mace

UK Market View

Q3 2020

A BIG DROP BEFORE THE RECOVERY BEGINS

As the economy continues through the early stages of recovery, the construction industry has proved so far to be remarkably resilient.

The focus upon managing the immediate disruption caused by labour and material shortages and drops in output and productivity may have dissipated, but the mitigation of the ongoing impact of Covid-19 and an impending Brexit deadline will continue to have a major influence on the market and tender prices.

The unprecedented drop in new orders in Q2 has compounded the growing sentiment that our industry faces a turbulent time ahead, and there will be increased pressure on the supply chain to secure workload at any cost. In spite of expected further fluctuations in input costs we expect this increasing appetite to secure future work to continue to supress tender prices for the remainder of 2020 and throughout 2021.

Steven Mason
Managing Director
Mace Cost Consultancy

	2020	2021	2022	2023	2024
NATIONAL	0.0%	-2.5%	0.5%	1.0%	2.0%
LONDON	0.0%	-2.0%	0.5%	1.0%	2.0%

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. With contractors likely to exclude risks relating to Covid-19 – such as programme delays and prolongation, material shortages and disputes – these figures do so as well.

Even though construction output rose 23.5% in June, the sector was still almost

25%

smaller than in February.

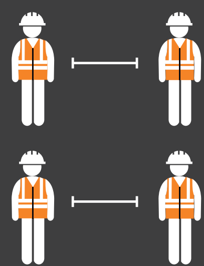
A scarcity of construction products meant material prices shot-up by...

2.1%

in May, although they have since eased back.

11.4%

reduction of construction productivity in Q2 gives an early indication of the impact of social distancing.



New orders hit their lowest level on record in the second quarter and were

half

the size of that in Q1.

Setting the scene

While for both construction and the wider economy, Covid-19 has been nothing if not a shock, there are several ways in which to report and analyse the latest data. Those who choose to focus on the glints of positivity among what has been an overwhelmingly troubling time, can discuss the large increases in output in May and June, whereas others may highlight just how far there still is to go. Whichever way we view the data, what should be clear is that we are still in the early stages of the recovery.

So far it looks as if the economy and the construction sector are recovering in a V-shape. However, due to the mammoth decline in April, a pronounced rebound is no surprise. Simply reopening construction sites and getting some workers back will have led to a substantial lift. Overall, the industry was 35% smaller in the second quarter than the first, but some sectors have performed markedly better than others. Infrastructure performed particularly well and, while output fell 11.8% over the three months, by June it had recovered to just below its March level. By contrast, housing still has a significant amount of lost output to recover, but its growth of over 40% in June shows it is also moving in the right direction.

However, returning to pre-Covid levels will be difficult. New social distancing regulations mean fewer operatives on site, limiting potential output. The fact that productivity fell by such a large extent in the second quarter also shows that, even for those not placed on furlough, producing output at the same level as before was not possible. The second reason why output may struggle is due to a lack of replacement work, with the commercial sector being particularly vulnerable.

One way to help an economy get out of a recession is through government spending. The government's job retention scheme prevented mass layoffs earlier in the year and the Prime Minister also revealed a large investment plan. This includes substantial amounts for education, roads and hospital maintenance. Combined with other large infrastructure projects, this is likely to provide the backbone for the industry in the coming couple of years.

RECENT GOVERNMENT SPENDING COMMITMENTS

- **£12bn** to be spent over eight years on the affordable homes programme
- **£96m** to improve town centres
- **£760m** for repairs and upgrades to schools and colleges
- **£900m** to support local growth and infrastructure projects
- **£100m** on road projects

Prime Minister's 'Build, Build, Build' speech, 30 June 2020

Though the government has also committed to building more homes, its new housing reforms won't improve conditions in the near term. Assuming the reforms outlined in the Ministry of Housing, Communities and Local Government's August White Paper are implemented, they will not take hold for a number of years. Additionally, with the plans set to change incentives to developers, it is possible they will actually have a negative short-run effect. If returns look likely to be better after the changes in policy, housebuilders could hold developments back.

