UK MARKET VIEW

Budget balances opportunity and risk for construction

Q4 2024

Introduction

The near-term indicators reported in Q4 underline that the industry continues to face a tough operational environment. We have nudged our tender price forecasts upwards for 2025 and falls in new orders may cause concern, but our expectation has always been that government would look past quick wins towards sustainable, longer-term growth on the road to national renewal.

October 2024's Budget has met with a mixed response in some quarters, but increases in capital spending promise growth in pipelines in the coming years. Further information due in the Spring on the major projects programme being assembled will be hotly anticipated.

What is encouraging is the assertive position being taken by government towards enabling delivery and enhancing productivity. The plan to unleash the biggest building boom in 50 years is an ambition the industry needs to be ready to meet, which means being agile and embracing the opportunities to drive change and deliver at pace in 2025 and beyond.

Oliver North
UK & Europe Director of Cost and Commercial Management, Consultancy

The third quarter saw construction output grow...

0.8% ↑

with expansion of 2% in all new work, the first time this part of the industry has enjoyed quarterly growth since the final quarter of 2022.

New orders slumped by...

22% ↓

in Q3 as finalising contracts continued to present a challenge.

Construction labour costs have accelerated and total earnings growth of...

5.4% ↑

is faster than the average across the private sector.

Material prices fell for the fourth consecutive month and, with prices...

0.8% ↓

lower than October 2023, pressures for many products remain.

The Bank of England cut interest rates to...

4.75% ↓

but increased inflation expectations may mean fewer reductions next year.

Tender prices

	2024	2025	2026	2027	2028
National	2.5%	3.5%	3.5%	3.5%	4.0%
London	2.0%	3.0%	3.0%	3.5%	4.0%

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.

Setting the scene

In our latest forecasts, we have nudged tender price inflation upwards nationally for 2025 and nationally (excluding London) for 2026. As well as increasing the National Living Wage from April, October 2024's Budget set out a rise in the Employers' National Insurance rate. While parts of the Budget will be inflationary, we are, for now, not making significant changes to our forecasts for future years based on government plans for increased spending. We discuss the Budget and what it means in this report but, while there are plans for an increase of almost 10% in government capital expenditure in the next fiscal year, it previously seemed likely that the new government would spend more - which is why we haven't adjusted our forecasts by more. Recognising it creates upside risks to tender prices, there is still uncertainty about how the money will be spent and when it will reach the construction pipeline.

The increase in ENI will likely see the supply chain, project teams and any firm employing UK workers adjusting pricing strategies. For this reason, we expect an uptick in inflation. For ongoing work, the situation is more complex and cost recovery will depend on the pricing model and contract type. Cost-plus arrangements are likely to offer more protection than fixed price lump-sum projects. Similarly, whereas those with a JCT contract are likely to find that recovering costs may not be possible, NEC contracts with Option X2 may provide potential entitlement to a compensation event for a change in law after the contract date. In some cases, it may be enough to understand the contract specifics while adopting a collaborative approach. In other cases, legal advice to ensure the correct outcome may be necessary.

In Q3, we highlighted how output was falling, but new orders gave hope of a recovery. The latest figures show a reversal, with output growing but new order volumes falling. For output, all new work increasing by 2% in the third quarter was the first such rise since Q4 2022. It has been a challenging few years for the industry. Recovery will be gradual and the latest fall in new orders is a setback. Declining by 22% in Q3, London experienced a large reduction. By far the biggest region for new orders, London's downturn accounts for much of the drop-off in the past two years. With key infrastructure and public sectors less London-centric, we anticipate that the regions will see faster tender price growth in 2025 and so have adjusted this for 2026. There was another drop in housing and, in addition to well-documented economic causes, the Building Safety Act has presented new processes and costs to navigate.

Along with the Budget came the updated forecast from the Office for Budget Responsibility. The most interesting aspect of the OBR forecast was its optimism on growth next year, anticipating that the economy will expand by 2% during the 2025 fiscal year. This is notably higher than both the Bank of England figure and an average from independent forecaster predictions – which indicate GDP will rise by 1.5%. Importantly for construction, the BoE, like other market participants, has interpreted the Budget as inflationary. Its latest forecasts show inflation peaking about 0.5% higher than previously and slipping below 2% per year later. Markets have already reacted, with gilts rising slightly and, although interest rates should continue to fall in 2025, that they might stay higher for longer doesn't help construction.

As well as domestic factors, global forces always hold the potential for shock. We considered some of these risks for UK construction in our Q2 2024 Market View, but now that a Donald Trump administration has been elected, they are worth revisiting. While threatening tariffs on Canada, Mexico, Europe and China, the bigger threat is if Mr Trump targets all global producers and triggers a trade war. As well as putting the brakes on trade and reducing global growth, the resulting inflationary environment could lead to a slower loosening of monetary policy. Much is uncertain, which is usually bad news for investment – a major risk which will require close monitoring in 2025.

