# Tender Cost Update UK
Q2 2018

mace

## SNOW, CARILLION AND GENERAL MALAISE CAUSE BIG DROP IN CONSTRUCTION OUTPUT

| | 2018 | 2019 | 2020 | 2021 | 2022 |
|---|---|---|---|---|---|
| NATIONAL | 1.5% | 1.5% | 3.0% | 3.0% | 3.0% |
| LONDON | 1.0% | 1.5% | 3.0% | 3.0% | 3.0% |

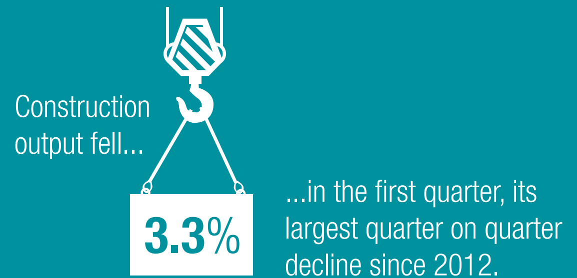
The poor weather had a significant effect on construction output in the first quarter meaning the industry was back in a technical recession. It was also its third quarter on quarter drop in the past 12 months as the industry struggles to push on. Falling output, weaker new orders in several sectors, as well as Carillion's collapse and Brexit are all contributing to the current mood of uncertainty and the increasing pressure on the supply chain to secure pipeline beyond 2018.

*"Falling construction output and weakening growth in the UK economy as a whole has done nothing to ease the sense of caution and uncertainty in the property and construction market in the first quarter.*

*"Despite these ongoing concerns and an increasing appetite to secure workload in 2019 and beyond, the persistent impact of strong input prices will continue to maintain a modest positive effect on forecast tender prices for 2018."*

**Steven Mason**
Managing Director
Mace Cost Consultancy

Construction output fell...



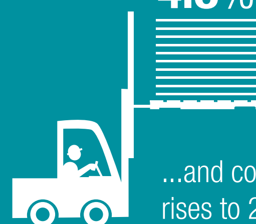

...in the first quarter, its largest quarter on quarter decline since 2012.

Earnings in the construction industry have risen rapidly in recent months and growth at...

...is close to a post-financial crisis high.

The economy fell to almost a standstill in the first quarter managing growth of just...

Inflationary pressures are starting to subside with material price rises reducing to... 4.8%



...and consumer price rises to 2.5%.

## TENDER PRICE INFLATION FORECAST

This quarter's tender cost update had the additional complication of several issues with construction industry data. Firstly, the bad weather at the end of February and beginning of March has had a clear impact on growth which was 3.3% down in Q1. However, it is not possible to split the lack of activity due to snow from the wider, underlying issues facing the industry. A rebound of some sorts is likely in the second quarter but the general trend for 2018 is one of weakness.

There are also a number of questions on the reliability of the Office for National Statistics' figures. For the second time in the past year the ONS has substantially revised up construction output. As a result the industry now only fell into a recession in Q1 as opposed to this taking place in the third quarter of 2017 as previously thought. Such large movements have the unsurprising consequence of making forecasting tender prices very difficult. One of the key factors in predicting how tender prices will shift is how busy the industry is. The better it is performing, the more work sub-contractors and contractors have and the more likely for large increases in tender prices.

So far Carillion's collapse has only had a limited effect on the supply chain but it is still early days and a number of sub-contractors are likely to be facing considerable pressure. Along with these obvious financial implications a second issue that has emerged is clients becoming increasingly cautious about who they take on. They are also pushing hard on prices and in response we have seen many cases of overhead profits and margins falling.

As expected, material price rises are continuing to ease but the slowdown so far has been gradual and prices are over 10% higher than at the start of 2016. With producer price inflation substantially lower than at the end of 2017, a further reduction in the pace of material inflation is likely. However, construction earnings growth is going in the other direction. After a noticeable slackening in the middle of 2017, growth has accelerated in recent months. Now standing at a yearly high, this is most likely as a result of ongoing skills shortages exacerbated by a reduction in EU labour.

