloads was a noticeable improvement from infrastructure, alongside private housing which remains by far the strongest sector. Expectations for the next 12 months show surveyors are becoming more concerned. While they still anticipate that workloads and employment will rise, if not quite as much as previously, they now expect profit margins to fall.

The IHS Markit/CIPS UK Construction PMI survey continues to show construction activity expanding, with October's level at its second-highest point in over a year. Providing a particular stimulus was civil engineering which having been weaker than both commercial and residential for several months, overtook both. As a result of rising activity, firms continue to hire aggressively and find stock shortages, while delivery times have lengthened. How long activity can continue growing has to be questioned, given the slow new orders growth and firms' severe lack of confidence.

There was a reduction in the number of firms reporting rising workloads in the Q3 Federation of Master Builders' State of Trade Survey. However, on balance, considerably more firms are still seeing an improvement in conditions. The ONS figures of falling commercial output in quarter three hides the monthly increases that took place in July and September, which may be the reason behind the survey's findings of a large rise in workloads in the commercial sector. As with other surveys, optimism is clearly a problem and there was a large reduction in expected workloads for the next quarter in both the residential and non-residential sectors. Adding to the difficulties will be costs which show little sign of coming down, both on the material and wage fronts.

In the Q3 RICS UK Commercial Property Market Survey, occupier demand fell, and although the net balance of retail did improve slightly, this came from an incredibly low base. The industrial sector remains the best performer, if not quite as strong as in the previous quarter's report, but there was a fall in demand for office space. Respondents also reported an increase in firms relocating due to Brexit.

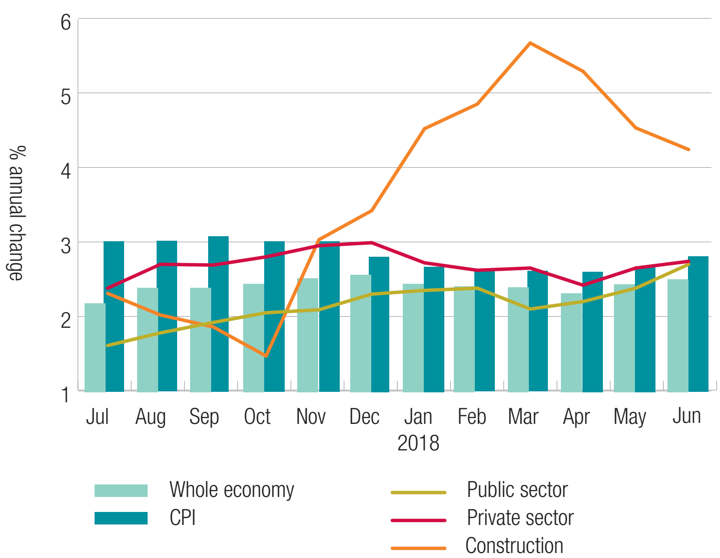
One thing that is evident from these surveys is that optimism has dipped across the board from both large and small firms. With Brexit negotiations ongoing it is not surprising that construction firms that rely on certainty, and the ability for their clients to make long-term investment decisions, are becoming increasingly worried. On the flip-side, and in-line with official market figures, surveys are showing healthy activity within the sector.

INPUT COSTS

Labour

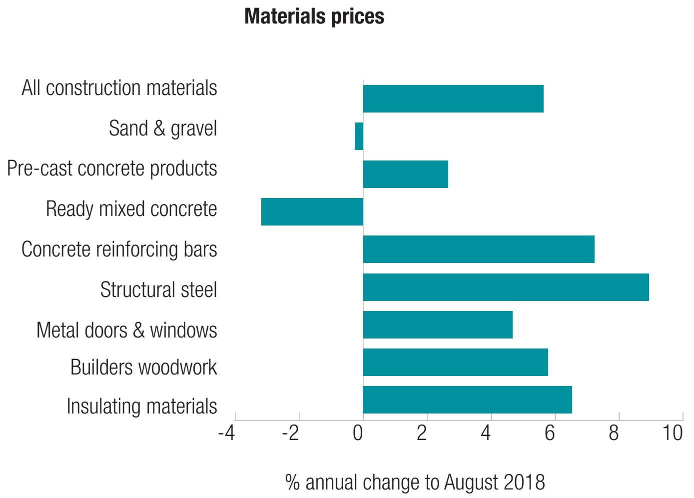
Earnings growth within construction remains high but pressures have eased slightly since the summer. Regular pay slipped from 5.7% to 4.6% and some of this slowdown may be due to wages pushing the limit of what companies are willing to pay. With robust growth in the third quarter pushing output to record highs, and the number of people employed in the industry at its highest since the global financial crisis, it is not surprising if there is little let-up in problems with skills shortages. There is a limit to firms' ability to continue meeting higher wage demands and the slowing earnings growth rate suggest we may be reaching that point.

