Tender Cost Update UK
Q1 2018

mace

2018 FORECASTS INCREASED AS 'WRONG TYPE OF INFLATION' CONTINUES TO BITE.

	2017	2018	2019	2020	2021
NATIONAL	2.5%	1.5%	1.5%	3.0%	4.0%
LONDON	1.5%	1.0%	1.5%	3.0%	4.0%

As a result of further material price rises and a pick-up in construction earnings we have nudged up our forecasts for tender price inflation in 2018. The industry has now suffered three successive quarters of declining output and for many firms, especially those not involved in HS2, the outlook appears challenging. For some sub-contractors closely linked to Carillion these conditions are likely to prove too much but for others absorbing rising costs can go on for only so long and we now expect tender prices to rise 1.5% nationally and 1% in London.

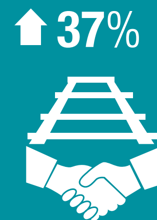
"Whilst concerns persist on the underlying strength of the UK economy and the impact of Brexit negotiations on the UK property and construction market, the effect of these uncertainties on the supply chain's appetite to secure work are offset by the impact of continued increases in input prices.

A hardening of a market place that has ongoing capacity issues and that is less willing than ever to accept unlimited risk will start to see a small upward shift in tender prices in 2018 as the supply chain is no longer able to continue to absorb the spiralling impact of increasing resource costs."

Steven Mason
Managing Director
Mace Cost Consultancy

In the third quarter HS2 contracts pushed new orders up...

37%



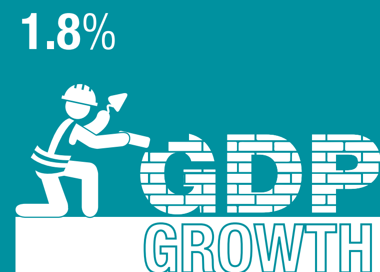
with growth also seen in housing and commercial sectors.

Construction output finished the year falling 1% but in total the sector was...

5.1% bigger in 2017 than 2016.

GDP growth of...

1.8%



...in 2017 was the slowest for five years and forecasts suggest 2018 will be even tougher.

Real wages earnings fell...

...in November but with inflation slowing and wage growth picking-up, the squeeze on households should end this year.

TENDER PRICE INFLATION FORECAST

In the three months to November 2017, the price of building materials increased 2.4% and regular construction wages rose 2.3%. This type of rising input inflation, often known as cost-push and occasionally described as the 'wrong type of inflation' combined with the falling output currently seen in the industry will be causing headaches for many.

Some easing of consumer prices is likely to take place this year but inflation forecasts suggest it should remain above 2%. Weekly earnings continue to grow but there is the potential for strong growth in Europe to increase the region's attractiveness as a location for construction workers potentially intensifying long-running skills shortages and driving wages up further. As a result of these ongoing pressures it is difficult to preserve our forecasts for 2018 of little tender price growth in the UK and no-change in London. Firms are only able to absorb costs for so long and will have no choice but to increase tender prices. Mace Cost Consultancy have therefore increased our 2018 forecasts to 1.5% nationwide and 1% in London.

Whilst conditions this year are likely to remain tricky, the successful conclusion of phase one of the Brexit negotiations may boost short-term confidence in the first half of the year. For the moment the transitional period should last until the end of 2020, diminishing substantially the chances of a 'cliff edge' at the end of March 2019. A softer Brexit is also looking more probable, which may provide some confidence to investors and developers to continue with projects, although this could change at any moment. However, given the lag time between new orders and activity, the industry is likely to continue to struggle in the coming months.

The liquidation of Carillion further complicates matters, with numerous elements having an impact on tender prices. It is likely to take a number of years before the effects of these are fully felt, but unfortunately some sub-contractors will almost certainly fail as a result. With regards to prices, at least initially, those hardest hit may become ultra-competitive in bidding for work driving down costs. Even those who are not directly affected may feel the need to take on more work and bid accordingly. There are also several forces likely to have an inflationary pressure, particularly once things settle down. These include firms being more selective around their bidding, concerned about risks and low margins, and demanding higher returns as a result. Main contractors facing less competition, following the demise of the country's second biggest construction firm, may also find it easier to make these changes. Lower down the supply chain, sub-contractors attempting to push back against onerous conditions such as Carillion's infamous 120 day payment terms could result in higher costs. One final area in which firms may face rising costs, as a result of the collapse, is through their borrowing costs. If banks become more cautious with their lending it could lead to higher borrowing costs and in turn higher tender prices. Overall, given the complexity of the supply chain, it is far too early to predict how these dynamics will play out. Along with continuing uncertainty from Brexit, tender price variations between individual projects is likely to be greater than usual.