Taking all these factors together, we have kept our forecast for tender price inflation this year at 1.5% nationally and 1% in London. Firms will continue to face rising input costs but will be limited in how much they can pass these on. Apart from in infrastructure, new orders continue to point to subdued conditions in the sector and for clients going ahead with work, price sensitivity will remain as important as ever.

## ECONOMIC CONDITIONS

Looking at GDP, the UK economy clearly struggled in the first quarter but other figures were stronger. Most notably, unemployment has continued to fall and this has helped push up wage growth. With the effects of the pound's deprecation disappearing from the data and inflation slowing, this has meant real incomes starting to improve. However, it appears doubtful this will result in consumers spending more and driving the economy ahead.

## GROWTH

First quarter growth was the lowest since the last quarter of 2012 and while the "Beast from the East" had an impact, particularly on construction and retail, there is also an underlying fragility. In services, by far the largest sector of the economy, the yearly pace of growth has slowed from 2.5% in Q1 2016 to 1.2%. Consumer facing industries have fared even worse declining from 5.3% to 0.4% and it is difficult to conclude anything other than Brexit is having a detrimental impact. Probably the best that can be hoped for the rest of the year is a rebound in the second quarter and moderate growth in the second half of the year.

## LABOUR MARKET

There was a further improvement in the unemployment rate which reached 4.2% in the three months to February. Along with record levels of people in employment and a high number of vacancies, this has helped apply upward pressure on earnings. For regular pay, earnings growth is now at its highest level since August 2015 and for the first time in a year above the level of inflation.

## EXCHANGE RATES

From the start of the year until the middle of April, the pound strengthened and it reached its highest level against the dollar since before the referendum. Part of this change was due to US policy but the pound was also performing well as expectations of an interest rate rise in May increased. However, in the last two weeks of April the chances of such a rise flopped and the pound weakened. Overall, the currency is marginally better against the euro and dollar than at the start of the year, which might provide a small amount of help to importers unable to pass on large parts of the price rises they have faced.

## INFLATION

The pace at which consumer prices are growing has fallen from 3% to 2.5% over the past three months and it now stands at its lowest level in a year. Although a slowdown was inevitable once the effects of the pound's depreciation started to fade, the speed is faster than expected. Price pressures are likely to continue easing over the year and it appears we are over the worst of the real income squeeze.

## MONETARY POLICY

Before the surprise reduction in GDP growth it seemed very likely that at the next Monetary Policy Committee meeting on 10 May interest rates would rise to 0.75%. At their March meeting, the Committee voted 7-2 in favour of leaving rates on hold but gave a strong indication of raising rates in May. However, the GDP figure as well as inflation slowing faster than anticipated may make the MPC think again. Similarly, the chances of a second interest rate rise this year which had also been on the cards, have diminished substantially. Keeping interest rates on hold is unlikely to cause a

turnaround in the poorly performing housing market but it may prevent conditions getting any worse.

## GLOBAL OVERVIEW

A slowdown in Europe also looks likely to have taken place as GDP growth in France collapsed from 0.7% to 0.3% with a number of early indicators pointing to similar issues in other countries. As in the UK, it is difficult to tell how much one-off factors such as the weather affected growth or whether this is the start of a fall in momentum lasting for several quarters. In the US, growth also slowed in the first quarter from an annualised rate of 2.9% in Q4 2017 to 2.3%.

Meanwhile, growth in China beat expectations coming in at 6.8% year on year. All of this comes as the world stands close to a trade-war triggered by US President Trump introducing tariffs on aluminium and steel and threatening additional action. While retaliation has so far been limited and early estimates are that it won't significantly knock global growth, there is the potential for this to escalate.

