Tender Cost Update UK
Q2 2019

mace

2020 FORECAST CUT AS DELAY TO BREXIT WILL HARDEN NEXT YEAR'S MARKET

	2019	2020	2021	2022	2023
NATIONAL	1.5%	1.5%	2.5%	3.0%	3.0%
LONDON	1.5%	1.5%	2.5%	3.0%	3.0%

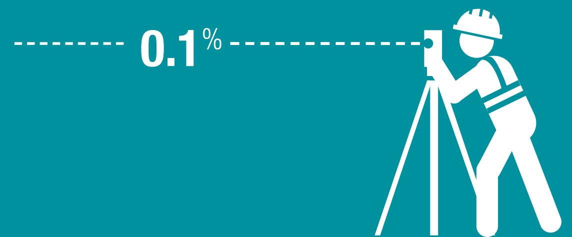
The extension to Brexit will have resulted in continued uncertainty among construction firms and developers. With minimal output growth in the first quarter and another decline in new orders numbers in Q4 2018, businesses would have been hoping for a Brexit deal, and a subsequent improvement in conditions over the summer.

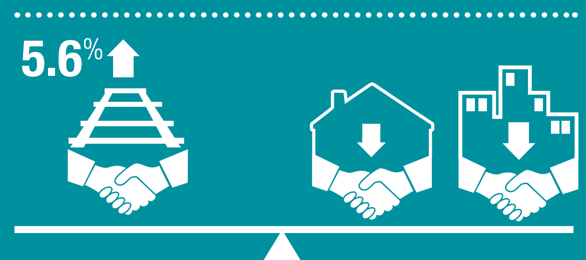
Meanwhile, costs continue to rise. Material price inflation had been slowing at the end of 2018, but has seen several sharp jumps in the first three months of this year. Construction earnings growth also remains robust. The longer this combination of a weakening industry with higher costs persists, the tougher it becomes to manage projects.

"Ongoing uncertainty continues to test the resilience of the UK construction market and the economy as a whole. In spite of an increasing appetite to secure pipeline work, construction tender prices are being buoyed by continued increases in material input prices. As we move into the second half of 2019, the ability of the market place to absorb these higher costs against a background of tightening margins will be limited, and we expect tender prices to continue to increase at a modest rate through to 2020."

Steven Mason
Managing Director
Mace Cost Consultancy

In the first quarter, all new work output was broadly flat with growth of...





...increase in infrastructure helped offset reductions in both the private housing and commercial sectors

New orders remain unconvincing, falling...

The table gives our current tender price inflation forecast. The figures should be treated as averages and there will always be variations due to procurement methods, project type and local factors.

TENDER PRICE INFLATION FORECAST

The start of 2019 has seen a number of important stories, but none of them can change the feeling that construction, like the rest of the economy, is operating in a state of limbo. Once again, Brexit has dominated the news. However, pushing back the date when the UK leaves the European Union from 29 March to 31 October does little to provide businesses with the certainty they desire. Similarly, the Conservative Party leadership contest and results from the European Elections give even less clarity and show a divided country. There was another decline in new orders in the fourth quarter of 2018, while the construction output all new work series barely grew in the first quarter. Based on a combination of all three factors, as well as the poor figures in 2018, Mace has decided to bring down its tender price forecast for 2020 from 2% to 1.5%. We believe next year will prove to be incredibly competitive, and firms wanting to win work will be limited in the amount they can increase prices. Beyond that, and assuming a Brexit deal occurs, we are leaving our forecasts unchanged, as we still expect prices to rise more rapidly. In part, this growth will come from projects that are on hold getting the go-ahead. Additionally, contractors and sub-contractors who are currently acting with caution will feel emboldened, with more scope for higher prices.

Mace has decided to bring down its tender price forecast for 2020 from 2% to 1.5%. We believe next year will prove to be incredibly competitive, and firms wanting to win work will be limited in the amount they can increase prices.

First quarter growth in construction output almost solely came from repair and maintenance, as all new work struggled to get off the ground. Private commercial continued its downward spiral, but it was another very strong period for the infrastructure sector. What could prove to be most problematic was the fall in private housing. It has consistently led construction growth in recent years, so any slowdown could create difficulties and there are a number of signs suggesting this is a risk. These include reports of large developers scaling back projects, house prices coming under pressure and softer new orders numbers. Without increases in housing, construction would become very dependent on infrastructure for growth.