ECONOMIC CONDITIONS

Recent figures suggest the economy is not performing as poorly as earlier in 2017 but there are still a number of problems. In the final quarter of the year GDP growth was faster than in any of the previous three quarters, but this only managed to help push total yearly growth up to 1.8%, slower than in 2016. Real wages continue to fall yet with unemployment remaining low, inflation slipping and the pace of nominal earnings growth climbing, this squeeze will hopefully come to an end at some point in 2018. There was nothing in the Autumn Budget which will drastically alter the economy's path this year and plans of further support for housing and infrastructure along with additional funding for training won't have any immediate impact. From a tender price perspective, if the idea of 300,000 homes a year was really to come to fruition this would likely have huge inflationary pressures on an industry currently only building 180,000 properties a year.

GROWTH

Q4's GDP growth of 0.5% was the fastest since the final quarter of 2016 but this was unable to prevent yearly growth in 2017 being the slowest in five years. There was another fall in construction output in the final quarter but services expanded by 0.6% in particular thanks to strong growth in the business services and finance sector. Forecasts for 2018 currently point to a slowdown to 1.4% in 2018, as Brexit uncertainty and falling real wages deter spending.

LABOUR MARKET

Stronger earnings growth was not enough to prevent real wages from a further fall. However with inflation forecast to ease in the coming months the squeeze could be coming to an end. Unemployment kept steady at its 42-year low of 4.3% matched by strong figures in employment and the inactivity rate. Forecasts for 2018 show a marginal pick-up in unemployment, leaving rates exceptionally low by historical standards.

EXCHANGE RATES

The increase in interest rates along with the agreement for a transitional period and general softening of rhetoric around Brexit, have helped provide support for the pound. This is particularly true when measured against the dollar as a variety of policies and announcements from the Trump administration have weakened the currency. Against the Euro the appreciation, over the past three months, is less impressive. The strengthening of the pound is likely to help ease some inflationary pressures, in particular providing protection against rising oil prices. However, given the majority of imported construction goods come from Europe the pound will have to strengthen considerably more before suppliers start to consider reversing previous price increases.

INFLATION

With inflation receding from 3.1% in November to 3% in December many analysts now think it has peaked. This should provide some consolation to the governor Mark Carney who has been requested to write a letter to the Chancellor Philip Hammond explaining why inflation was so far above its target of 2%. His explanation is likely to focus on the impact of the pound's depreciation and Bank of England forecasts that inflation will slow in 2018. One factor which may limit such falls is the large increase in the price of oil, but with little signs of other inflationary pressures, most significantly wages, prices should ease this year.

MONETARY POLICY

Following their decision to raise interest rates in November, it was no surprise that the Bank of England's Monetary Policy Committee decided to leave them unchanged at 0.5% at their final meeting of the year on December 13th. They are now likely to adopt a wait-and-see approach for a number of months although if their forecasts prove correct, a rate rise later in the year may be necessary. Given the state of the economy and, with households not being used to rising interest rates, the Bank will provide a number of warning signals that a rate hike is due before making any change.

GLOBAL OVERVIEW

The global economy has continued to see solid growth. China grew at its fastest rate in two years in 2017 whilst the US managed an annualised rate of 2.6% in the fourth quarter. Based on the European Commission's recent surveys, construction is surging with confidence. Activity has risen to its highest level since 2007 in the Euro Area, but with these developments come price risks for the UK sector. Firstly, it means increased demand for construction materials, many of which the UK imports from Europe. Additionally, improving conditions on the continent, coupled with lower wages due to the weaker pound and concerns around Brexit, could lead to European workers seeking employment elsewhere. Both these factors may result in rising costs in the UK, with further strength expected in Europe in 2018.