One item almost forgotten over the past six months, following four years at the top of the news, is Brexit. Yet, with the UK's transition period coming to an end on 31 December, a no deal Brexit is still a strong possibility and it would be a mistake not to be mindful of the issues this could cause. For most clients, contractors and sub-contractors, making sure that plans previously in place for such an event are still appropriate would seem the minimum action to take. Returning to these plans won't stop Brexit related uncertainty from delaying projects in the autumn, but it should help prepare for difficulties in obtaining materials in the new year.

As with our last UK Market View, our latest report focuses on a number of key issues. Firstly, we look at the most recent data releases, explaining what they show and the impact they have had on tender prices, and the latest feedback from the Mace supply chain. We then consider how the rest of the year will develop and the difficulties facing the sector, before finally discussing some of the multitude of risks that we expect to continue throughout 2021.

What the data and current updates mean for tender prices

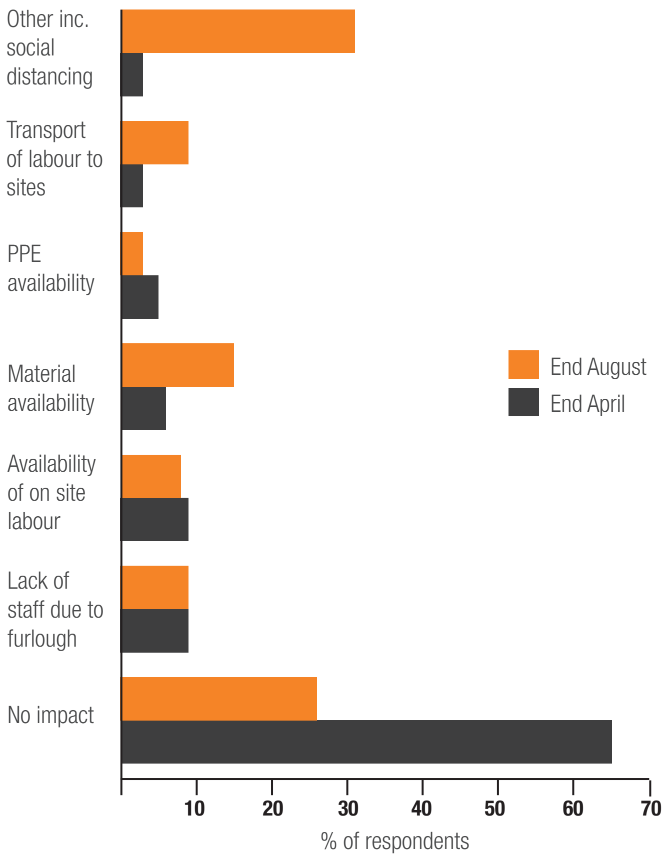
	Recent changes	Current impact on tender prices
Demand ↘	The forced closure of many construction sites in April resulted in a 40% drop in output and, while the sector has since rebounded strongly, June's output was still 25% lower than that seen in February. Overall, output in the industry was 35% lower in Q2 than Q1 and it is going to be a long hard slog to return to the levels seen at the start of the year.	In addition to the large drop in output, new orders halved in Q2 and some contractors may have won very little new work. Ironically, programme delays may offer some support, limiting the urgency with which to find replacement work. Nonetheless, the slump in output and battle to keep revenues up will suppress tender prices.
Materials costs ↗	In May, the 'all work construction material price index' rose 2.1% month-on-month, almost double the previous largest monthly jump. The closure of many manufacturers, as well as trade merchants, may have made it very hard to obtain certain materials. In contrast to May, prices fell 0.6% in June. As the economy has reopened and restrictions have lifted, materials have become more readily available and prices have dropped.	Despite May's price rise being substantial, it is unlikely to be something that has a significant impact on tender prices. The increase only pushed yearly inflation up to 1.1%, meaning contractors should still have some breathing space. Contractors are also likely to view the change as temporary and, as such, it should not significantly alter bids.
Preliminaries ↑	New social distancing measures look set to stay in place until well into 2021 and this will push up construction costs in two ways. Firstly, there are the direct costs from designing and implementing site changes, such as wider walkways and temperature checks upon entering. Additionally, the indirect costs of reduced productivity and lengthier programmes are potentially substantial.	The immediate impact on preliminaries is undoubtedly inflationary. Tenders for small projects are due to start soon and need to reflect the changes. For larger projects, it is possible that rules around social distancing will ease as construction progresses.
Risk ↔	In conversations with clients, there has been recognition that passing on all the risks to contractors is not feasible in the current market. However, clients too are facing new stresses with viability assessments coming under increasing pressure. Balancing out these concerns requires considerable expertise as well as flexibility from all involved.	In some cases, contractors may manage to put risk below the line and persuade clients to accept it. However, this isn't always the case, with some clients less accommodating. In such circumstances, tender prices will be pushed up accordingly. Overall, the immediate changes of the risk profile may even themselves out, but as we move into next year and it becomes more of a client's market, this may change.
Labour costs ↓	Unemployment in the three months to June was unchanged at 3.9%. However, two other indicators show just how badly the labour market has performed. Firstly, estimates for July indicate the number of those on payroll has fallen 730,000 since March. Secondly, there was an 18% decline in the number of hours worked in the second quarter.	Official data shows that regular weekly earnings in the construction industry were 8% lower in June than February. As those placed on furlough returned to work, there was a slight improvement compared to May, but labour costs are significantly lower than earlier in the year. With vacancies still incredibly low, those looking for new work may have to accept lower pay. Contractors may find lower labour costs provide them with some scope to cut tender prices.