## CONSTRUCTION OUTPUT AND ORDERS

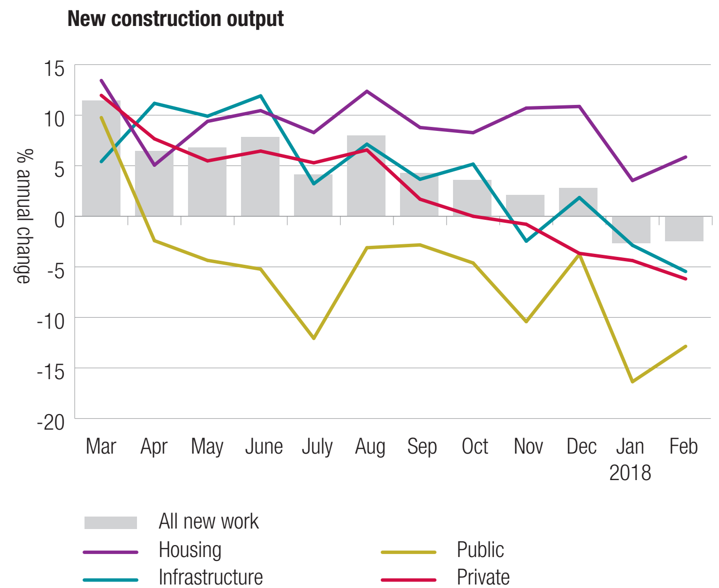
All three months in the first quarter saw output decline and while it is easy to blame the large drop on the snow and Carillion there are also other factors at play. One of these is output in the industry reaching its largest point ever in December and a cooling off period not coming as a surprise. More important is the continuing unease felt by clients who in some cases are putting projects on hold.

Based on the first two months of the year, private housing looks to have played a large part in the first quarter's slump. Rather than being too worrying though, the decline is more a slight easing from November and December's output. These were the highest two months on record. Private housing output has grown dramatically over the past few years and in 2017 was 9% higher than in 2016 while almost twice as large compared to 2010.

Unfortunately such strong growth has not been matched by a similar increase in the number of completed properties. In England this was only 50% higher last year than in 2010. Since 1997 when records began, the ratio between private housing output and number of new private properties completed has been steadily rising. While part of this change may come from different tenures, there are more flats and fewer houses than 20 years ago, it also implies more is involved with building properties than before. Every property requires a greater level of output than was previously the case and this has potential implications for house prices.

The commercial and infrastructure sectors are both showing considerably more signs of weakness. This is especially true of commercial which has seen a noticeable reduction since early 2017 as firms have held back from investing in new office space. Weak new order figures and the ongoing uncertainty around Brexit point to a sustained lull over at least the next year. Infrastructure's struggles stem most recently from the poor weather but also more widely from the lack of new work replacing completed projects.

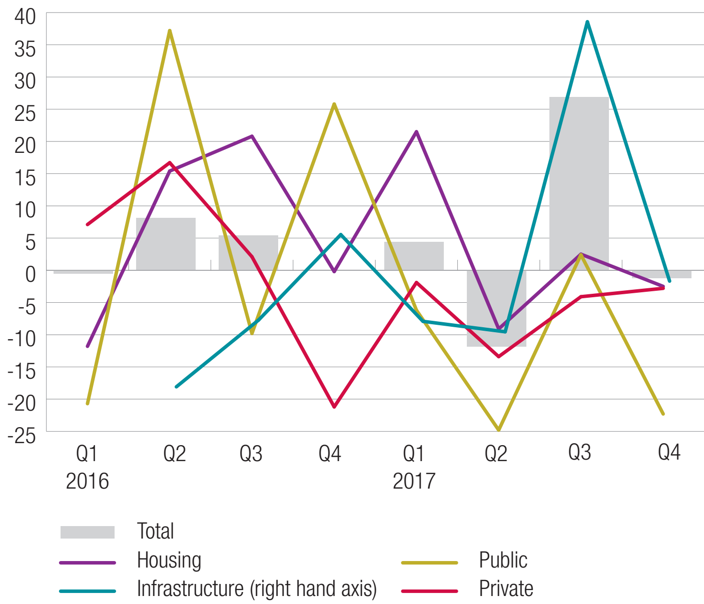
Over the next 18 months as a number of large jobs progress we would expect to see a turnaround.