Elsewhere globally, there is less cause for concern – at least from a material prices perspective. Although the Middle East situation presents risk to supply, oil prices remain subdued. Due to lower demand, the oil producing nations in OPEC+ have again pushed back the date for increasing production levels. China implementing a large fiscal stimulus has only led to a moderate commodities reaction, with no surge in metal prices. Meanwhile, sterling remains strong against the euro helping control import costs and, despite weakening against the dollar, it's at a higher level than a year ago. Material prices have now fallen in each of the past four months and generally, while the annual rate of -0.8% isn't as deflationary as it was, materials shouldn't be causing the supply chain too many headaches.

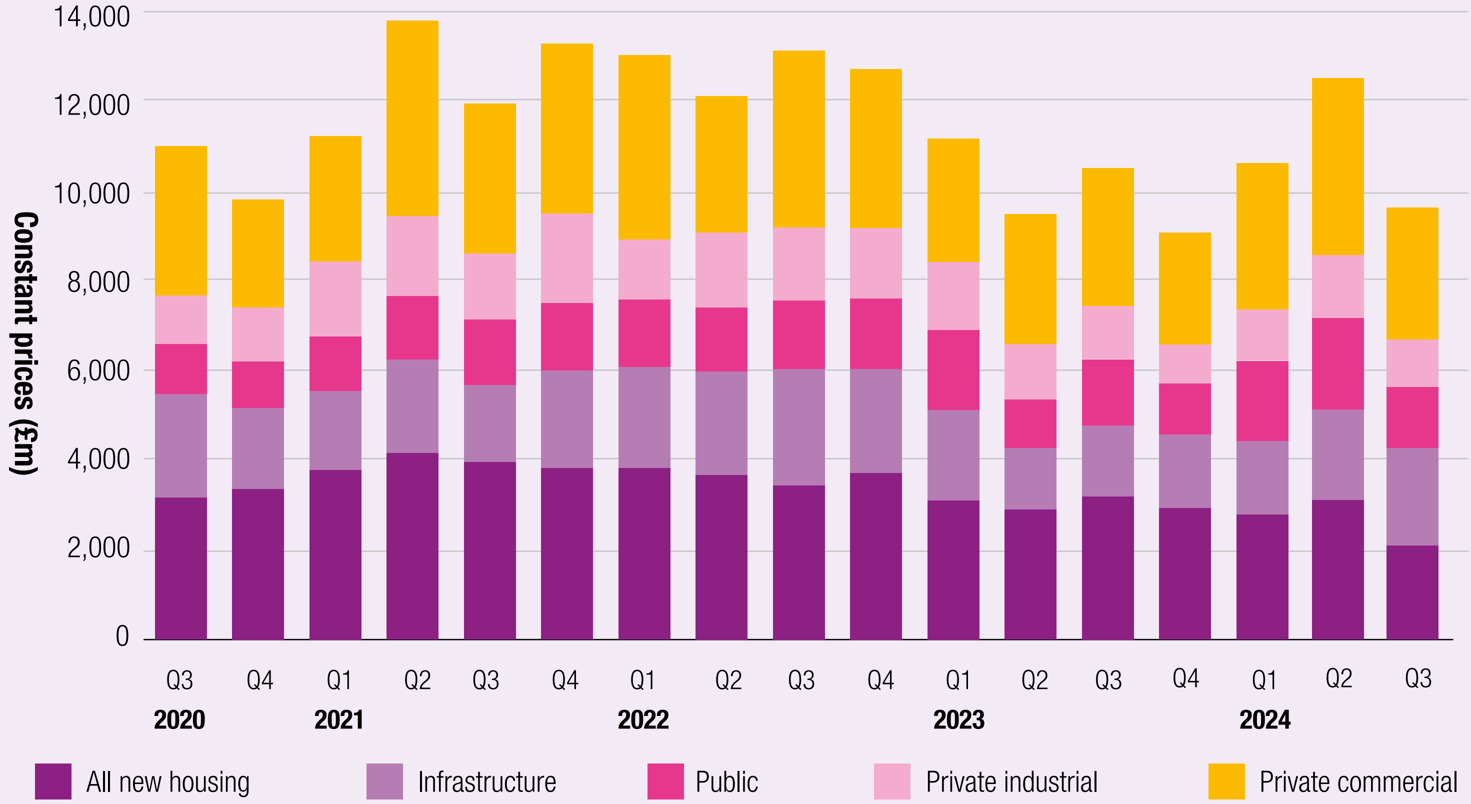
Latest drop in new orders will hit pipelines

The third quarter was not a good one for new orders. After a strong start to the year, the setback in Q3 underscores the vulnerability of the sector. Although new orders for 2024 should represent an uplift on 2023, that they were 22% lower in Q3 than Q2 means that pipelines won't be as full as contractors would hope and this will continue to keep a lid on tender price inflation. Other than infrastructure, where there was only a 1% rise, the latest Office for National Statistics release showed falls in every sector. There were drops of over 20% in public and private housing, public non-housing, private industrial and private commercial as confidence waned. Since the pandemic, only the second and fourth quarters of 2023 reported lower figures. That September's S&P Global UK Construction Purchasing Managers' Index reported new orders being at their highest for two-and-a-half years clearly creates some hope for Q4 – even if it wasn't matched by the official data.