Impacts and future challenges – our supply chain's view

At Mace, we regularly engage with our strategic supply chain partners to develop our understanding of the key issues affecting their businesses with the potential to impact on project delivery or to influence market dynamics. Since the start of the pandemic, the need for such a collaborative approach has only increased and, as part of this, we have conducted regular surveys.

The headlines from our analysis show how responses to the key Covid-19 challenges have evolved since April. While the sample size is small, and the focus is on London, we see that the sector has made good progress, although Covid-19 related delivery challenges are still taking their toll.

Covid-19 related delivery challenges



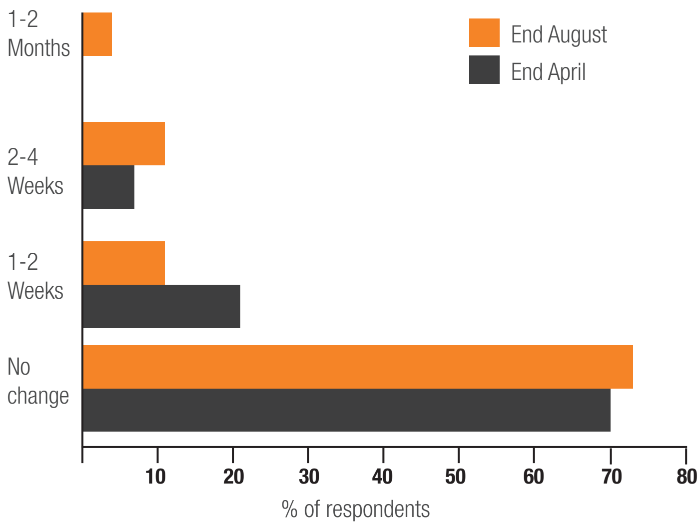
Compared with April, more firms are encountering delivery challenges associated with Covid-19. As site activity has increased, difficulties associated with operating safely and maintaining social distancing have come to the fore and the limited availability of some materials has caused a few issues. One near-term concern is that the Government's Self-Employment Support Scheme may have inadvertently discouraged skilled tradespeople from immediately returning to work.

Manufacturing capacity

Construction products manufacturing has proven resilient and manufacturing capacity has generally increased relative to the end of April. Performing best has been structural framing systems and structural steel. Firms in these sectors experienced little change in capacity while continuing to operate at over 95% of potential. Since April, there have also been noticeable improvements in capacity for manufacturers of joinery, lifts and escalators, and MEP components.