Despite hardening market conditions, which are now likely to persist for longer than hoped, costs are still rising. A bounce in the price of oil has fairly quickly fed through into faster material price inflation, whereas construction earnings continue to rise rapidly, outpacing earnings in the wider economy. With costs showing few signs of abating and firms restricted in their ability to pass these on, there is likely to be a further squeeze on margins and profits.

Last year, the country's second largest contractor collapsed and, in March, Interserve, another top 10 contractor, went into administration. The pre-pack administration that Interserve underwent resulted in a takeover by debtholders, allowing business to continue as normal and, therefore, the failure was much less dramatic than Carillion's. While a relief to employees and the supply chain, it once again highlights a major problem for Tier 1 contractors, in particular those also involved in outsourcing. By operating on such fine margins, it doesn't take many projects going wrong before there is significant damage to a firm's viability. Carillion's collapse led to lenders tightening credit conditions and greater due diligence from clients. Interserve's failure will likely result in even tougher criteria; changes which will only add to the costs facing contractors and sub-contractors.

Interserve's failure will likely result in even tougher criteria; changes which will only add to the costs facing contractors and sub-contractors.

ECONOMIC CONDITIONS

Brexit continues to prevent firms and consumers from enjoying the low inflation, low interest rate, rising real wages backdrop. Many businesses chose to stockpile in the first quarter of 2019, providing a particular boost to manufacturing, which grew at its fastest rate since 1988. However, with the delay to Brexit, they could now be sitting on excess inventory, while also not knowing whether they will encounter similar problems in October. In addition, the ongoing uncertainty from the Brexit delay will continue to hinder investment.

GROWTH

2019 first quarter GDP growth of 0.5% was strong, but there were several factors that make longer term sustainability unlikely. In addition to a rise in stockpiling, the increase in GDP was partly a result of rebounding from a poor final quarter in 2018. One area which might prove less temporary is consumer spending, which experienced an increase at the start of the year. The recent rises in real wages appear to be having a noticeable positive impact and are part of the reason for this increase. A 4% quarter-on-quarter rise in private housing repair and maintenance shows consumers are also using their increased disposable income on house improvements.

LABOUR MARKET

Official data continues to show the labour market is in good health. Unemployment fell to a 44-year low in the three months to February, dropping to 3.9%. Earnings for the whole economy have also been increasing at a higher rate than at any point since before the global financial crisis. There are, however, some signs that conditions may be starting to cool. The number of job vacancies, which are still very high, declined in both of the last two months. Additionally, the pace of growth of regular earnings slipped from 3.5% to 3.4% between January and February. Finally, the monthly increase in employment of 7,000 was the slowest rate of growth since August 2018.

EXCHANGE RATES

At the start of May, the pound was at its strongest level against the euro since early 2017. This was, in part, supported by traders believing that the chances of a no-deal Brexit had reduced. However, attitudes are fickle and results in the local and European elections triggered a sharp reversal. The pound is now only slightly better off against the euro than at the beginning of 2019. As such, exchange rate changes this year will have provided few inflationary effects and, if a deal is reached, the pound should appreciate, leading to even lower inflationary pressure.

INFLATION

For each of the past three months, Consumer Prices Index inflation has stood below the Bank of England's target rate of 2%. Falling clothes prices and a weaker contribution from housing and household services have helped keep inflation down at the start of 2019. The recent rebound in the price of oil may create some upwards pressure later in the year, but there are few other underlying issues likely to trigger a noticeable increase. This is particularly true if the recent high levels of wage growth continue to fail to feed into higher prices.

MONETARY POLICY

On 1 May, the Bank of England's Monetary Policy Committee voted unanimously to leave interest rates unchanged at 0.75%. In its latest inflation report, it noted that Brexit uncertainty was having a particularly damaging effect on business investment and, with the extension not providing any clarity, investment will continue to struggle. While the Bank expects to raise rates at a slightly faster pace than that priced by markets, any increases will be gradual and dependent on Brexit. For the time being, it is difficult to see a scenario where there is more than one rate rise this year and next, with considerable risks to the downside. As a result, contractors will experience difficulty in overcoming lender cautiousness within the construction industry. After the collapse of Carillion last year, Interserve's problems coming to a head in March will have only made conditions tougher.