Housing had an especially poor quarter. Down by over 30%, it was its worst since the pandemic, despite monetary policy finally starting to ease. Housebuilders are still incredibly cautious with specific issues around higher risk buildings and building safety related operational delays being worked through. There was a decline of almost 30% in public non-housing and, while over the past four quarters it is the sector which has fared best, there are still challenges. Most notably, much of the reason it has grown over the past year is down to an outlier of a Q1 figure in the miscellaneous sector. New orders for schools and health having both fallen considerably in the last 12 months is possibly a better reflection of the situation and highlights the scale of the challenges facing the Labour government in turning things around. With respect to public spending, the position for this part of infrastructure is more positive. Outgrowing the private part, the public portion's jump was the reason why total infrastructure grew in Q3 with its best quarter in almost two years. There may be less scope for growth in infrastructure, but it will continue to be a key contributor to construction output in the coming years as the government set out its intention to fast-track planning decisions on 150 major infrastructure projects during December.

AFTER A STRONG FIRST HALF OF YEAR, NEW ORDERS FELL DURING Q3

Source: ONS

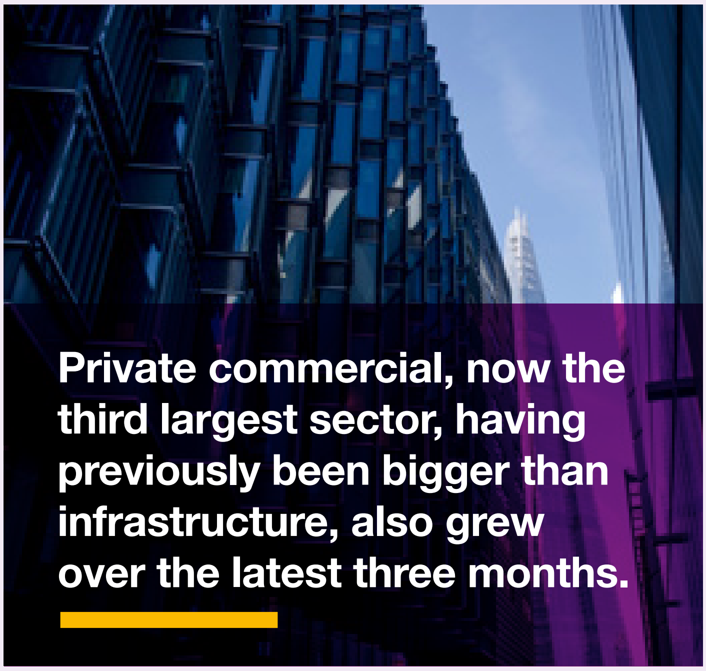


Construction output

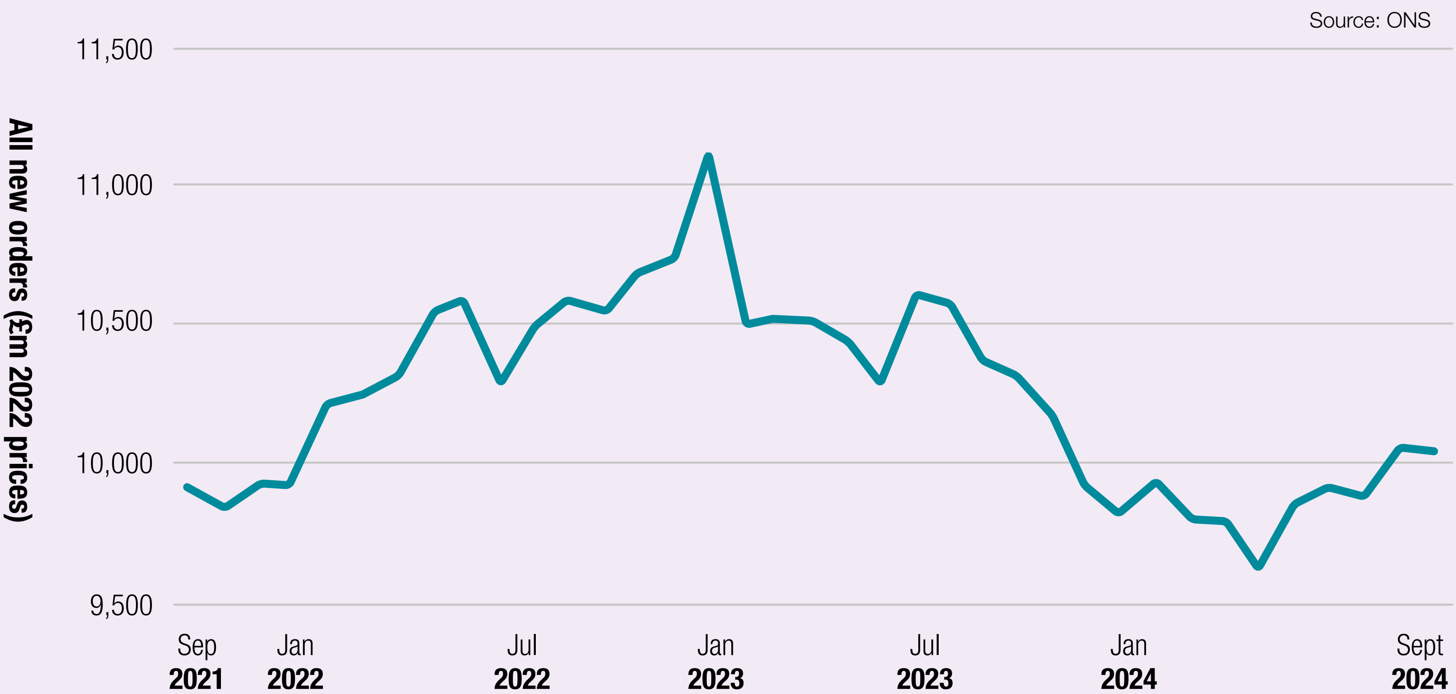
Since April, construction output has been steadily rising. Overall, the industry was 2.4% larger in September than five months ago, with all new work expanding 4.3%. Nevertheless, this is a recent rebound including the broad-based increase in the third quarter and needs putting into context. Having faced a multitude of headwinds such as viability issues, high interest rates and planning problems – all of which have put programmes under review – all new work is still 4.1% less than it was in Q3 2023, with each of its three largest components shrinking over this time.

Starting with construction's largest sector, housing is almost 4% down on a year ago. While the 1.2% growth in the third quarter may mean the sector has finally bottomed out, the collapse of new orders puts this in doubt. Similarly, that inflation is now set to be higher than expected may mean monetary policy doesn't loosen as much as it might have. Either way, from output's peak in Q3 2022 to its trough in Q2 2024, the sector contracted by over 20%. Having a worse 12 months is infrastructure. Declining 8.8% since Q3 2023, the 2.8% increase in Q3 2024 was the first quarterly rise in a year. That new orders for infrastructure were so poor in 2023, most noticeably for roads, pointed to output struggling in 2024. HS2 has also passed peak construction but, despite these recent challenges, infrastructure remains comfortably the best performing sector since the pandemic. Private commercial, now the third largest sector, having previously been bigger than infrastructure, also grew over the latest three months. However, its 1.4% rise did little to offset falls in the second half of last year, and the sector is 4.2% smaller than it was 12 months ago.