Of more concern is MEP prefabrication firms. At the end of August, these businesses were operating at less than 50% of total capacity, down from around 70% four months earlier. Capacity for these firms, whose problems have been exacerbated by continuing with traditional summer factory closures, was by the far the worst of the firms surveyed. Next weakest was entrance systems who reported operating at 60% of total capacity.

Materials – lead times



Most respondents reported no material changes in lead times. Where problems have occurred, however, the situation has not improved, and lead times are lengthening. At the end of August, concern centred on: MEP equipment, such as sprinklers, wet riser tanks, pumps and audio products; timber products; raised access floors; drylining; and stone. This adds to the impression that while the majority of products shouldn't be seeing abnormal price movements, some are likely to face considerable pressure.

The second half of a turbulent year

Output and productivity

That output was still 25% lower in June than February shows just how far the industry has to recover. June data still reflects output lost from site closures, which would have been the case particularly earlier in the month and in Scotland. As such, we may need to wait for July or August's data to fully understand the impact social distancing is having on sites across the country. Output per hour excludes furloughed workers and is a measure of productivity. It can also be used as a very rough proxy of the impact of social distancing. Unfortunately, this measure declined 11.4% in the second quarter and will need to improve significantly if the industry is to get back to anywhere near full capacity.

Recent analysis by the Mace Business School found that, for the majority of packages, lead times had not changed. The conclusion based on surveying a wide variety of subcontractors was that lower work areas were balancing out labour and material shortages. Packages which did increase included electrical and fire detection, while August's PMI data also reported lengthening in lead times. However, while it may not seem obvious at the moment, given material shortages should be less of a problem later in the year, and that there is a possibility of weaker demand, lead times for some packages may narrow in Q4.

Brexit

So far this year, Brexit negotiations appear to have yielded little progress. Politicians having to focus their attention elsewhere partly explains this, but there are also still significant differences between what the UK and EU are ready to compromise on. With the transition period ending on 31 December, time is ticking on a trade deal. Last year, when there were doubts about whether the UK would even agree to a transition, the uncertainty led to some clients delaying projects. This is clear from the weak new orders numbers in Q2 and Q3 of 2019, which then rebounded in Q4 following the Withdrawal Agreement in October.

Given the lack of progress, Brexit uncertainty is set to once again become an issue. Negotiations are due to continue into October; as well as giving national Parliaments little time to confirm a deal and businesses not long to adjust, it also means there is very little margin for error. Brexit uncertainty may dampen the recovery and keep contractors even more competitive with their tenders.

Materials

The 2.1% price jump in May was down to widespread problems accessing materials. According to an ONS survey, at the start of the month, almost 20% of construction businesses had not been able to get the materials they needed. However, by the second half of July, this proportion had dropped to 7.8%, with the number of firms using alternatives also having declined. In June, data from the same survey found barely any respondents seeing falling prices even though this is what the official data showed. This highlights a general weakness of survey data and, while there may still be price spikes for specific materials or in particular areas, in general and for most products, conditions should continue to settle down. Prices are also likely to come under pressure from lower demand. With social distancing limiting output, there is less need for materials at any given point.

Labour

The government's furlough scheme has been a massive success, but in August the scheme began to unwind. Initially, businesses only had to pay National Insurance and pension contributions. However, employers' payments will increase in September and October, before the scheme finishes in November. As government support lessens, firms will have to make some hard choices and it appears certain that unemployment will rise.

At the end of April, at the height of the crisis, just over 40% of construction employees were on furlough, a proportion only beaten by the accommodation and food service sector. While the number has steadily decreased, it is still considerable. By early August, it stood at 9.2% and there has been a noticeable slowdown in the rate of people returning to work. Despite employers wanting to get people back to work, social distancing restrictions may limit the numbers who can. However, getting this proportion down will be paramount in order to reduce the number of redundancies later in the year. For contractors, this means general wage pressures are unlikely to be an issue and, if anything, labour costs will fall.