GLOBAL

Major economies got off to a better start in 2019, compared to how they finished 2018, but headwinds persist. The biggest threat to global macroeconomic stability remains the potential trade war between the US and China. After a deal had appeared possible, boosting equity markets, tensions have resurfaced. Again, this has had an immediate effect on markets. However, if the issue is not resolved, the entire global economy could suffer serious repercussions, with slowing growth in the two largest economies capable of dragging down other countries. For construction, speculative property developments in the UK which are already suffering, will become even less attractive.

CONSTRUCTION OUTPUT AND ORDERS

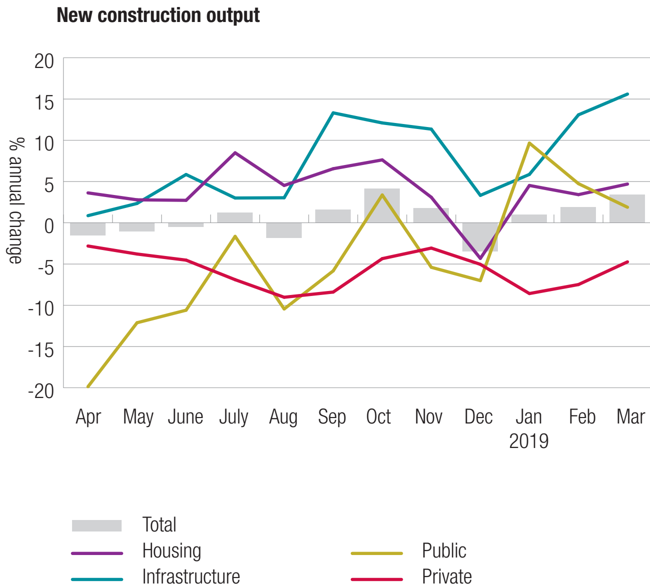
It was a disappointing first quarter for much of the construction industry. While all work rose 1% during the first three months, this nearly all came as a result of increased spending in repair and maintenance. All new work mustered growth of just 0.1% and it required a large jump in infrastructure to help offset declines in private housing and commercial.

Not for the first time recently, private commercial was the worst performing sector. A 4.7% quarter-on-quarter drop saw the sector's worst quarter since 2012 and, other than a small increase in the fourth quarter of 2018, follows six successive periods of falling output. Weakness in commercial output trails the poor performing new orders figures seen since the referendum and further struggles are likely. The reasons given for the problems are the incredibly difficult conditions on the high street, and low business confidence. Both are well rehearsed but show few signs of turning.

Surveys continue to show housing as the strongest segment, but a fragile market, as well as relatively weak new orders numbers, point to a potentially tricky year.

In our last quarterly report we discussed how a substantial decline in private housing output in December could potentially be a blip. Unfortunately, the start of 2019 suggests this might not be the case and, while January and February saw a rebound, March's number was low and led to private housing dipping 1.2% during the period. Surveys continue to show housing as the strongest segment, but a fragile market, as well as relatively weak new orders numbers, point to a potentially tricky year. The spending announcements in the Spring Statement won't have an immediate effect, but may help housing associations in the coming years. As always with the housing numbers, it needs to be recognised just how much output has grown in recent years and, therefore, some form of slowdown is natural.

Private housing and commercial make-up around 60% of all new work and, if they can no longer be relied on for growth, it means the infrastructure sector becomes even more important. After being the fastest growing sector in 2018, infrastructure started 2019 in strong fashion, increasing 5.6% in the first quarter. Crossrail's problems may mean future large projects, especially Crossrail 2, come under even greater scrutiny, but shouldn't damage existing schemes. HS2, while progressing well, will still take some time to ratchet up, but Thames Tideway and Hinkley Point C will provide considerable impetus this year. Whether this is enough to push all new work output up this year remains to be seen. But irrespective of the direction of change, many contractors and sub-contractors will face some level of pressure.