New orders continued to disappoint in the fourth quarter. Given that HS2 contracts pushed infrastructure up to record levels in the third quarter, it is unsurprising to see a reversal in Q4. Even so, infrastructure new orders were still higher than in any other quarter since 2009, showing it is not just one scheme providing all the support. Private housing saw a further dip in the final quarter but while it stands 5.7% lower than its Q1 2017 high, it remains far above its post financial crisis average. After the large falls in the second half of 2016, the top level Q4 commercial figures give the impression it has stabilised. This however may prove a mirage as new orders for offices continue to weaken and the large boost from entertainment is unlikely to prove sustainable.

Whereas output in 2017 was 5.7% higher than 2016, new orders excluding infrastructure were 4.2% lower. There were a couple of reasons for this slump. Firstly, over the year there was an 8% reduction in the commercial sector as the West Midlands saw a particularly large decline compounding the ongoing weakness in London. In part the fall in the West Midlands comes due to 2016 being exceptionally strong but the 2017 figures were also softer than in other recent years.

The public sector also suffered a large drop last year both in housing and non-housing, most noticeably healthcare. The underlying trend looks better for private housing which continues to perform well, growing by 4.5% last year. New infrastructure orders were 35% higher last year than in 2016 but the longer programme times for these projects mean they can't solely be relied on to replace other sectors. Overall, the Q4 new order figures do little to change the impression that the next year or two will be tough for the industry but the fall in output this leads to is likely to be moderate rather than calamitous.




## MARKET VIEW

The Q1 2018 RICS Construction and Infrastructure Market Survey reported that on balance 23% of surveyors were seeing rising workloads. This was an improvement on Q4 2017 and in contrast to ONS figures which show a decline in both quarters. More in-line with the official figures is the strength in private housing and infrastructure. Expectations are that workloads will rise over the next 12 months especially in the energy and rail sectors. A majority of surveyors anticipate tender prices rising over the next year as input costs and labour shortages continue to bite.

The poor weather had a far more significant impact on the IHS Markit/CIPS UK Construction PMI survey where in March activity fell for the first time in six months. The January and February figures were also weaker than seen at the end of 2017 with even the residential sector declining. A slight improvement in optimism is more likely a reflection of the low levels they have reached than a true sign things will suddenly improve. Input inflation has now fallen to a 20-month low but decreased availability of sub-contractors has led to them raising prices and cost pressures remain.

There was a slight slowdown in construction output growth according to the Bank of England's first quarter Agents' summary of business conditions. They also found little evidence Carillion's collapse was having a significant impact on the supply chain. Construction firms were expecting output prices to rise at a more modest pace this year than last with labour costs having the biggest impact. So far firms have only managed to pass on around half of the increase in import costs and given they don't expect to be able to push through much more, will have to take a hit to their margins. One issue driving up labour costs for construction firms was staff attrition while a smaller pool of EU migrant labour was exacerbating skills shortages.