FURLOUGH FACTS

- **76%** of construction firms had furloughed staff, making claims of almost £3bn
- **20%** of construction businesses still had sites paused or ceased trading
- In the past two weeks turnover was down by over **20%** for **25%** of construction firms
- **25%** of construction firms have had to use an alternative supplier to get the materials needed, with **5%** reporting an inability to source materials

Data from HMRC and ONS

A multitude of risks remain next year

Demand for new work

As we discussed in our last report, the main driver behind lower tender prices next year will be fewer tender opportunities, and little has changed since to dissuade us of this view. If anything, the outlook is probably worse for the commercial sector than it was previously. Compared to other EU countries, fewer UK workers have returned to their offices and, although footfall in shopping centres, high streets and retail parks has improved, the recent pace of change has only been gradual. With the situation still so far from typical levels, it only increases the likelihood of commercial developers cancelling projects.

More positively, house prices have risen according to the latest data from Halifax. Supported by the raise in tax threshold for stamp duty until March next year, this should at least firm-up existing residential projects. Nevertheless, housebuilders have to be nervous about rising unemployment and the impact that will have, meaning prospects for next year are still poor. Infrastructure and the public sector should face fewer headwinds and, while Boris Johnson's 'build build build' speech sounded promising, it is always tricky to determine just how much of the announced funding is genuinely new.

Procurement

One sure fire way for a project to go wrong is to have a company fail. From a project completion perspective, and in the context of a company collapse, there may be a hierarchy of client, contractor, sub-contractor in terms of severity of impact, but all three parts must be aware who they are working with. As a result, due diligence requirements and associated costs increase. Similarly, public sector projects and the assurance that government backing brings may become more attractive, while it becomes even more important for both clients and contractors to make payments promptly.

A second issue in terms of procurement is making sure the delivery model is appropriate and correctly manages the risks. In some cases, it may be possible to design incentive structures that reward a contractor who performs well, delivering the service a client needs. If such incentives work, they could help keep tender prices and total costs down through achieving more efficient outcomes. These won't be suitable for all projects and would also require stronger, more collaborative working arrangements between all parties.

Materials

The coronavirus has only worsened what a no deal means, and we can therefore reiterate much of our previous analysis. It is worth remembering that non-tariff barriers are likely to be more costly than tariffs. Delays to getting materials on site is possibly the biggest risk, but even simple things such as extra paperwork add costs. Simple sounding solutions such as bringing in materials earlier or using alternatives may not work in practice. Storage space is expensive, whereas alternatives could either not exist or come with their own problems. Even if a deal is reached, changes are probable. These may take time to fully understand and adjust to, leaving the supply chain no choice but to push up prices.

There is also some debate around the impact of monetary policy decisions. Central Banks are supposed to be able to control inflation with looser policy, resulting in higher prices. With the coronavirus leading to interest rate cuts and a new round of quantitative easing, there is a risk, albeit currently a small one, that the current low levels of consumer price inflation won't last. Were a vaccine to become available soon and policies left loose, this risk would increase and, as such, is something that may require assessing next year.

THE FIVE LARGEST CONSTRUCTION MATERIAL IMPORTS BY VALUE IN 2019

1.	Electrical Wires	£1,936,389
2.	Lamps & Fittings	£982,957
3.	Sawn Wood > 6mm thick	£798,895
4.	Air Conditioning Equipment	£665,685
5.	Central Heating Boilers	£622,362

Monthly Bulletin of Building Materials and Components (£'000)

Labour

Unless there is an extension to the furlough scheme, the majority of business resizing is likely to take place this year. This may mean that 2021 will be slightly less dreadful for the labour force, but in most scenarios weaker wages will act as a drag on tender prices. If the economy recovers slowly and construction firms fail to find suitable replacement projects, it may be necessary to make further redundancies. Even were this not to be the case, due to profits having taken a hit this year, many firms may have limited scope to offer healthy pay rises. In addition, however fast the economy recovers, unemployment will finish next year higher than it was at the start of this year. Because of this, businesses will have limited need to offer above inflation increases.

The only feasible scenario where wage pressures may come to the fore is if a large number of foreign workers choose to leave the UK. It is possible that the coronavirus will persuade some workers of the need to be closer to family, compounding the issue of Brexit. Were it only Brexit that was a factor, we would not anticipate this to be a problem. There is still net migration from the EU and for those who are settled in the UK, leaving is not straightforward.

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