Average weekly earnings

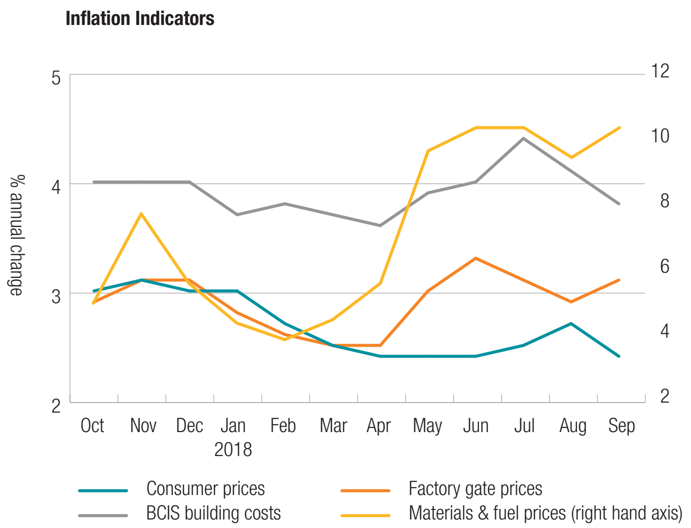


Materials

Over the past quarter the pace of material price inflation has eased slightly. However, it remains above 5% and since the start of 2016, when the ONS's 'all work construction material price index' was at its recent lowest, prices have increased almost 14%. The explanations behind such a large jump are well known and include the pound's substantial depreciation, a doubling of the price of oil, as well as noticeable increases in key products such as steel and timber.



Looking ahead, analysts are forecasting that the price of both Brent oil and steel should slip a bit in 2019 and 2020. Were they to prove accurate, it should help alleviate some pressure from material inflation. The pound's direction is dependent on Brexit negotiations but if a deal is reached it has the potential to strengthen, which will also help inflationary pressures. Overall, it seems likely that material price inflation in 2019 will fall back, but individual products may face their own challenges and a no-deal Brexit would trigger considerable difficulties.



PACKAGE SPOTLIGHT: HARD AND SOFT LANDSCAPING

Thanks to conversations with Maylim we are able to provide a spotlight on hard and soft landscaping, offering information on the issues facing this package.

As developers try to find new ways of increasing the value of their projects, the public realm works are becoming more important. This is one possible explanation behind why tendering for jobs is now taking place at a much earlier time than before. Instead of the usual 6-10 months beforehand, tenders for projects are coming in two or three years in advance. It is also probable that Brexit is contributing to this change in tendering profile as clients want to better understand all parts of a project in order to manage risks. Given the difficulty in knowing costs so far in advance, this change in expectations has added complexity as well as workloads to the bidding process.