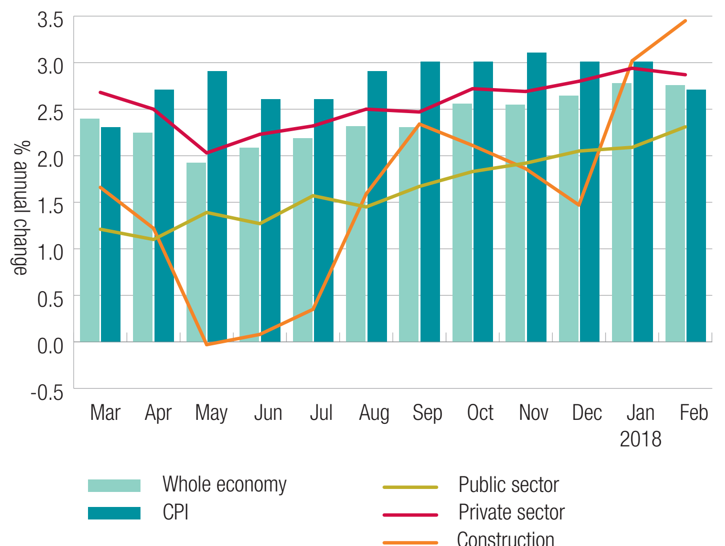
In their Q1 State of Trade Survey, the Construction Products Association found both heavy and light side firms to have had a tough start to the year. On balance 15% of firms selling heavy side products such as concrete and reinforcing steel reported a reduction in sales, the sector's worst quarter in five years. Things were slightly better for light side firms, covering products including fixtures and fittings, but it was still its worst period since Q2 2013 with no firms on balance seeing any change. Possibly due to such a poor performance in the first quarter both heavy and light side firms expect an improvement in sales over the next year at a greater rate than in the Q4 2017 survey. Costs continue to be an issue faced by nearly all firms but there was a reduction in the number of firms expecting these to carry on rising over the next 12 months compared to last quarter's survey.

In a similar fashion to a number of indicators, recent surveys paint a confused picture. Some point to growth whereas others are showing a fall. One particular difficulty with surveys such as these is they tend to focus on growth and how things are changing rather than looking at levels. The ONS does provide this information, showing construction close to a record high. As with other types of official figures these surveys report that input costs are high but output growth is receding.

## INPUT COSTS

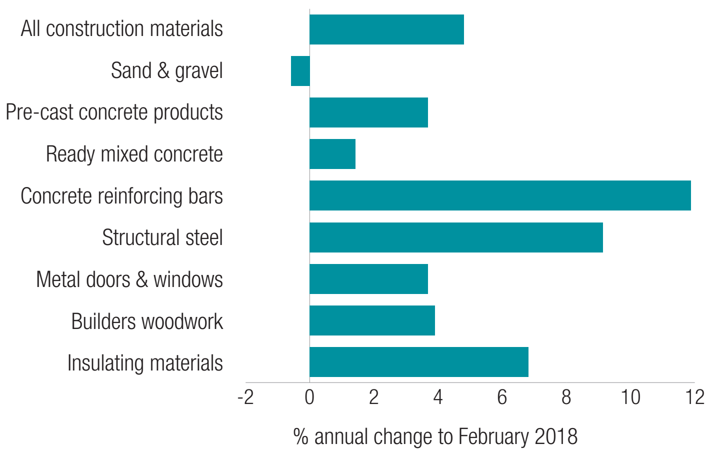
### Labour

Earnings in the construction industry are now rising at their fastest rate in over a year and as bonuses are shrinking this means all of the pressure is coming from growth in regular pay. There are a number of contributory factors to regular pay growth reaching 4.2% in February as well as the usual ones such as skills shortages and wage increases in the wider economy. In particular, while the number of vacancies in the industry has eased in recent months, for much of 2017 they stood at elevated levels. This suggests firms weren't finding it easy recruiting the right workers last year and pushed up salaries in response. A reduction in vacancies, along with weak new orders and likely lower output growth all point to weaker pay growth later in the year. As the Bank of England Agents' Survey has noted, reduced availability of EU labour is likely having an impact so a lot may depend on how the workforce changes..