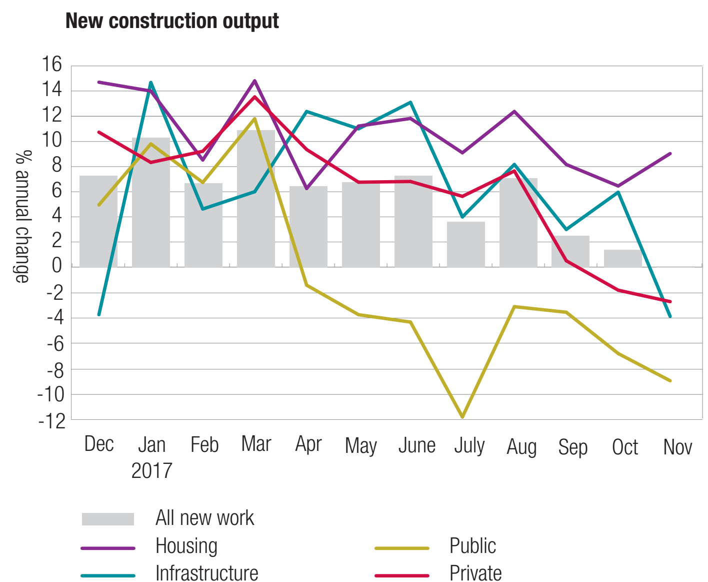
CONSTRUCTION OUTPUT AND ORDERS

For the third successive quarter construction output fell, its rate of decline accelerating to -1% from -0.5% in Q3 and -0.3% in Q2. For the time being the current slowdown is not as bad as seen in the previous recession in 2011-12 when there were five continuous quarters of negative output. It has even further to fall if it is to match the reduction seen during the global financial crisis. Taking a more positive view, the industry was 5.1% bigger than in 2016 and some of the reduction may be due to a cooling off in the market. This rise comes mainly as a result of large jumps in the fourth quarter of 2016 and the first quarter in 2017. Given the difficulty in recruiting labour, a minor slowdown may help ease some inflationary pressures.

The more detailed figures, only provided to November 2017, show where the recent weakness lies. It should come as no surprise that the private commercial sector is leading the way down. With uncertainty around Brexit and the general muted domestic growth, businesses have been less keen to invest. The recent change to business rates, ever increasing use of online shopping and falling real incomes also appear to have had a particular negative effect on the retail sector. As a result, in the three months to November commercial output was 5.4% lower than in the three previous months, the lowest growth rate in five years. Infrastructure also performed poorly during this period, but is likely to rebound strongly in 2018 as HS2 starts to get going.

Housing continues to grow. With total output in the sector only 0.8% higher on a quarterly basis this is at a slower rate than witnessed previously. In England in the third quarter the number of completed dwellings was 5.4% higher than in the same period of 2016, with the year to date increase showing even greater growth. However, further substantial growth is required if the government's goals of 300,000 homes a year are to be met. Given levels in 2016/17 were only 180,000, they may prove far too ambitious.

New construction output



At first glance, new orders in the third quarter were incredibly positive. Overall they rose 37%, compared to the second quarter. This was mainly due to infrastructure orders increasing by 175% as a result of the signing of the first HS2 contracts, but there was also growth in most other sectors. Over the quarter total housing was up 9.4% and private commercial grew 1%. Yet caution is also required when looking at these figures. Commercial new orders are down almost 10% compared to the third quarter of 2016. Private housing is only 0.5% larger. Excluding infrastructure, new orders are lower than where they were in Q3 2016. Similarly, when we look at the most recent four quarters, which the ONS suggests as a better measure of the underlying trend, excluding infrastructure produces a fourth successive decline

in new orders. Given the lag between new orders and output, the new order figures for the third quarter are the best indicator so far of what is likely to take place in 2018. Based on these, infrastructure led by transport should do well. Housing is likely to continue close to its recent record highs, but the commercial sector may weaken further.

The sheer size of HS2 is likely to create a micro-climate around it in a similar fashion to the area around Hinkley Point C in Somerset where wages have risen dramatically drawing in workers from across the country. With the key hubs for HS2 being in Birmingham and London a greater availability of labour exists than in Somerset. Following the completion of Crossrail, many workers will already have relevant skills so wages are unlikely to be driven up quite so much. Even so, demand for over 25,000 workers over the HS2 project lifecycle will undoubtedly have an effect on labour costs. These will also feed through into sectors other than infrastructure.

MARKET VIEW

Having fallen below the level indicating no-change in activity in September, there was somewhat of a recovery in the three months to December in the IHS Markit/CIPS UK Construction PMI survey. Even though activity has been positive in each month, it has been at a considerably slower rate than seen earlier in 2017. The commercial sector continues to be the biggest drag on the industry, showing little signs of recovery. Civil engineering finished the year with some rising activity for the first time since August, whilst residential continued to shine. Optimism around 2018 was weak and there were further rises in input costs. With solid demand for materials and lengthening delivery times, suppliers are likely to believe they can continue raising prices.