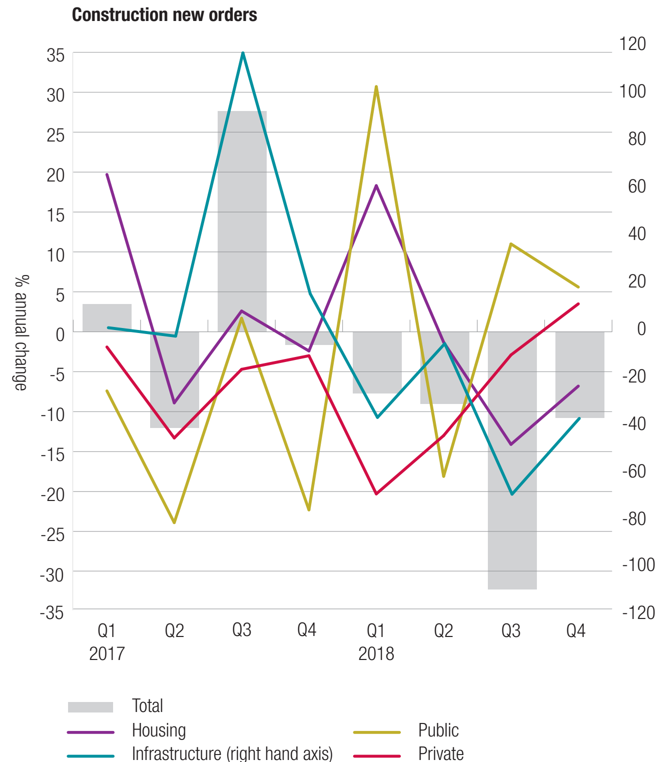


A small reduction in new orders figures for the fourth quarter suggests a degree of stability might have been reached for developers and clients. For the past three quarters, new orders have been at similar levels but, importantly, this is at a considerably lower point than in previous years. Despite the relative calm at the end of last year, it shouldn't come as a surprise if further upheaval occurs in 2019. Some businesses, attempting to understand where Brexit is heading, may have delayed spending. Similarly, the delay to Brexit won't have calmed any nerves, and those who had previously held back will likely continue doing so.

Overall, new orders fell 1.9% on a quarter-on-quarter basis in the fourth quarter. For 2018 as a whole, they were down 3.6% (having excluded infrastructure due to HS2's large contracts) after also falling 4.5% in 2017. The commercial sector is evidently lagging, with new orders down 11.6% last year, despite an upturn in the second half, where the office sector most notably rebounded. However, shops remain weak and there was a significant drop within entertainment in the final quarter, which contributed to lower total commercial new orders in Q4 compared to Q3.

While private housing saw a quarterly increase in Q4, there has been a definite softening in the sector. Following a very strong first quarter, each of the next three quarters have been relatively poor and this is reflected in the rolling four-quarter numbers dropping in each period. Private housing accounts for just over a third of all new work and has been the powerhouse behind construction growth in recent years. If there is a slowdown, it will knock both the industry and the government's ambitions of building 300,000 houses a year. Adding further difficulty to the residential market was the drop in public housing new orders. Not only did the sector decline 11.3% in the fourth quarter, over the year it was down 27.3%.

Finally, infrastructure also appears to be stuttering. According to the ONS, in each of the past two quarters a separate, large order for a wind farm has pushed up the number. However, even with these orders, recent infrastructure data is still weaker than in 2016 and early 2017, a more comparable period due to the distorting effect of HS2. For those companies not involved in HS2, infrastructure slowing comes at the worst time possible.



MARKET VIEW

The Bank of England Agents' fourth quarter summary of business conditions reported weakening output growth in construction as well as a dwindling pipeline. Large housing developers have been particularly affected by the weaker housing market, choosing to scale back projects in the face of toughening conditions for new-builds. Similarly, new commercial projects were running into difficulty. Construction firms were also encountering problems when trying to borrow. The report mentioned banks were cautious, an issue that will have only worsened, since the survey took place before Interserve's collapse.

For two of the past three months, the IHS Markit/CIPS UK Construction PMI has reported falling activity. Driving the return to growth in April was the residential sector but, while it performs strongly, other sectors are much weaker. Commercial has now been falling for four successive months, while civil engineering has declined for the past three. The latest report also signalled a reduction in new orders and, although these grew in both February and March, the modest increases similarly point to future constraints on activity. With firms encountering these problems, it's unsurprising that optimism is low and, for the first time in almost three years, this has fed through into a reduction in employment.

The Q1 2019 RICS Construction and Infrastructure Market Survey reported a positive balance to total workloads, although its level fell to its lowest point in six years; marginally below where it stood at the end of 2018. Private housing was by far the strongest sector and, while both public sector and infrastructure were weaker than in Q4, the only sectors for which there was a negative net workload balance were private commercial and industrial. Profit margins have been forecast to fall in each of the past three quarters and this is still the case, even with a rising proportion expecting higher workloads.