Whereas the repair and maintenance sector may have done enough to leave total construction output higher in 2024 than 2023, all new work will have almost certainly declined again. Facing a lack of demand, contractors tendering for such projects are unlikely to have an opportunity to increase margins, and in some cases may have been unable to pass on all their input cost inflation.



ALL NEW WORK
STARTING TO RECOVER



Construction costs

Somewhat surprisingly, construction labour cost growth has accelerated over the past quarter. From slipping to 2.7% in March, regular construction earnings have recovered and now stand at 4.3%. This is in contrast to the wider economy, where regular earnings have been steadily slowing for the last year. At 4.8%, this is still slightly higher than the construction sector, but the gap is at its lowest since early 2023. Furthermore, after accounting for bonuses, and looking at total earnings, the construction sector is enjoying faster annual growth. In September, total earnings in construction were 5.4% higher year on year, the fastest growth rate in almost two years. What's driving this rebound isn't immediately obvious – output growth is hardly stellar, and the number of workforce jobs fell substantially between March and June. That vacancies remain elevated and continue to come down in other sectors offers a partial explanation. However, if it is due to skills shortages that are biting in this way rather than more general volatility in the data then, given the current lack of output, labour costs may rocket in the coming years as output grows. This isn't a feature of our baseline forecast but it is a clear risk.

Material prices fell 0.4% in October, the fourth month where they have slipped. Leaving the 'all work construction material price index' 0.8% lower than a year ago, the rate of deflation has slowed considerably from the peak of 3.1% earlier in the year. With prices having fallen 0.8% over the past quarter and essentially offsetting the 0.7% increase over the previous three-month period, there seems little for the supply chain to be worrying about with prices on average. Fabricated structural steel is the biggest faller over the past 12 months, declining 7.3%, and with rebar also lower, those projects reliant on the metal will be getting some respite following the surge in cost during the preceding years. The immediate outlook for materials seems modest, although risks around the tariffs to be introduced by the incoming US President and conflict in the Middle East persist.