Deloitte's Winter London Office Crane Survey reported a 9% drop in activity, however levels are still high relative to the long-term average. Details on the volume of new starts are more worrying and these are under 2 million square feet for the first time since 2014. One reason for the reduction in volumes was a limited number of new build starts with the smaller refurbishment market making up most of the new schemes. Deloitte still expect strong levels of development over the next few years but view developers as being more cautious than before.

The Bank of England's fourth quarter Agents' summary of business conditions found the construction industry to be slowing. It is now at its lowest level since July 2013. Margins were coming under pressure due to slowing demand and rising costs with delays to major projects and risk aversion damaging the commercial and infrastructure sectors. Housebuilding continued to outperform but issues around planning, land availability and skills were hindering growth. The outlook for commercial real estate was described as fragile. Some areas have high occupancy rates and excess investor demand but decisions are being delayed and in London confidence is weak.

The fourth quarter Construction Products Association trade survey showed a slowing industry with concerns around prospects for the upcoming year. In the final quarter of 2017, 6% of heavy side manufacturers (e.g. steel, bricks, concrete) reported falling sales, down from 10% seeing a rise in Q3 and being the first negative score since 2013. Light sales, such as finishing products, performed better as 50% of firms saw a rise which was an improvement on the third quarter. Expectations for 2018 were weak in both sectors. On balance, no heavy side manufactures are forecasting a rise, and only 10% of light side companies anticipate one. Both scores considerably down on third quarter predictions. There also remains no let-up in price rises, with the vast majority having seen cost increases in 2017 and only a slightly smaller proportion expecting rising costs this year.

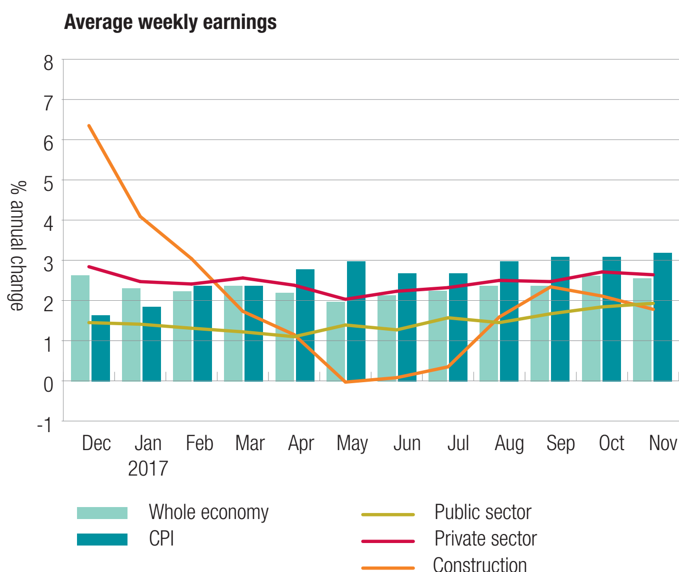
The dominant theme of all recent surveys is that the industry is slowing. In most cases there is not an outright reduction in output, activity or sales, however, as with the ONS figures, housebuilding is by far the best performing sector and commercial the weakest. Firms tended not to be optimistic around 2018, and following Carillion's fall we can expect this to worsen.

INPUT COSTS

Labour

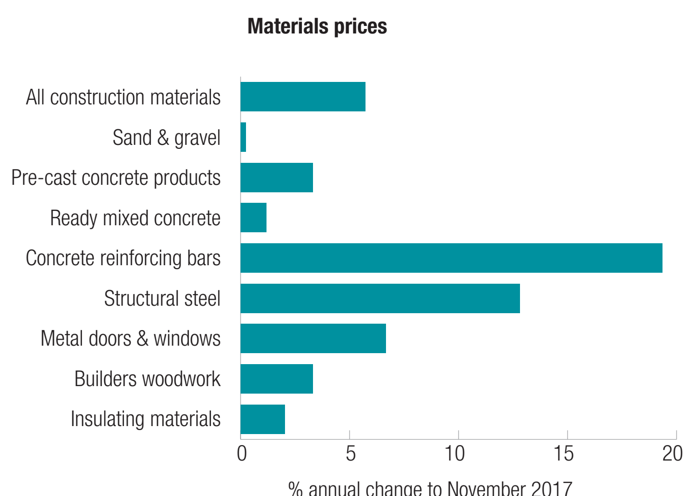
Total earnings in the construction industry, which in the middle of 2017 had been falling, have now returned back to near 2%. Looking solely at regular pay and excluding bonus payments, growth has risen to 2.3%, in-line with the economy as a whole. After a slip between March and June, the number of people working in the construction industry rose by 17,000 in the following three months to September. This is slightly surprising given the size of the industry contracted by 0.5% over the same period. Although employment did fall in the second quarter when construction growth was also negative. After reaching a peak of 32,000 roles in September, these had slipped to 29,000 by November but this is still far higher than in previous recessions. In the depths of the financial crisis, vacancies