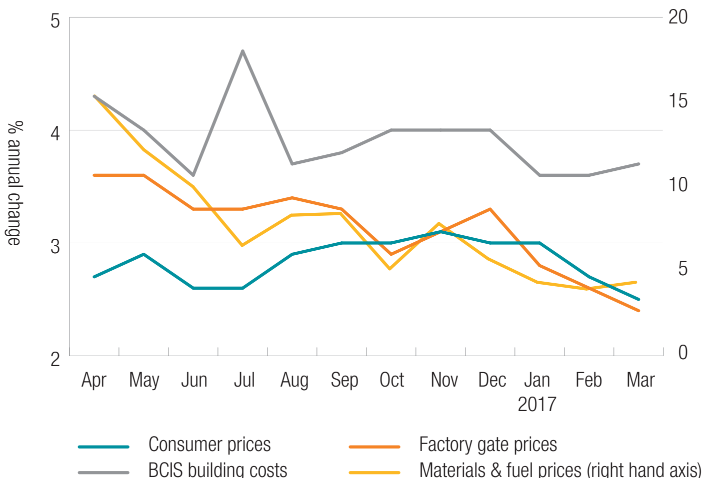


## Materials

Over the past quarter, material prices have continued to rise albeit at a slower rate than before. This has meant that the yearly growth rate of the all work construction material price index has slipped from 5.8% in October to 4.8% in February. Inflation is likely to continue falling over the rest of the year as the impact of the pound's depreciation disappears from the numbers. Nonetheless, the current slowdown can't hide the problem of recent substantial price increases. Since the start of 2016 material prices have risen by over 10% and given firms have only managed to pass on some of these increase in costs, it means some may well have taken fairly large hits to their margins.




The biggest upside risk to inflation comes from commodity prices rising as a result of geopolitical issues. Oil prices recently hit their highest level since 2014 as traders fretted around issues in countries such as Iran and Venezuela. This has added a premium to the price increases over the past year caused by Opec cutting supply. Secondly, actions by Mr Trump are already having an impact on a number of other commodities. In particular, the price of aluminium jumped




as sanctions against Russian producers were threatened. Aluminium, like steel could also face import tariffs into the US and this has caused considerable volatility in metal markets. It is not necessarily all negative for consumers though; if steel tariffs lead producers to look for alternative markets, prices in Europe could come down, but much will depend on how the EU respond.

## PACKAGE SPOTLIGHT

Thanks to conversations with William Hare we are able to provide a spotlight on steel engineering and fabrication, offering information on the issues facing this package.

One of the biggest challenges faced is the quality of information provided by the engineers and architects which is often incomplete or wrong and getting involved earlier could help mitigate against this. An example of where this might work is that in some cases using more material but less fabrication can result in a cheaper solution but this isn't always obvious to the design team. Similarly, the earlier that discussions occur and the more collaboration that takes place, the easier it is to spot and therefore usually manage risk.

Managing risk is a key consideration but not always easy given the nature of the steel market and its volatility driven by global trends. This risk most obviously manifests itself when there is a change in the mills price after agreeing a price with the main contractor. While inflation allowances are built in, protecting against unforeseen circumstances which may have the largest impact on prices and thus the biggest risk often isn't possible. One factor which does not currently appear to be affecting prices is the availability of steel. In the short-run with the market weakening in London but performing better in the regions, most notably the North West and Midlands, this is unlikely to change. Looking slightly further ahead, demand for steel could rise given the number of large infrastructure projects taking place.