Fabricated structural steel is the biggest faller over the past 12 months, declining 7.3%, and with rebar also lower, those projects reliant on the metal will be getting some respite following the surge in cost during the preceding years.

The Budget

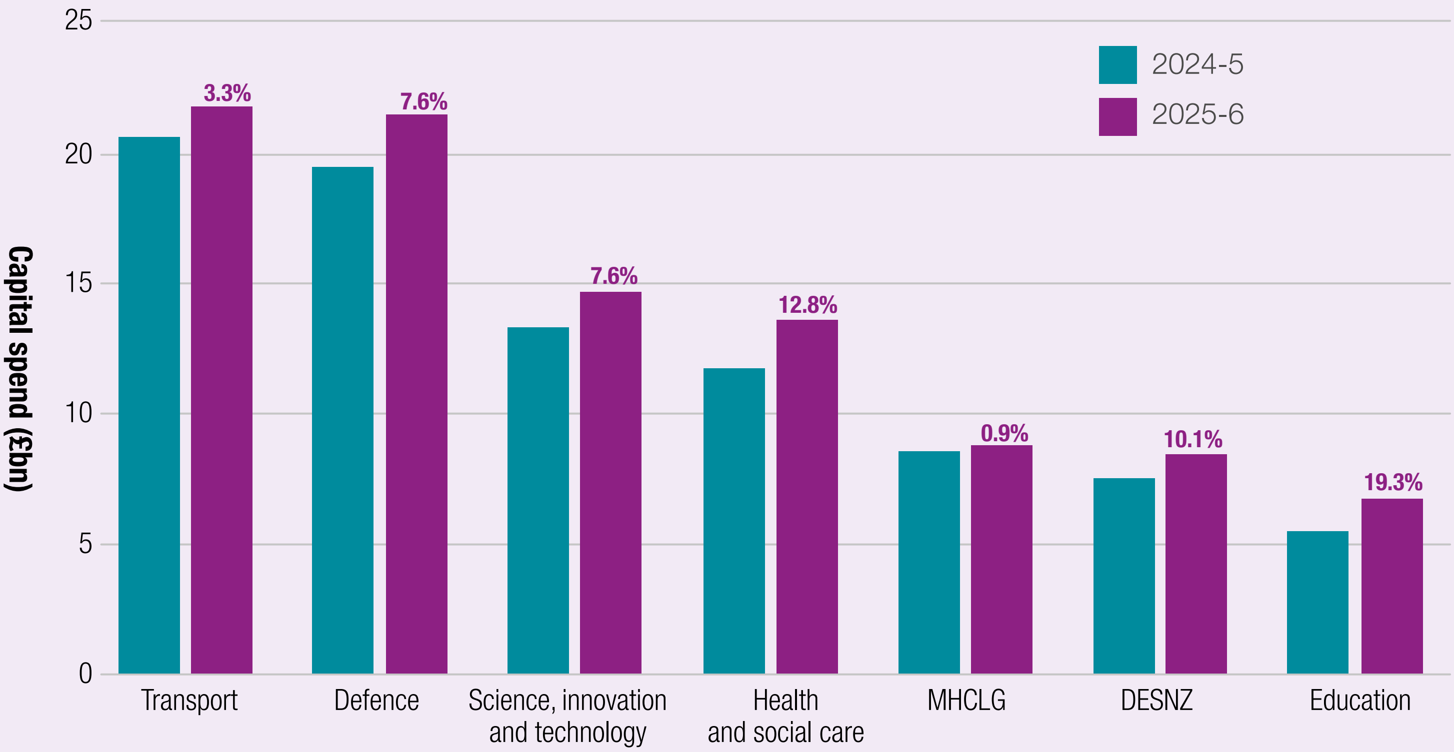
Almost four months after the general election, the much-anticipated Budget was set out on 30 October. After promising an increase in spending, the new Labour government loosened fiscal policy, announcing increases in both current and capital spending. Overall, around two-thirds of the increase will go towards day-to-day spending with a third spent on investment. For day-to-day spending, much of the jump comes from the decision to raise public sector pay in July, with the more generous offer also feeding through into an uplift in spending in later years. That this decision looks to have put an end to the prospect of damaging industrial action will help the economy.

For construction, proposed increases in capital spending should feed directly into more projects and higher revenues throughout the supply chain. With an additional £100bn of capital investment over the next five years, the government's aim is to boost productivity and, in turn, support long-term growth. While not all of it will go to construction schemes, with investment also covering things like additional beds for the NHS and research and development funding, much will. It includes £1.6bn for local road maintenance, £1.4bn to help rebuild schools, £1.2bn for extra prison places and £1bn for NHS maintenance, repairs and upgrades.