had fallen to just 9,000. With vacancies so high and surveys, such as the Federation of Master Builders', highlighting increasing skills shortages in a number of trades, unless the industry falls into an even bigger slump, earnings should continue to rise.

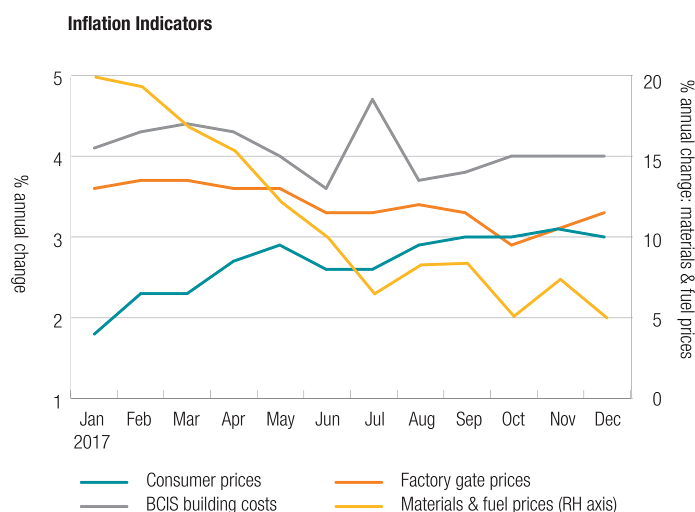


Materials

The last quarter has seen a re-acceleration of material prices. Growth over the three months to November was 2.4%, the fastest quarterly rate since January and a marked reversal on the slowdown that occurred earlier in the year. Mace Cost Consultancy has seen a number of cases of suppliers insisting on higher prices as a result of the pound's depreciation. Even though this took place in 2016 the explanation still has some validity. In many cases firms will have tried to absorb higher import costs without passing everything on. However, their ability to continue to do so may be limited and, as such, they now have little choice but to increase prices. This however, will not be the case for all firms and some will definitely be exploiting the situation to push through higher prices than strictly necessary.



The most noticeable rise in materials was once again steel rebar. In our last report, yearly growth had reached 10%, having stood at 0% in the summer report. Annual growth has now reached almost 20%. A change that, given the importance of the material in most projects, will be having a significant impact on total costs. Whilst some analysts expect steel prices to ease in 2018, due to slowing Chinese demand, the impact of these recent large increases will continue to be felt. Oil prices have also been on the rise for a number of months now with Brent breaking through US$70 a barrel. This is its highest since December 2014 and over 55% higher than in last summer.



PACKAGE SPOTLIGHT: M&E

Thanks to conversations with Michael J Lonsdale we are able to provide a spotlight on M&E, offering information on the issues facing this package.

Rises in the cost of materials are certainly having an impact on the sector, with some suppliers trying to push through very large increases. Given the substantial proportion of products imported from Europe and the inability of these firms to carry on absorbing the costs, which some initially did, this is unsurprising. It does however mean that flexible thinking is required with alternative suppliers, not always from the usual places, being identified.