Possibly due to stockpiling, the Construction Products Association's State of Trade Survey for Q1 found firm's reporting a strong start to the year. The 46% increase in light sales, which covers fixtures and fittings, was higher than at any point in 2018. Heavy side firms, which sell materials including concrete and steel, also saw a 46% increase. While this was not quite as high as in Q4 2018, it's an improvement on the three previous quarters. Brexit has not completely dampened spirits, with 50% of light side firms and 33% of heavy side firms expecting an increase in sales in the second quarter.

Conditions have not deteriorated to the point where surveys are pointing to negative growth, but they are in agreement that it is weakening. Mentions of poor pipelines also suggest that an immediate rebound is unlikely and, with an extension to Brexit, the recent disruption and uncertainty will not disappear.

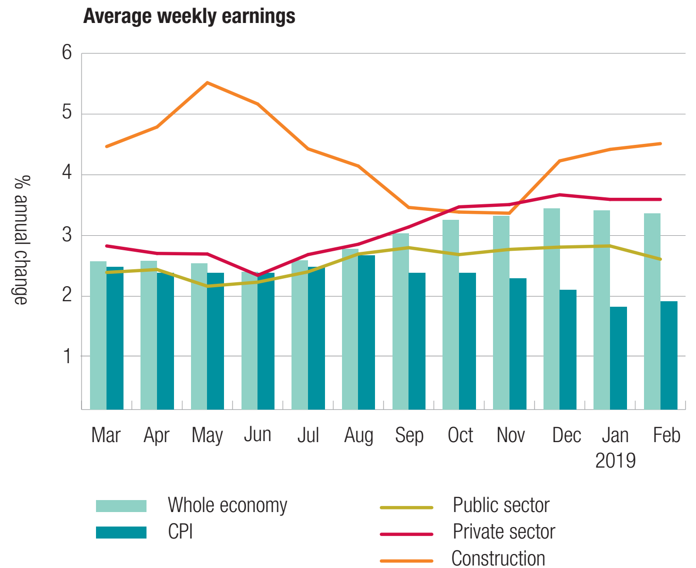
INPUT COSTS

Labour

The past quarter has seen a rebound in the growth rate of regular construction earnings. In February, the annual rate of growth had risen to 4.2%. Still some way short of last year's peak of 5.7%, it is also noticeably faster than the low of 3.3% which occurred in October. Since the referendum and the pound's depreciation, there has been much discussion around rapidly rising material prices, but labour costs have also risen steeply. Between July 2016 and February 2019, construction earnings had risen 9.8%. By comparison, material prices had increased 13% over the same period, while consumer prices are only 6.1% higher.

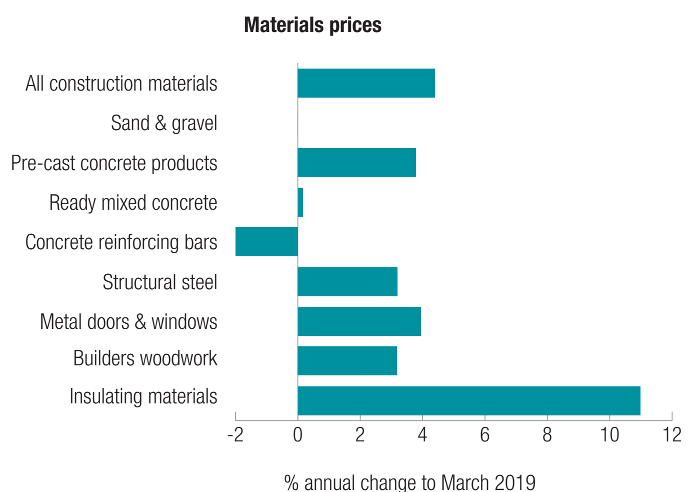
One thing the construction industry continues to struggle with is productivity. In the final quarter of 2018, the size of the workforce reached 2.4 million – a new record. Overall in 2018, the number of people working in construction rose 1.4%, whereas real output increased by just 0.3%. Admittedly, using total employees is a crude measure and number of hours worked is preferable but, with the number of employees rising at a faster rate than output, it does suggest falling productivity. In theory, this could have at least some bearing on earnings. If output per person is falling, employer willingness and ability to pay higher wages may only go so far, especially as capital intensive alternatives such as modern methods of construction are becoming ever more attractive.