There are several ways in which we can see just how big the change is. Most important is the initial jump in the first full fiscal year for the new government. Pushing up capital spending from a little under £100bn to over £110bn, the almost 10% real terms increase contrasts with the previous government's planned reduction. Growth will be more moderate in the following two years, and then is set to decline in the final two years of the forecast, but this is also an improvement on the further cuts that the Conservatives set out in March. On average, capital expenditure as a share of GDP will now be 3.8% over the next four years as opposed to 3.2%. Having also undergone a period of significant austerity during the 2010s when capital spending's share of GDP averaged 2.6%, and at one point dropped to 2.4%, this represents a significant shift in the government's priorities.

PLANNED INCREASES IN CAPITAL EXPENDITURE

Source: HM Treasury



Nevertheless, there are concerns and uncertainties around the Budget. One is around the split of spending across the different departments. Department splits are only available for the next fiscal year, and despite setting forecasts for total spending in the following years, there are no details. A spending review, where capital budgets for five years will be set, is currently taking place, but its complexity has resulted in the government pushing its publication date back to June 2025. A second concern is the lack of clarity about the new planning regime. Despite the government promising changes, they are currently out to consultation, and it is too early to say what their impact will be on housing and infrastructure delivery. The OBR recognises this issue, saying that they don't currently have enough information to update their forecasts. A final challenge will be whether the projects are ready and deliverable. Given the government wants an almost 10% real terms increase almost immediately, work needs to start very soon. Labour shortages and the ongoing insolvency headwinds may limit the potential for such a quick turnaround. What seems more likely is that growth won't be quite as rapid as hoped but, and this will depend on the wider economic backdrop, it will pick-up more noticeably as we progress through Labour's current term.

While additional government spending is desirable, the money has to come from somewhere. Having ruled out adding to the tax burden on working people already over-exposed to the cost-of-living crisis and therefore ruling out several of the biggest potential tax levers that they could pull, Labour had little option but to turn to businesses. In doing so, the party has raised Employers' National Insurance. A two-fold change, the government increased the rate from 13.8% to 15%, while also cutting the employee's earnings threshold from £9,100 to £5,000. For a median earner on £33,000, the Institute of Fiscal Studies calculates that it will cost the employer an extra £900. It wasn't all pain though, for the smallest businesses in industries with a greater share of four employees or less than construction (agriculture, forestry and fishing), the increase of Employment Allowance from £5,000 to £10,500 will provide some support. Overall, the government expects more than half of employers who pay National Insurance to be better off or see no change.

Yet companies with four or fewer employees only account for less than 20% of the value of construction work done, whereas over 60% comes from firms with 20 or more employees. These businesses will respond to the change in a variety of ways. Firstly, as we mentioned at the start of our report, higher costs will be passed on through price rises - meaning it will be inflationary. The increase in the National Living Wage will also exacerbate this trend. Secondly, it will lead to lower pay increases. That the cost to employ someone has gone up will result in attempts to control total staff costs and a lower likelihood of an offer of higher rewards. How National Insurance increases will be split between these two forces will differ by company and sector. Unfortunately, construction may face the worst of both worlds. In the current competitive climate, firms may be unable to pass on costs, whereas skills shortages and lack of labour may mean a limit on how much employers can push back on higher wage demands. Following on from this, it will put businesses under renewed pressure, and insolvencies, which are already a huge problem, could continue to act as a brake on growth. Higher staff costs may also lead to firms who don't have the projects to cut back on workers whereas, for those firms that do have the projects, they will be less willing to expand and grow. One final effect of higher National Insurance is that it will encourage greater use of self-employed workers. For construction, where around 30% of jobs are self-employed, it may therefore be easier for firms to shift towards this type of worker.

If we are to take one positive from the increase in Employers' National Insurance, then firms which are better able to productively use resources should face fewer challenges than those which are less nimble. Despite facing higher costs, and the sort of money needed for investment not necessarily being available, innovation could help offset the changes. When labour costs go up, it makes using capital more attractive. For construction, a sector that repeatedly talks about the need for shifting towards modern ways of working, the end result could be greater use of off-site manufacturing, and other less labour-intensive solutions. That higher construction spending by the government will only make labour shortages worse, should only encourage firms to move in such a direction.