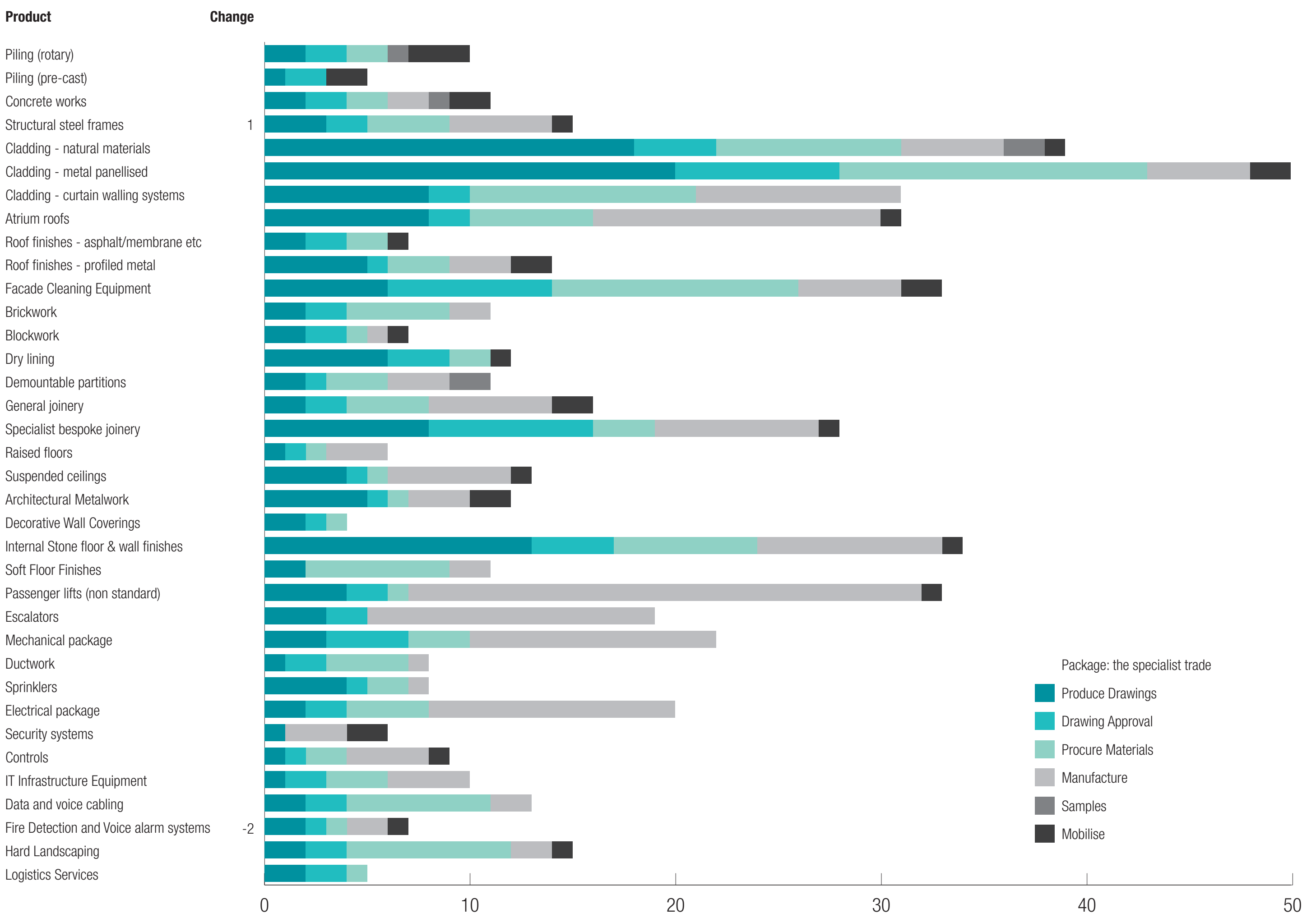
Controlling costs is particularly important given the current climate. Having learnt from previous downturns in 2008 and 2012, the difficult conditions are leading to greater caution and selection when choosing jobs. This is especially the case with the residential sector, which is where the industry is focusing, but jobs are often high-risk. It should also be noted, whilst our discussion took place before Carillion's liquidation, the importance of getting paid regularly and on time was mentioned. This is likely to be a key issue for all sub-contractors going forward and is an issue being pushed by Build UK.

From a labour perspective, costs are also increasing. In part, this is due to trade agreements and, whilst there is a general shortage of skilled labour, this is nothing new. There does however appear to be a tendency for some workers to think nothing has changed, having unrealistic expectations about what they should be paid. The electrical side of work is typically less skilled than mechanical and involves more immigrant labour. As yet, finding these workers is not proving any more problematic than usual.

SUPPLY CHAIN FOCUS

"There are no changes in lead times this quarter, this follows a trend over the past three quarters indicating that the market is leveling off at its peak. The majority of the companies also see their level of enquiries and order book leveling off therefore no major changes are anticipated in the next quarter."

Brian Moone
Director of Supply Chain Management at Mace



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