...with the number of employees rising at a faster rate than output, it does suggest falling productivity

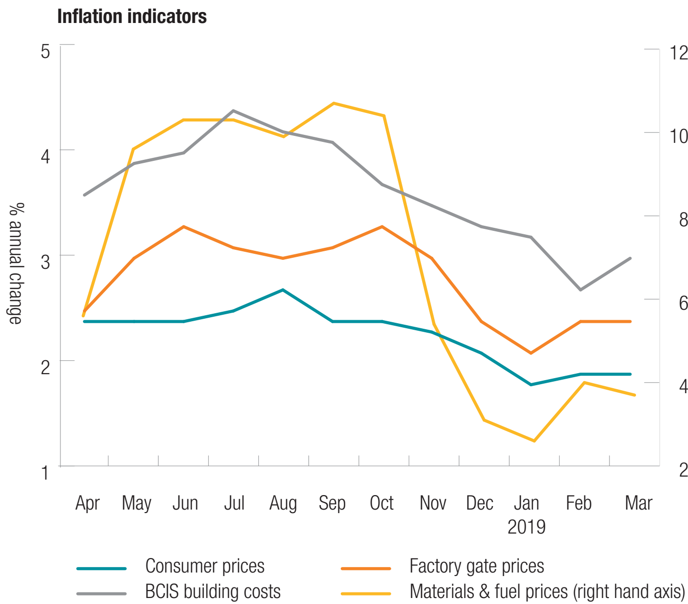


Materials

At the end of 2018, material prices slowed considerably and, in January this year, there was a month-on-month decline in the 'all work construction material price index'. However, in the two months of data released since, there has been a sharp reversal. In February, the index rose 1.3% month-on-month. This was one of the series' largest ever monthly increases and this was followed by 0.7% increase in March. While the strong increases in early 2018 prevented too substantial a jump in the annual rate, it has now risen back up to 4.4%.



The rise in the price of oil is the obvious starting point for higher material costs. From a trough of just above US$50 per barrel in December, it has rebounded back above US$70, with reductions in supply from Venezuela and Iran having hit the market. Of the materials tracked by the ONS, insulating materials have risen the most over the past 12 months, with imported sawn wood and kitchen furniture also surging. On the other hand, rebar has fallen 2% over the past year and the outlook for European steel prices for the rest of 2019 also appears weak.



PACKAGE SPOTLIGHT: SCAFFOLDING

Thanks to conversations with GKR Scaffolding we are able to provide a spotlight on scaffolding, offering information on the issues facing this package.

In contrast to other packages we have considered, scaffolding is often overlooked. Rather than a true package it is seen as an 'attendance' or 'general contractor' item. With this approach sometimes leading to significant issues later in the construction process –including the cost of access ending up greater than the work it is supposed to facilitate – we believe it requires more attention.

Scaffold is ever-present on site, from demolition to final handover. As such, contractors are well placed to spot a weakening market and this has been the case over the past year. Last year, this was particularly true with demolition projects, while there has been a broader weakening so far this year. That said, this has not led to a lowering of prices, in part because of the recent substantial rise in inputs, but also because the market easing came from very busy levels.

The labour force is mostly British, with differences in approach to scaffolding explaining why there are few Eastern European nationals working in the sector. This may provide some protection against workers leaving after Brexit and it also means a considerable amount of effort is put into training and retaining the workforce. Labour also accounts for a greater proportion of total costs than with many other packages, helping explain the strong focus on training and retaining people. Finding the right people is not always easy and the skills shortages in tandem with a strong market has helped push earnings up 20% over the past few years. Materials, which are predominantly steel and timber, have also risen by a similar amount.