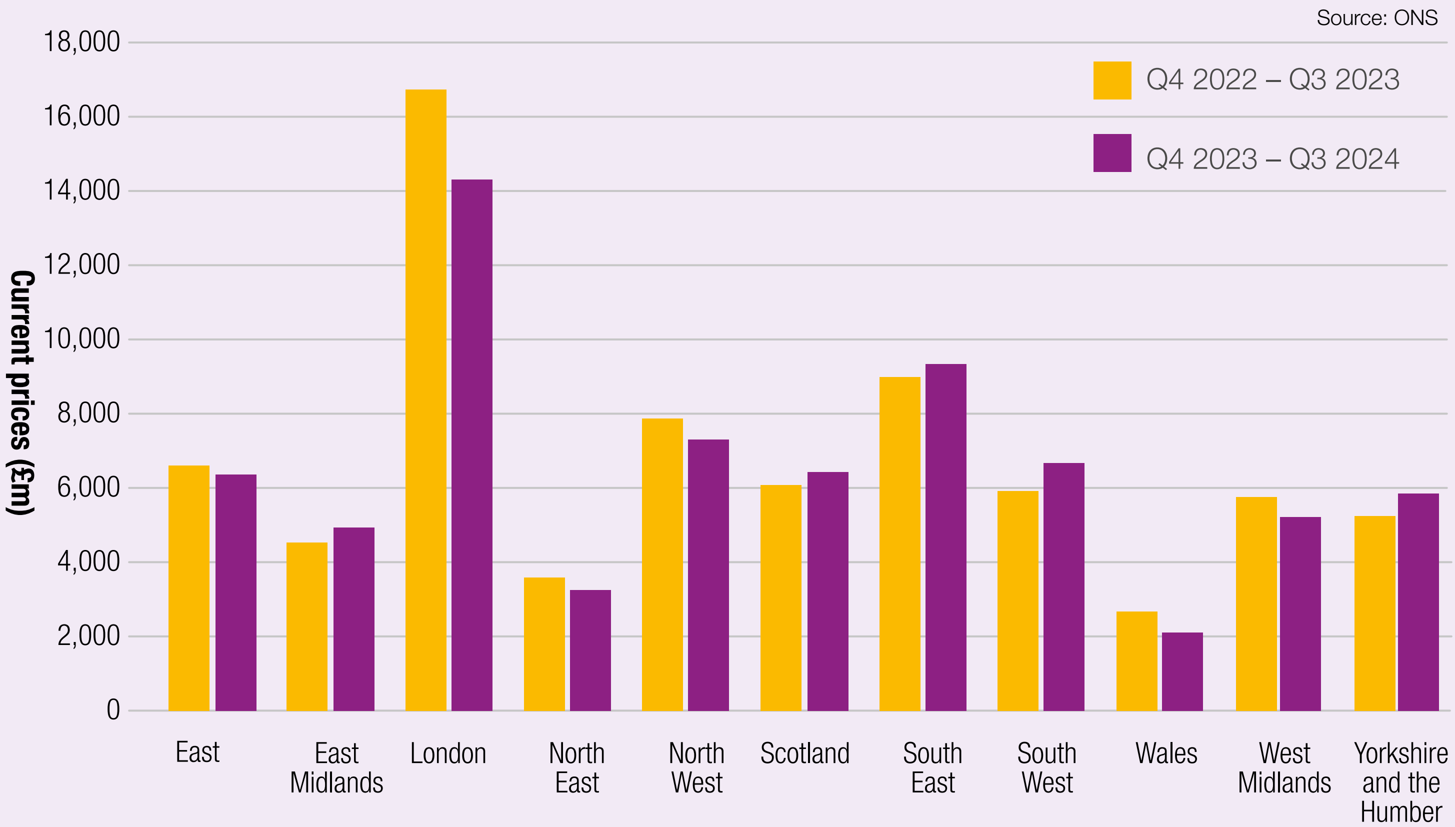
London new orders drop

The Q3 new orders numbers were disappointing for London. While at this granular level the ONS doesn't adjust for seasonality or inflation and the figures are often volatile, the quarter-on-quarter drop of almost 50% is considerable. Overall, in nominal terms, new orders in the capital were 14% lower than in the four quarters to Q3 2023. By comparison, there was barely any movement in total new orders for the rest of Great Britain.