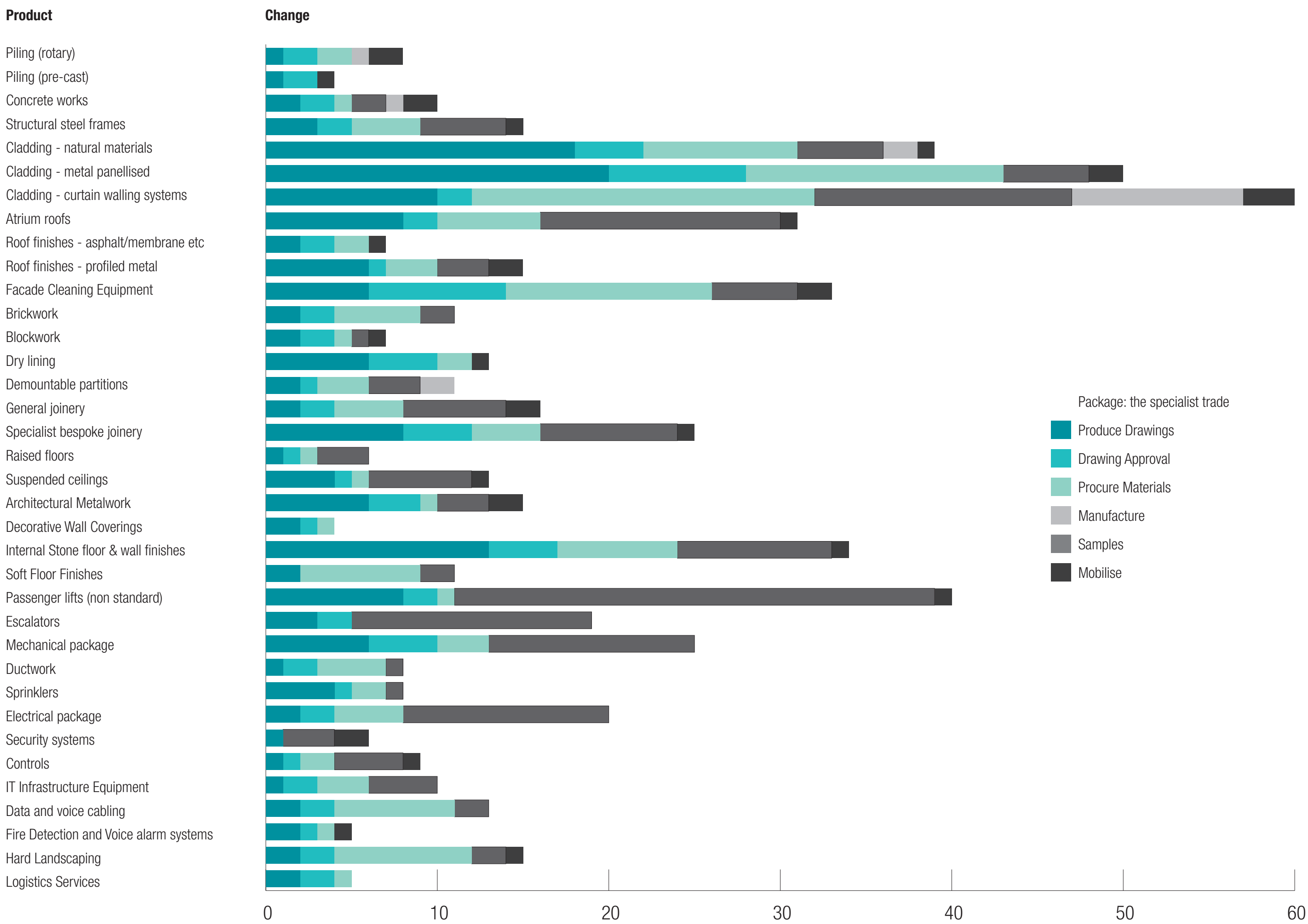
Managing the pipeline has also become trickier due to an increase in the number of projects returning to the market due to the successful bidder failing to deliver. Focusing too much on prices as opposed to quality has led to the client's expectations not being met which has led to the need for a replacement specialist contractor.

Unlike with some packages, recent cost increases have not been pronounced. This is particularly true with respect to labour, where skills shortages are not currently an issue. Employing labour directly, as well as having a diverse workforce from a variety of countries, has possibly helped this issue. Material costs have in some cases risen, especially as a large proportion are imported, but for some products, such as paving prices, little movement has been seen. An increase in the number of suppliers of materials has meant that there has been a lid kept on cost increases.

SUPPLY CHAIN FOCUS

“Only two packages are fluctuating this quarter with increases for the second quarter in succession for mechanical packages and non-standard passenger lifts. Both reported increased pressure on design and manufacturing resources as the reason. Uncertainty over the impact of Brexit, on labour and imported materials, remains a concern. Across the majority of packages workload and enquiry levels remain at a consistent level.”

Brian Moone
Director of Supply Chain Management at Mace



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