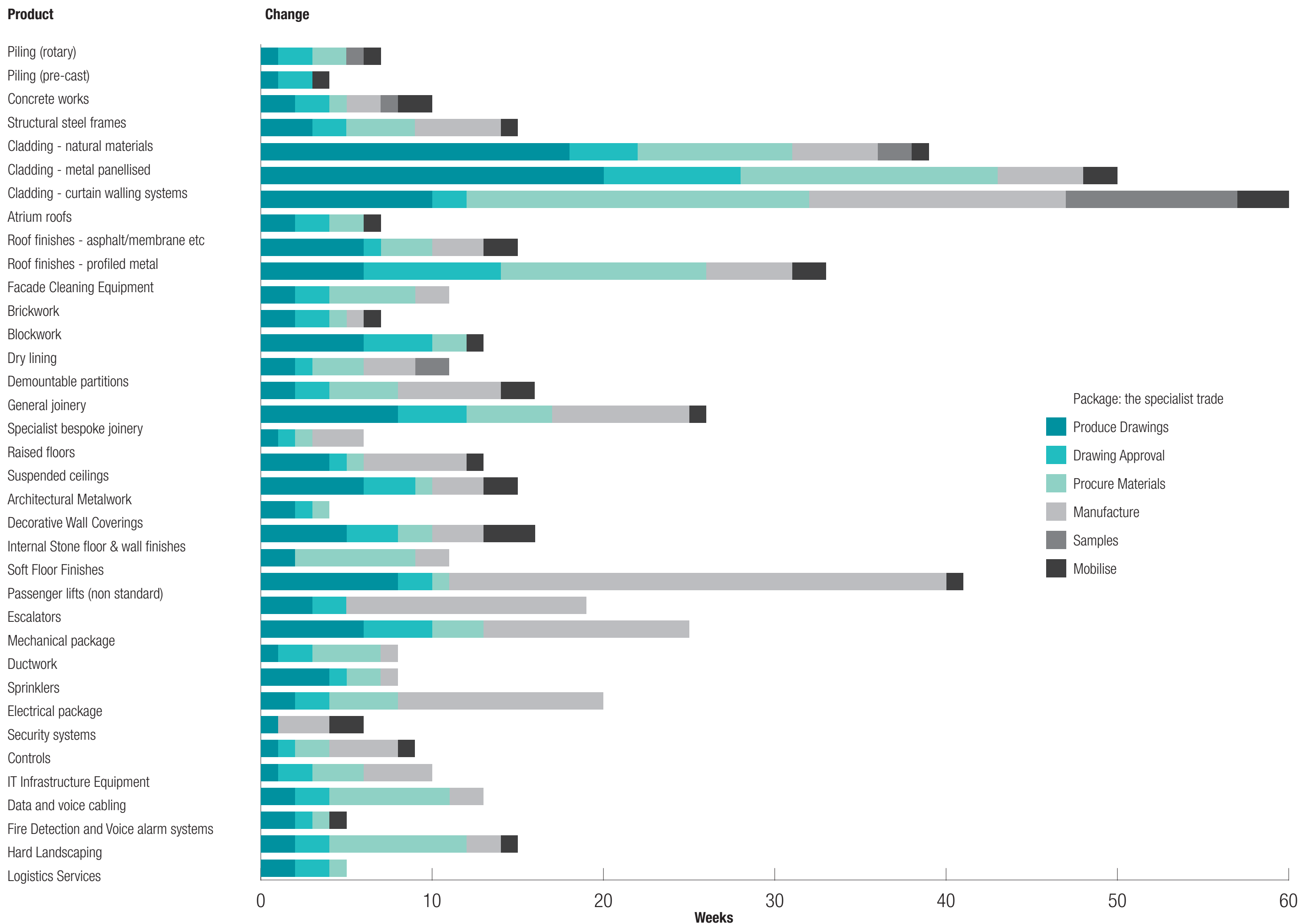
In previous editions, a common theme raised by those we have spoken to in this section is the need for earlier supply chain involvement, and this is particularly true with scaffolding. In providing access for many trades, early engagement allows the scaffolding contractor to support the main contractor keeping to programme and also build in efficiencies. It also allows for improved safety, in particular with regards to risks associated with working from height. Similarly, many sub-contractors talk about incomplete or poor quality drawings. The issue is exacerbated with scaffolding, considering that it is regarded as temporary works and, therefore, often not included in the drawings. This makes determining what is required that much harder. It is not unheard of for cost plans to simply use a weekly rate, leading to very large movements when greater detail is provided, further highlighting the benefit of early engagement.

SUPPLY CHAIN FOCUS

"There continues to be very little change in lead times, with only bespoke joinery reporting a small increase of one week. The forecast is generally for little change, with workload and enquiry levels remaining static. A shortage of quality skilled labour is a recurring theme reported by many companies."

Brian Moone
Director of Supply Chain Management at Mace

Lead times



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