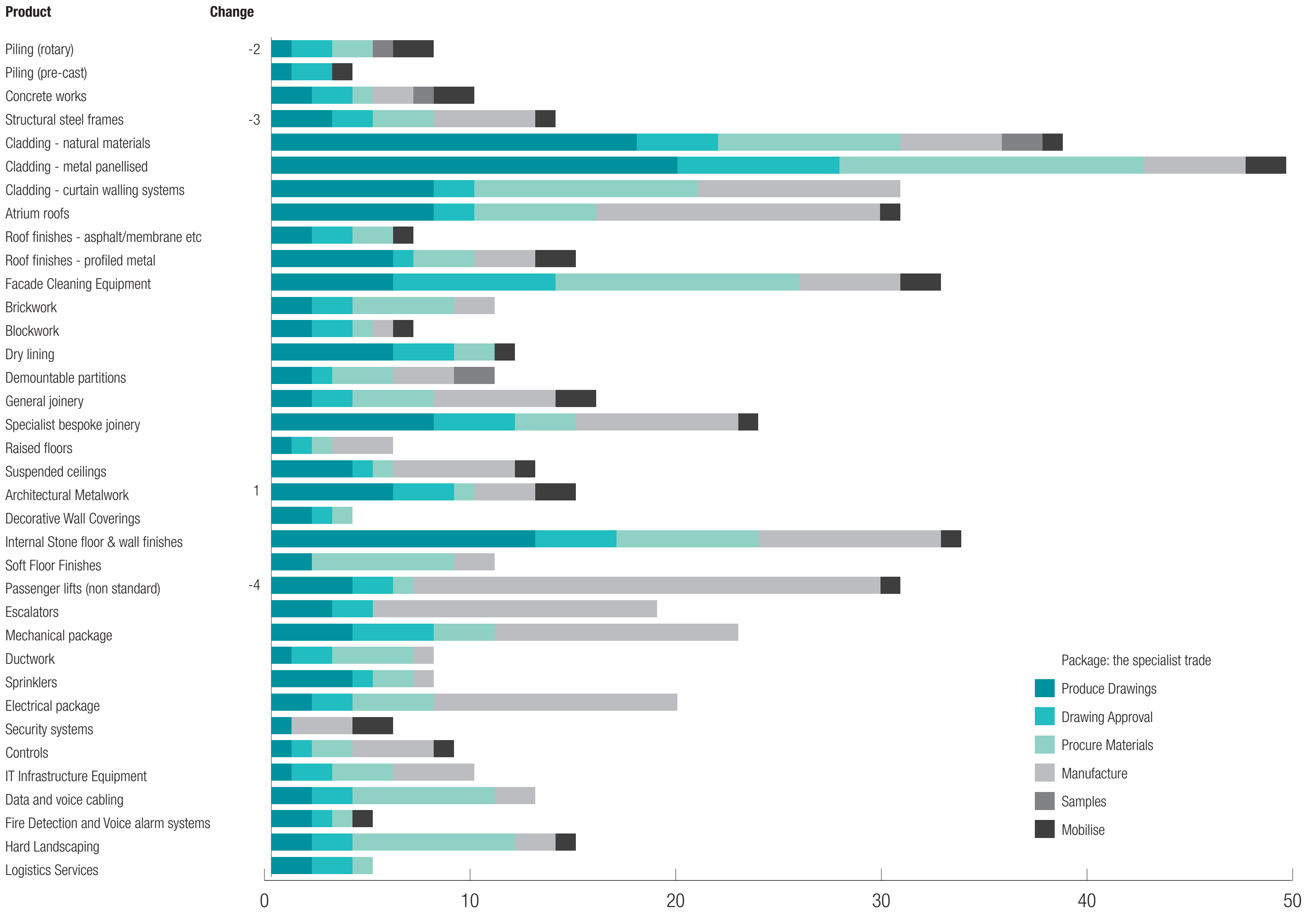
Larger projects may also pose a problem for labour availability. Currently there is no difficulty in finding workers both for steel erectors who are predominantly from the UK as well as for those involved with paint who more typically originate from Europe. As with other parts of the industry, the age of the workforce is a concern and this is particularly true within factories and the fabrication process. In order to protect against this, a number of apprentices have been taken on and they now play a vital role in the workforce. Similarly there has been considerable investment in automation also leading to increased efficiency and capacity.

## SUPPLY CHAIN FOCUS

*"As previously reported, the market levelled off last quarter and as anticipated it is now showing signs of beginning to decline with lead times reducing across three packages: rotary piling, structural steel frames and non-standard passenger lifts. Companies are continuing to experience a reduction in levels of enquiries. Only Architectural Metalwork is experiencing an increase in lead times due to delays in drawing approval."*

**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 |