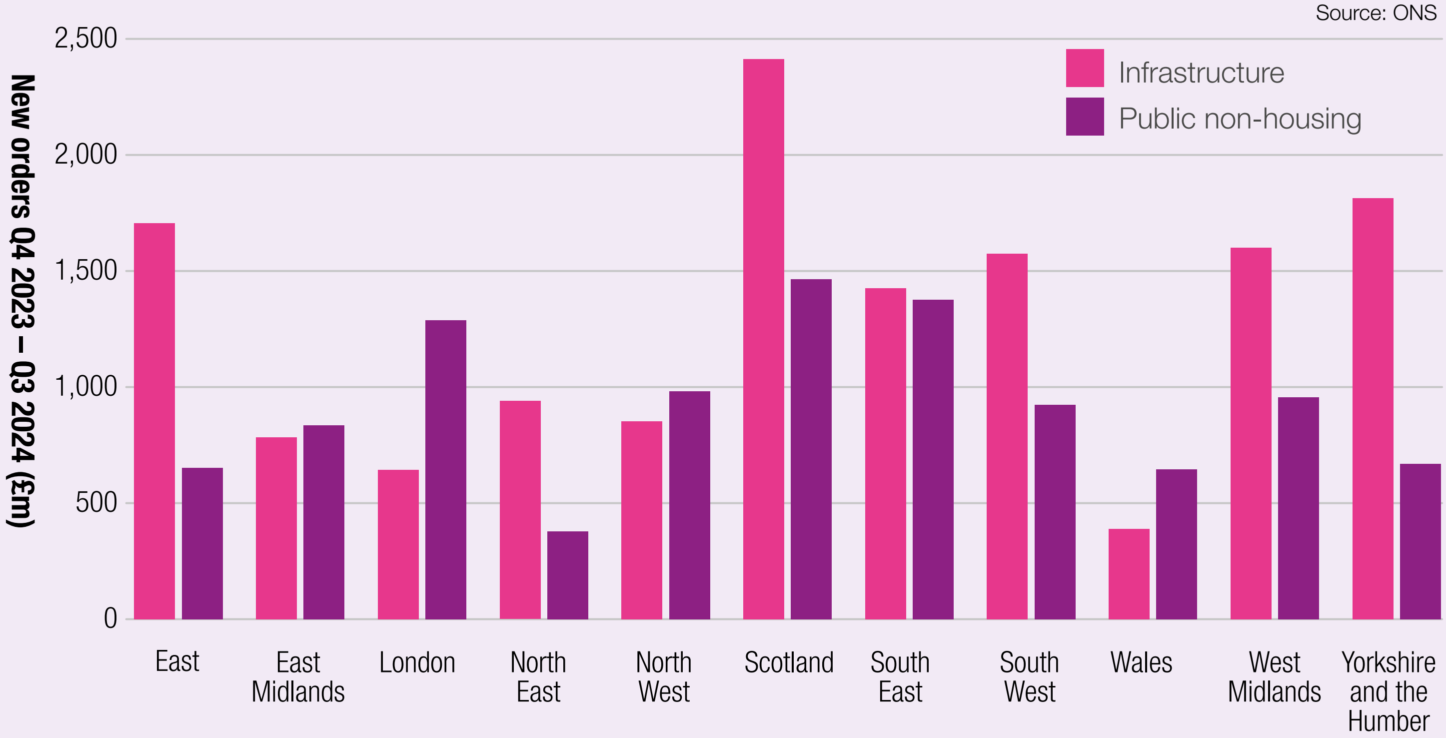
Accounting for a much larger part of the London market than elsewhere, private commercial's drop explained around 40% of the latest reduction. There was also a considerable drop in housing. As we discussed in our last report, despite London being one of the few areas the government has lowered the targets for, it will still require the most growth in order to meet them. Alongside doubts about the potential to meet such targets, for housing, economic drivers are dominant, and the tough market pressures won't dissipate next year.

There are also other fundamental reasons to expect London to face weaker growth in the coming years relative to other parts of the country. Higher capital expenditure by the government is likely to provide particular support to infrastructure and public non-housing construction sectors, neither of which London currently accounts for more than its fair share. Over the past decade, London has benefited from large infrastructure projects such as the Thames Tideway Tunnel and Crossrail, however, both are now complete. Even if, as seems likely, the government decides HS2 has to finish at Euston, it won't make up for these mammoth projects. Such issues become even more apparent when, over the past four quarters, only Wales has had fewer new infrastructure orders than London. For the non-housing public sector, London was the third largest for new orders over the last year. However, again, this shows that as government spending rises, it won't simply be London that benefits, and growth will be more evenly distributed.

A POOR 12 MONTHS FOR NEW ORDERS IN LONDON



INFRASTRUCTURE AND PUBLIC SPENDING NO LONGER LONDON-CENTRIC



However, it isn't all bad news, with London getting support from two of the fastest growing sectors – life sciences and data centres. For life sciences, work has recently started in Canary Wharf on Europe's largest commercial lab building. Meanwhile, estimates suggest that London accounts for over a third of the UK's data centres, and with ever-increasing demand, this sector will also experience strong growth. Data centres, and the M&E expertise they require, are creating specific problems for these packages and certain products such as generators. For tender prices, more general supply issues in industry may also be able to push back against weak demand. Within the commercial sector, Lendlease's sale complicates a market where there are only a handful of contractors who can deliver the largest projects. Similarly, the sad news of ISG's collapse will have a sizeable impact on tendering for large fit-out projects.

Mace
155 Moorgate
London EC2M 6XB
+44 (0)20 3522 3000

Contacts
Oliver North oliver.north@macegroup.com
James Donald james.donald@macegroup.com

macegroup.com